



# REPUBLIC OF KOREA

## FINANCIAL SECTOR ASSESSMENT PROGRAM

October 2014

### DETAILED ASSESSMENT OF COMPLIANCE ON THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

This Detailed Assessment of Compliance on the IOSCO Objectives and Principles of Securities Regulation on the Republic of Korea was prepared by a staff team of the International Monetary Fund and the World Bank. It is based on the information available at the time it was completed on July 2013.

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September 2014

# DETAILED ASSESSMENT OF OBSERVANCE

## IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

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This Detailed Assessment Report was prepared in the context of a joint IMF-World Bank Financial Sector Assessment Program (FSAP) mission in the Republic of Korea during April 2014, and overseen by the Monetary and Capital Markets Department, IMF, and the Finance and Private Sector Development Vice Presidency, World Bank. Further information on the FSAP program can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>



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## Glossary

AEFSC	Act on the Establishment of the Financial Services Commission
APA	Administrative Procedure Act
ATS	Alternative Trading System
AUM	Assets Under Management
BOK	Bank of Korea
CIS	Collective Investment Scheme
CCP	Central Counterparty
CME	Chicago Mercantile Exchange
CNS	Continuous Net Settlement
CPA Act	Act on Certified Public Accountants
CRA	Credit Rating Agency
DART	Data Analysis Retrieval and Transfer
ELW	Exchange Listed Warrant
ETF	Exchange Traded Fund
FMI	Financial Market Infrastructure
FSAP	Financial Sector Assessment Program
FSC	Financial Services Commission
FSCMA	Financial Investment Services and Capital Markets Act
FSS	Financial Supervisory Service
FTC	Fair Trade Commission
GOA	Government Organization Act
HTS	Home Trading System
IAASB	International Auditing and Assurance Standards Board
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
ISA	International Standard on Auditing
ISIS	Intermarket Surveillance Information System
ISQC	International Standard on Quality Control
IT	Information Technology
KAASB	Korea Auditing and Assurance Standards Board
KAI	Korea Accounting Institute
KASB	Korea Accounting Standards Board
KCIF	Korea Center for International Finance
KDIC	Korea Deposit Insurance Corporation
KICPA	Korean Institute of Certified Public Accountants
K-IFRS	Korean International Financial Reporting Standards
KIND	Korea Investor's Network for Disclosure
KOFEX	Korea Futures Exchange

KOFIA	Korea Financial Investment Association
KONEX	Korea New Exchange
KOSDAQ	Korean Securities Dealers Automated Quotations
KOSPI	Korea Composite Stock Price Index
KRW	Korean won
KRX	Korea Exchange
KSA	Korean Standard on Auditing
KSD	Korea Securities Depository
KSFC	Korea Securities Finance Corporation
MEFM	Macroeconomic Financial Meeting
MERF	Management Evaluation Regulatory Framework
MOSF	Ministry of Strategy and Finance
MoU	Memorandum of Understanding
MMoU	Multilateral Memorandum of Understanding
MPC	Monetary Policy Committee
MTF	Multilateral Trading Facility
OTC	Over-the-counter
RAMS	Risk Analysis and Management System
RRC	Regulatory Reform Committee
SFC	Securities and Futures Commission
SRO	Self Regulatory Organization
UGS	Unified System for Global Trading

## SUMMARY

**The Korean authorities have made significant progress since the last FSAP in revising the securities regulatory framework, with the current framework achieving good overall compliance with the International Organization of Securities Commissions (IOSCO) Principles.**

Importantly, the earlier legal impediments to international cooperation and exchange of information have been removed. Since 2011, Korea also applies the Korean International Financial Reporting Standards (K-IFRS) that follow the International Financial Reporting Standards (IFRS).

**Although the regulators' responsibilities are defined in legislation, the complexity of the structure obscures the transparency of the decision-making processes.** The responsibility for deciding on a particular supervisory or enforcement action can lie either at the Financial Services Commission (FSC), Securities and Futures Commission (SFC), or Financial Supervisory Service (FSS), depending on the nature and gravity of action, but it is not always clear which one of them is ultimately in charge. The process is further complicated by the use of pre-deliberation committees at various levels. Self-regulatory organizations—the Korea Exchange (KRX), the Korea Financial Investment Association (KOFIA) and the Korean Institute of Certified Public Accountants (KICPA)—also play a role in the regulatory and supervisory processes. Publication of additional information on the decision-making structure and processes would be beneficial.

**Operational cooperation and coordination between the various authorities is currently addressed by having the agencies represented in each others' decision-making bodies.**

However, the full participation of the Minister of Strategy and Finance at the FSC Board has the potential of compromising the independence of the FSC's supervisory and enforcement decisions. Consideration should be given on how best to mitigate the potential for undue political influence arising from such governance arrangements by, for example, restricting the participation of the Minister of Strategy and Finance in the supervisory and enforcement decisions. Attention should also be paid to ensuring that the various arrangements for gathering commercial input provide for equal and transparent treatment of market participants.

**The authorities have a broad set of powers, most of which are used effectively.** The on-site examination program could be expanded to ensure sufficient coverage of smaller entities, in particular asset management companies and auditors. Improved oversight of small auditors is important to address challenges in enforcing compliance with the auditor independence and quality control requirements. The on-site inspections should also continue to focus on ensuring proper handling of customer securities and funds.

**Despite recent improvements announced or taken by the authorities, challenges remain in enforcing compliance with the unfair trading/market abuse provisions of the Financial Investment Services and Capital Markets Act (FSCMA).** This is primarily due to the lack of sufficiently dissuasive administrative sanctions and the length and less than optimal outcome of the criminal enforcement process. Jointly with the public prosecutor's office, the authorities should

continue to seek ways to improve both the administrative and criminal enforcement powers and processes.

**Comprehensive disclosure requirements apply to both issuers and collective investment schemes (CIS).** Applicable rules prescribe the content of primary market, periodic and ongoing disclosures. While their prescriptive nature ensures compliance with the IOSCO Principles, the authorities are encouraged to monitor whether the current ongoing disclosure requirements for issuers continue to best serve the interests of investors and market evolution while maintaining a manageable compliance burden. Given the risks arising to investors from any shortcomings in CIS custody and valuation, it is important to focus on monitoring compliance and require the use of market or fair value for all CIS.

**The current processes to monitor systemic risk do not appear to sufficiently acknowledge the potential for systemic risk arising from the securities sector.** This combined with certain deficiencies in the regulators' arrangements to manage defaults could negatively impact their ability to deal with market disruptions and institutional failures.

## INTRODUCTION

**1. An assessment of the level of implementation of the IOSCO Objectives and Principles of Securities Regulation (IOSCO Principles) was conducted in the Republic of Korea (Korea) from April 3 to 19, 2013 as part of the IMF-World Bank Financial Sector Assessment Program (FSAP).** The assessment was made by Eija Holttinen, Monetary and Capital Markets Department, IMF, and Andrea Corcoran, an external expert working for the World Bank. The previous IOSCO assessment of Korea was conducted in 2001-02 before the first IOSCO Assessment Methodology had been developed. From the perspective of the IOSCO Principles, this is therefore effectively a first assessment. Hence, comparisons with the prior assessment are discouraged since the process has since been refined to promote consistency and has become progressively more rigorous.

## INFORMATION AND METHODOLOGY USED FOR ASSESSMENT

**2. The assessment was made based on the IOSCO Principles approved in 2010 and the Assessment Methodology adopted in 2011.** As has been the standard practice, Principle 38 was not assessed due to the existence of separate standards for securities settlement systems and central counterparties.

**3. The IOSCO Assessment Methodology requires that assessors not only look at the legal and regulatory framework in place, but also at how it has been implemented in practice.** The ongoing global financial crisis has reinforced the need for assessors to make a judgment about supervisory and other operational practices and to determine whether they are sufficiently effective. Among other things, such a judgment involves a review of the inspection programs for different types of supervised entities, the cycle, scope and quality of inspections, as well as how the relevant authorities follow up on findings, including by using enforcement actions.

**4. The assessment was based on:** (i) a self-assessment and additional written responses prepared by the authorities; (ii) reviews of the relevant legislation and regulations; (iii) meetings with the management and staff of the FSC, SFC, FSS, Ministry of Strategy and Finance (MOSF), Bank of Korea (BOK), Seoul Central District Public Prosecutor's Office; and (iv) meetings with SROs and market participants, including the KRX, Korea Securities Depository (KSD), KOFIA, KICPA, Korean Chamber of Commerce and Industry, banks, securities companies, fund managers, issuers, credit rating agencies, audit firms and local lawyers specialized in securities markets law.

**5. The assessors want to thank the Korean authorities and market participants for their cooperation and willingness to share information during the mission.** In particular, the FSC's and FSS's patience in responding to the numerous follow-up queries after the mission was highly appreciated. Our particular thanks go to the translators, without whose assistance it would not have been possible to complete this report.



# INSTITUTIONAL AND MARKET STRUCTURE— OVERVIEW

## A. Regulatory Structure

**6. The Korean securities regulatory and supervisory structure is comprised of three main agencies established by the Act on the Establishment of the Financial Services Commission (AEFSC).** The FSC is responsible for setting financial and supervisory policy across all financial institutions and markets in Korea. The SFC established under the FSC deals with matters related to unfair trading on the capital markets and accounting and auditing. The FSS conducts the supervision, inspection and investigation of financial institutions under the guidance and supervision of the FSC or SFC. In addition to these three regulatory and supervisory agencies, the MOSF, the BOK and its Monetary Policy Committee (MPC), and the Korea Deposit Insurance Corporation (KDIC) play significant roles in the Korean financial system. The Fair Trade Commission (FTC) also has the ability to review the terms of certain financial contracts and to bring actions related to anti-competitive activities, including manipulation.

**7. The overall structure for the supervision of financial markets, institutions and products is that of an integrated regulator/supervisor with internal functional diversification.** Supervision of all financial institutions, including banks, insurance companies, financial investment business entities (which include securities companies, fund management companies, investment advisors, discretionary portfolio managers, and managers of trusts) and other entities such as operators of securities and derivatives markets, mutual savings banks, and other non-bank financial institutions is executed from within separate departments of the FSS. Various arrangements are used to promote collaboration on overall policies and information exchange.

**8. The core regulatory and supervisory function is located within the FSC, which acts like a Board with a Secretariat and has staff devoted to policy issuance and supervision, whereas the SFC and FSS have prescribed roles in effectuating this policy operationally.** The FSC is a governmental agency with Ministerial/Cabinet level status and 287 staff, of which about 20 are in the Capital Markets Bureau. The FSC oversees the FSS, which is a publicly chartered private corporation with an Executive Director/CEO (the FSS Governor). The FSS has approximately 1750 employees of which about 23 percent (404) are dedicated to capital markets issues. The FSS has an independent budget that is funded through statutorily permitted fees and by a constant contribution of the BOK. The SFC, within the FSC, has a separate Board but no staff or secretariat of its own and relies on access to staff from the FSC as needed to fulfill its individual mandate.

**9. The relevant authorities have multiple interlocking governance and coordination arrangements.** For example, the Vice Chairperson of the FSC serves as chairperson of the SFC and the Governor of the FSS serves on the board of the FSC. The Vice Minister of the MOSF, the President of the KDIC and the Deputy Governor of the BOK are by law ex-officio commissioners of the FSC with full voting rights, including on supervisory and sanctioning decisions. The Vice Chair of

the FSC, the Vice Minister of the MOSF and the Vice Governor of the BOK are members of the Deposit Insurance Committee of the KDIC. The following chart illustrates the agencies and some of the inter-locking arrangements among them.

**Table 1. Governance Arrangement of the Korean Authorities**

Name	MOSF	BOK	FSC	FSS	SFC	KDIC	OTHERS
FSC	Vice Minister	Deputy Governor	Chair: FSC Chair & FSC Vice Chair	Governor		President	3 external members including one recommended by the Chamber of Commerce
SFC					Chair: FSC Vice Chairman		1 standing commissioner and 3 non-standing commissioners
FSS				Chair: Governor, Senior Deputy Governor			
BOK	1 member	Chair: Governor & Senior Deputy. Governor	1 member				1 member each recommended by BOK, Chamber of Commerce & Banks' Federation
BOK MPC	1 member	Chair: Governor, Senior Deputy Governor & 1 member	1 member				2 external members
KDIC Deposit Insurance Committee	Vice Minister	Vice Governor	Vice Chair			Chair: President	3 external members
Macro-Economic Financial Meeting <sup>1</sup>	Chair: Vice Minister	Deputy Governor	Vice Chair	Senior Deputy Governor		Vice President	

Source: FSC.

<sup>1</sup> See Principle 6.

**10. Multiple laws govern the legal framework for regulation and supervision of the capital markets.** These include:

- AEFSC and related Enforcement Decree;
- FSCMA and related Enforcement Decree;
- Act on the External Audit of Stock Companies and related Enforcement Decree;
- Certified Public Accountant Act (CPA Act) and related Enforcement Decree;
- Use and Protection of Credit Information Act and related Enforcement Decree;
- Act on Real Name Financial Transactions and Confidentiality and related Enforcement Decree;
- Administrative Procedure Act (APA);
- Framework Act on Administrative Regulations;
- Commercial Act;
- Government Organization Act (GOA);
- Act on Debt Rehabilitation and Bankruptcy; and
- Act on the Structural Improvement of the Financial Industry.

**B. Market Structure**

**11. Korea has one exchange (Korea Exchange, KRX) into which three markets, the Korea Stock Exchange (securities), the Korean Securities Dealers Automated Quotations (KOSDAQ) Stock Market (smaller cap securities), and the Korea Futures Exchange (KOFEX) (futures), were combined in 2005.** The KRX acts as the central counterparty (CCP) for the exchange-traded securities and futures markets. The Korea Securities Depository (KSD) is the central securities depository. The KRX has links with the Chicago Mercantile Exchange (CME) and Eurex for night trading of futures and options. The KRX has one of the largest markets in the world, with 1,788 listings, and a market capitalization of USD 1,179.4 billion. It trades the world’s most traded futures contract, the Korea Composite Stock Price Index (KOSPI) 200, which has a daily turnover of 7.4 million contracts. The Korean market is highly volatile with more than 60 percent of trading originating with retail investors and another 20 percent from foreign investors with little institutional participation. The KRX has recently (June 2013) announced the addition of a new platform Korea New Exchange (KONEX), which will specialize in small and medium enterprises.

Figure 1. Korea Exchange Composite Index Values



Source: KRX Fact Book 2012.

Table 2. Korea Exchange Equity and Bond Business

	2009	2010	2011	2012
Number of Listed Companies	1,788	1,798	1,816	1,784
Market Capitalization, USD Billions	834.6	1,091.9	996.1	1,179.4
Market Capitalization, KRW Trillions	971.9	1,239.2	1,147.6	1,262.7
Value of Bond Trading, USD Billions	438.1	515.6	716.0	1,285.6

Source: World Federation of Exchanges

**12. A small platform for quotations in companies not listed on the KRX with a market capitalization of USD 554 million and annual trading value of USD 24 million operates under the oversight of KOFIA.** KOFIA is a self-regulatory organization (SRO) with various statutory functions, including the certification of securities professionals and the pre-clearance of advertisements. Membership is not mandatory, but it is not practicable to work in the area of financial services without being a member. Alternative trading systems (ATS) or multilateral trading facilities (MTF) were not permitted at the time of the on-site visit, but the law has recently changed. A bill passed in March 2013 contemplates the creation of a CCP for OTC derivatives clearing. At the moment the plan is that this infrastructure would operate under the auspices of the KRX. Bonds trade over-the-counter (OTC) and on the exchange.

**13. The number of authorized and registered financial investment business entities and the banks and insurance companies conducting financial investment business activities as of March 31, 2013 was as follows:**

<b>Table 3. Financial Investment Business</b>									
	<b>Securities Companies</b>	<b>Futures Companies</b>	<b>Asset Management Companies</b>	<b>Investment Advisory Firms</b>	<b>Trust Businesses</b>	<b>Banks</b>	<b>Insurers</b>	<b>Others</b>	<b>Total</b>
Investment brokerage business	62	7	44	0	0	34	11	11	169
Investment trading business	58	7	45	0	0	48	9	2	169
Discretionary investment management	0	0	84	0	0	0	0	0	84
Trust business*	21	0	0	0	11	20	5	0	57
Investment advisory business	39	7	62	157	0	1	0	139**	405
Source: FSS.									
* As of July 2013.									
**Offshore investment advisors only.									

**14. The assets under management (AUM) in the domestic collective investment schemes totaled KRW 307,592 billion at the end 2012.** The funds are primarily investment trusts, with a small proportion being investment companies. Private offerings are commonly made. The hedge fund industry in Korea remains small, with AUM of KRW 1,739 billion as of end-2012.

**Table 4. Assets Under Management in Domestic Collective Investment Schemes**

		Securities					Money Market Funds	Derivatives	Real Estate	Funds of Funds	Special Assets	Sum
	Fund Type	Stocks	Mix of Stocks	Mix of Bonds	Bonds	Sum						
Public Offering	Investment Trust	78,481	4,837	5,699	12,907	101,925	62,010	10,954	534	5,204	579	181,209
	Investment Company	1,177	108	682	0	1,968	0	372	513	0	2,229	5083
	Sum	79,659	4,945	6,381	12,907	103,894	62,010	11,327	1,048	5,204	2,808	186,293
Private Placement	Investment Trust	6,480	4,278	13,021	34,343	58,124	1,975	20,387	18,386	2,856	13,665	115,395
	Investment Company	122	90	51	0	264	0	-74	466	0	5,247	5,904
	Sum	6,602	4,369	13,073	34,343	58,389	1,975	20,312	18,852	2,856	18,913	121,299
Total	Investment Trust	84,962	9,115	18,721	47,250	160,050	63,985	31,341	18,921	8,060	14,245	296,605
	Investment Company	1,299	198	734	0	2,232	0	298	979	0	7,476	10,987
	Sum	86,262	9,314	19,455	47,250	162,282	63,985	31,640	19,901	8,060	21,721	307,592

Source: FSC/FSS.

## PRECONDITIONS FOR EFFECTIVE SECURITIES REGULATION

**15. Korea is a civil law jurisdiction which has drawn its financial services legislation from multiple models including the United Kingdom, the United States, the European Union and others.** The law is highly detailed and comprises thousands of pages of text. Korea has an independent judiciary and the prosecutors are officers of the courts. Korea has made a significant effort to benchmark its financial sector framework against international standards and to implement international accounting and auditing standards. Its insolvency law supports finality of settlement, the protection of customer funds held by securities brokers, and close out netting procedures. Its commercial law, originally based on the German model has been updated to be more consistent with Anglo Saxon corporate governance structures and to permit the governmental agencies implementing capital markets law some scope to interpret their primary legislation. There are some residual legal issues relative to the integrity of pledged collateral in indirect holding systems.

Uniquely the deposit protection scheme and the resolution arrangements are extended to all financial institutions covered by the financial supervisory architecture, including not just deposit taking banks but also investment brokers and traders. The Korean system makes use of self-

regulatory organizations that are themselves empowered by statutes, and to whom delegations of various functions related to financial services regulation are made in a transparent manner. The judicial system is observed to be fair, although the amount of prosecutorial resources available for combating financial crime is limited and may retard prosecuting financial crimes.

## MAIN FINDINGS

**16. Principles for the regulator:** The Korean regulatory structure is intended to permit an integrated approach to supervision, while maintaining functional expertise, and to enhance the capacity of the securities regulator to issue binding guidance. Nonetheless, the operational structure and the procedural allocation of responsibilities are so complex that individual mandates seem unclear and the overall system lacks operational transparency. The interlocking governance structures, particularly through the voting participation of the Minister of Strategy and Finance in supervisory and enforcement decisions, can at least be perceived to compromise independence. There may also be structural impediments to maximizing the use of existing resources, especially because the SFC does not have its own staff. Effort should continue to be dedicated to refining the cooperative protocols among domestic authorities. The procedures for consultation could be improved by providing a feedback statement and increasing the transparency of the Regulatory Reform Committee's (RRC) decision-making processes. Communication of restrictions on personal trading and the monitoring for compliance should be enhanced. Despite cross-agency arrangements for identifying and mitigating potential systemic risks, the possibility for risks to arise from the capital markets seems underweighted. Although there is a system for developing policy responses to emerging regulatory issues, the process for assessing perimeter risks is not documented. Prevention of conflicts of interest and misaligned incentives has been addressed in the regulatory framework.

**17. Principles for self-regulation:** SROs are used to augment the front line oversight of markets and certain market professionals. There is a comprehensive program by the FSC/FSS to oversee the self-regulatory responsibilities of each of the statutory SROs. This includes approval of rules and processes, receipt of notifications of SRO activities, including sanctions, dispute resolution results, and business reports, and on-site and off-site reviews.

**18. Principles for enforcement:** The FSS, together with the SROs, has sufficient inspection, investigation and surveillance powers vis-à-vis regulated entities. Its on-site examination program is largely based on periodic and thematic examinations, with some elements of a risk-based approach. The program is relatively robust with the exception of limited examinations of certain types of smaller regulated entities. The FSS, FSC and SFC jointly have a broad set of investigative powers that are however currently not fully utilized, leading to the need for the public prosecutor's office to be largely in charge of the investigative process after a referral by the SFC or FSC. The three authorities can impose a range of administrative sanctions, but their power to impose pecuniary administrative sanctions is limited to certain violations. The maximum amounts for civil money penalties and administrative fines are low. The enforcement process appears to take a relatively long time. Numerous administrative measures have been taken, subject to the limitations on the

types of sanctions available. Available evidence suggests that the criminal process has not necessarily led to a credible use of the range of sanctions available.

**19. Principles for cooperation:** The FSC and FSS have sufficient authority to share information with their domestic and foreign counterparts without a need for any external approvals. They are signatories to the IOSCO MMoU, a number of bilateral MoUs with their foreign counterparts, and a domestic MMoU on macroprudential cooperation and exchange of financial information. In practice, they have provided timely assistance to a number of requests for assistance.

**20. Principles for issuers:** The regulatory framework includes comprehensive and sufficiently timely primary market, periodic and material event disclosure requirements for issuers of listed and publicly offered securities. Relevant accountability provisions and enforcement mechanisms are in place. Derogations from disclosure obligations are clearly defined. The basic rights of shareholders are addressed in the Korean regulatory framework. Acquisitions of large shareholdings are required to be disclosed. Obligation to make a public tender offer and prepare a public tender statement and prospectus applies to those that intend to acquire at least 5 percent of the equity securities of a company. All listed corporations are required to prepare their financial statements according to the K-IFRS that are fully in line with the IFRS, and attach them to the registration statements and annual business reports. The Korea Accounting Institute (KAI)/Korea Accounting Standards Board (KASB) has been entrusted with the duty to set and interpret the K-IFRS, whereas compliance with them is supervised by the FSS and KICPA, with enforcement measures taken by them or by the SFC or FSC in more serious cases.

**21. Principles for auditors, credit rating agencies and other information service providers:** The FSS and KICPA share the responsibility for the oversight of audit reports and auditors. Their oversight programs are based on the sampling of audit reports and periodic on-site visits to audit firms and teams, with smaller entities subject to less frequent visits. Despite the active use of enforcement measures, non-compliance by audit firms remains a challenge, leading to a recent legislative proposal to strengthen quality control requirements for the audit firms of listed companies and financial institutions. Relevant auditor independence requirements and the obligation to apply the Korean Standards on Auditing (KSAs) are in place, but in practice non-compliance by some auditors has been a concern. The KSAs will be fully aligned with the revised International Standards on Auditing (ISAs) in the beginning of 2014. Credit rating agencies are required to be authorized, and are subject to a regular on-site examination program and periodic reporting requirements. The IOSCO CRA Code of Conduct requirements have been fully implemented. The FSC has rules in place to prevent conflicts of interest by sell-side analysts that follow IOSCO guidance and are in the vanguard in applying oversight to all types of evaluators, in the manner of CRAs. Nonetheless, the pricing by bond pricing agencies should be kept under review as guidance on benchmarks for pricing evolves.

**22. Principles for collective investment schemes:** CIS can be provided in various legal forms, although in practice publicly offered funds are either investment trusts or investment companies. All CIS operators and those that market or distribute CIS are required to be authorized and are subject



to a full range of conduct of business, organizational and reporting requirements. The on-site examination program of the FSS does not provide sufficient coverage of the small CIS operators. Custodians are subject to limited examinations in relation to their role as CIS custodians. The assets of a CIS have to be properly segregated, and related party custody is forbidden in the FSCMA, but sufficient evidence was not available to conclude that compliance with this prohibition is effectively monitored and enforced. A potential investor in a CIS has to be provided with an investment prospectus that is analogous with the registration statement reviewed by the FSS. The requirements on advertizing, periodic and ongoing reporting, disclosure of investment strategy, valuation of CIS assets, and subscription and redemption of CIS securities are largely appropriate. However, money market fund assets are valued at book value. Pricing errors above a certain level have to be disclosed, but compensating investors that have suffered from an error is based on market practice rather than an obligation. Hedge funds can be offered only as private placements to qualified investors, but operating a hedge fund requires the same authorization as operating a regular CIS. Hedge funds are exempted from the FSCMA audit requirements, and the FSS has not yet conducted any on-site examinations on them.

**23. Principles for market intermediaries:** The Korean authorities have comprehensive rules for licensing intermediaries, which include the vetting of principals, including major shareholders. Ongoing supervision uses detailed examination guides that combine actively followed compliance and risk-based regimes, as well as appropriate early warning information reporting. Steps should be taken to further document contingency arrangements, and risk basing would be enhanced by designing supervisory models that give more weight to intra-group exposures. Additionally, care should be taken to assure that forbearance with respect to compliance with capital requirements does not lead to the accrual of unmanageable risks.

**24. Principles for secondary markets:** The KRX is a participant utility with a monopoly in exchange trading. It has multiple programs to control risk, including short interest reporting procedures, individual price limits, circuit breakers, and the power to isolate failures through the transfer of positions. Disclosure of more information on the use of these provisions would be useful. According to the authorities, OTC activity is limited and is subject to reporting consistent with international standards. However, the actual amount may not be readily measurable and the level of enforcement of reporting requirements is difficult to substantiate. The exchange plays an active front line role in the oversight of the markets, with real time surveillance and active surveillance staff. More information on the delineation of events of default and corresponding resources for completing settlement should be readily available to the market at large as well as to clearing participants. International benchmarks with respect to pre- and post-trade transparency of various transaction types and valuation of illiquid securities by pricing agencies should be kept under review.

**Table 5. Summary Implementation of the IOSCO Principles—Detailed Assessments<sup>2</sup>**

Principle	Grade	Findings
Principle 1. The responsibilities of the Regulator should be clear and objectively stated.	BI	The regulatory mandates of the FSC, SFC and FSS are defined in the AEFSC and in procedural legislation applicable to government organizations and administrative activity, such as the Government Organization Act. The decision-making processes within the authorities involve multiple steps. The operational processes for fulfilling the defined mandates and accountability within and among the various structures are hence virtually impenetrable. The FSCMA is intended to apply to all financial institutions and activities, with functional specialization within the supervisory program. Although all financial investment business must be conducted within an authorized or registered entity, more accessible information on the business conduct requirements for insurance investment products is desirable. The law explicitly requires the BOK, KDIC, FSS and FSC to exchange supervisory information and to conduct joint inspections. However, no additional implementation protocol on decision-making responsibilities beyond an MoU on sharing periodic and ad hoc information exists.
Principle 2. The Regulator should be operationally independent and accountable in the exercise of its functions and powers.	PI	The Minister's participation in the FSC Board is intended to ensure coordination and introduce appropriate checks and balances. However, this arrangement has the potential to jeopardize the regulators' independence. There are appropriate procedures and criteria for the appointment and removal of the FSC and SFC Chair and Commissioners, but as part of the Cabinet the FSC Chair typically resigns when the government changes. The process by which the RRC can require the revision of secondary legislation proposed by the FSC is not transparent and RRC decisions must be followed by the FSC. Potentially, the RRC process also could limit the FSC's regulatory independence.

<sup>2</sup> Readers should be aware that standards assessments are neither audits nor investigations. They are a review of existing laws, regulations and practices. The assessors are not expressing legal opinions on the laws, and it is not expected that such reviews will expose individual cases of misconduct or malpractice.

**Table 5. Summary Implementation of the IOSCO Principles—Detailed Assessments (continued)**

Principle	Grade	Findings
Principle 3. The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.	BI	The FSC, SFC and FSS have a broad complement of powers; including powers to take administrative enforcement actions (see Principle 11 for gaps in the enforcement powers). Although they have different funding structures, both the FSC and FSS are adequately funded to undertake their current activities. However, the staff and information technology (IT) resources dedicated to the capital markets are limited, even taking into consideration the use of self-regulatory resources to augment those of the regulator. The SFC relies on the FSS resources to investigate market abuses, and the technology for oversight of trading activity by the regulator is limited.
Principle 4. The Regulator should adopt clear and consistent regulatory processes.	FI	The FSC, FSS, SFC and the other authorities have well-documented processes, which must be followed to propose, adopt and implement rules and operations. The DART system keeps an electronic record of all required filings and these are accessible to the general public. There is a consultation process, which however does not necessarily result in a feedback statement. The decision making process of the RRC is not transparent (see Principle 2). The informal committee system, while informative and useful in keeping the authorities abreast of market developments, may also leave some stakeholders less well represented than others, thus making a feedback statement particularly valuable. Administrative decisions that affect individuals must be in writing and provide reasons. There is also an opportunity for persons subject to investigation to be heard. Interpretations of general applicability must be made public.
Principle 5. The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.	BI	Commissioners and staff of the regulators are subject to a duty of loyalty and confidentiality and are required to avoid conflicts of interest or to disclose them. The staff is subject to a written Code of Conduct and can be subject to disciplinary action for unprofessional conduct. Although guidance exists, there was substantial confusion among staff as to the scope of applicable securities trading restrictions and related requirements. Despite reporting requirements, no program for active ongoing monitoring of compliance with securities holding and trading rules exists. Whistle blowers are granted anonymity.

**Table 5. Summary Implementation of the IOSCO Principles—Detailed Assessments (continued)**

Principle	Grade	Findings
Principle 6. The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.	BI	The Korean authorities (MOSF, BOK, KDIC, and FSC) cooperate through the Macroeconomic Financial Meeting to consider the emergence of potential risks, the channels for risk transmission and the impact of macro-prudential matters on financial stability and the real economy. Work has advanced on developing what information should be readily available and exchanged. Although some steps have been taken to address the potential systemic risk arising from market intermediaries, the prevailing view does not sufficiently acknowledge that systemic risks can originate from the securities sector. In the bottom-up process, the FSS uses various mechanisms to identify risks within the financial system, but its existing processes are extremely siloed considering the number of large, integrated financial groups and the potential benefits of integrated regulation.
Principle 7. The Regulator should have or contribute to a process to review the perimeter of regulation regularly.	BI	The FSC and FSS have a bottom-up process to identify emerging problems and market evolutions that require regulatory/supervisory attention through periodic industry self-assessments and review of information from complaints and various advisory committees. The FSS also conducts thematic and ad hoc inspections based on emergent issues that can feed into the policy formation process for policing the perimeter. However functional silos prevent full use of the potential synergies that could be applied to perimeter review within an integrated authority. Further, the current process is not documented either as to how its results are disseminated within the FSS and among the relevant authorities, or as to how the review should affect policy making.
Principle 8. The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.	FI	As a condition of authorization, each financial investment business entity must have a system for prevention and management of conflicts of interest that needs to be tested and updated from time to time. The Korean business conduct rules directly address conflicts of interest that could result from misaligned incentives relative to the underwriting/offer of new issues. These rules preclude contingent compensation related to sales, and provide requirements for CRAs and other evaluators as to required independence of judgment and to integrity of the evaluative methodologies used (see Principles 20, 22 and 23).

**Table 5. Summary Implementation of the IOSCO Principles—Detailed Assessments (continued)**

Principle	Grade	Findings
		Internal conflict prevention processes of regulated entities are reviewed internally by compliance personnel and as part of on-site monitoring.
Principle 9. Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.	FI	The FSS has a comprehensive program to oversee the self-regulatory responsibilities of each of the SROs. This includes approval of rules and processes, receipt of notifications of SRO activities, including sanctions, dispute resolution results, and business reports, and on-site and off-site reviews. The FTC may also review certain SRO practices or contracts. The KRX is currently effectively a monopoly for profit mutual company. Access to trading must be through an authorized broker. The Principles on Secondary Markets address some issues relative to adequate availability of certain SRO rules.
Principle 10. The Regulator should have comprehensive inspection, investigation and surveillance powers.	FI	The FSS has sufficient inspection, investigation and surveillance powers vis-à-vis regulated entities, either directly or through delegation to the SROs (see Principle 9). The primary responsibility for market surveillance lies with the KRX. The regulatory framework includes detailed record-keeping requirements for regulated entities.
Principle 11. The Regulator should have comprehensive enforcement powers.	BI	The FSS, SFC and FSC jointly have a broad set of investigative powers that are however currently not fully utilized. They can also impose a range of administrative sanctions, but their power to impose pecuniary administrative sanctions is limited to certain violations. The maximum amounts for civil money penalties and administrative fines are low. The SFC and FSC can refer matters for criminal prosecution. The public prosecutor's office can use all its investigative powers in suspected criminal violations of the FSCMA and other securities markets related acts, and the FSS, SFC and FSC can share information with it.
Principle 12. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.	PI	The FSS examination program is largely based on periodic and thematic examinations, with the examination plan of financial investment business entities incorporating a more risk-based approach. The on-site examination program is relatively robust with the exception of smaller collective investment business entities and audit firms/teams, which are subject to less frequent examinations. The investigative and enforcement process has taken a relatively long time, and the authorities reported that they are not using all

		the existing investigative powers due to resource constraints.
<b>Table 5. Summary Implementation of the IOSCO Principles—Detailed Assessments (continued)</b>		
Principle	Grade	Findings
		Numerous administrative measures have been taken primarily in relation to regulated entities and their executives and employees, subject to the limitations on the types of sanctions available. The unfair trading investigations and enforcement rely on the criminal process. Limited information was available to assess the effectiveness of the criminal enforcement process, but that gathered indicates that the sanctions available have not been optimally utilized.
Principle 13. The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts.	FI	Within the scope of their respective mandates, the FSC and FSS have the authority to share both public and non-public information with their domestic and foreign counterparts. No external approvals are needed and information can be provided also on an unsolicited basis. There is no requirement for the conduct to constitute a breach under Korean law to enable the Korean authorities to share information with their foreign counterparts.
Principle 14. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.	FI	The FSC and FSS are signatories to the IOSCO MMoU and to a domestic MMoU on macroprudential cooperation and exchange of financial information (see Principle 6). In practice, they have provided timely assistance to a number of requests for assistance.
Principle 15. The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their powers.	FI	The FSC and FSS are signatories to the IOSCO MMoU and can provide assistance to foreign regulators under it and other MoUs that they have signed.
Principle 16. There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investors' decisions.	FI	The regulatory framework includes comprehensive primary market, periodic and material event disclosure requirements for issuers of listed and publicly offered securities. Some requirements, in particular those for material event disclosures, are very prescriptive. The timeliness of disclosures complies with IOSCO minimum requirements, even though the following day deadline for material event disclosures is late compared to international best practice. Relevant accountability provisions and enforcement mechanisms are in place. Derogations from disclosure obligations are clearly defined.
Principle 17. Holders of securities in a company should be treated in a fair and equitable manner.	FI	The basic rights of shareholders are addressed in the Korean regulatory framework. Acquisitions of large shareholdings are required to be disclosed. Obligation

to make a public tender offer applies to those that intend to acquire at least 5 percent of the equity securities of a company. In such cases, a public tender statement and prospectus have to be published.

**Table 5. Summary Implementation of the IOSCO Principles—Detailed Assessments (continued)**

Principle	Grade	Findings
Principle 18. Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.	FI	Audited financial statements are required to be attached to the registration statements and annual business reports. All stock-listed corporations are required to prepare their financial statements according to the K-IFRS that are fully in line with the IFRS. Companies that have issued fixed income securities or whose stocks are not listed can use Korean GAAP. The KAI/KASB has been entrusted with the duty to set and interpret the K-IFRS, whereas compliance with them is supervised by the FSS and KICPA, with enforcement measures taken primarily by the SFC or FSC. There have been cases of accounting fraud, and the related enforcement challenges are addressed in Principles 19 and 20.
Principle 19. Auditors should be subject to adequate levels of oversight.	BI	The FSS and KICPA have been assigned with the responsibility for the oversight of audit reports and auditors in Korea. The former is in charge of the review of audit reports of all stock-listed corporations and oversight of the largest audit firms. Both the FSS and KICPA have implemented an oversight program based on the sampling of audit reports and periodic on-site visits to audit firms and teams to assess the implementation of relevant auditing, independence and quality control requirements. Smaller firms and teams are subject to relatively infrequent visits. Despite the active use of enforcement measures, non-compliance by auditors remains a challenge. Due to this, quality control requirements for the audit firms of listed companies and financial institutions are in the process of being strengthened.
Principle 20. Auditors should be independent of the issuing entity that they audit.	BI	The regulatory and self-regulatory framework in Korea sets standards on auditor independence, including restrictions on the provision of non-audit services. Rotation requirements for auditors are in place, and the nomination of an auditor requires the approval of the audit committee. In practice, there have been violations of the independence requirements, which might reflect the need to strengthen oversight and enforcement.
Principle 21. Audit standards should be of a high and internationally acceptable quality.	BI	Audits in Korea have to be conducted in line with the KSAs set by the Korea Auditing and Assurance Standards Board (KAASB). They are currently not fully in line with the ISAs, but will become so in the beginning of 2014.

		The KAASB follows an open and transparent process in standard setting, and the standards are subject to the approval of the FSC. There has been a significant amount of enforcement cases against violations of the auditing standards.
<b>Table 5. Summary Implementation of the IOSCO Principles—Detailed Assessments (continued)</b>		
Principle	Grade	Findings
Principle 22. Credit rating agencies should be subject to adequate levels of oversight. . The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.	FI	Credit rating agencies are required to be authorized for credit information business. They are subject to a regular on-site examination program and periodic reporting requirements. The IOSCO Code requirements have been implemented.
Principle 23. Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.	FI	The FSC and FSS have regulations and processes intended to prevent conflicts of interest between sell side analysts and the broker that follow IOSCO guidelines. These prohibit conduct inconsistent with a duty of loyalty to a particular customer and the company investor base overall. The FSC and FSS are in the vanguard in introducing comparable oversight to that advocated for CRAs to all evaluators used by their regulatory system for valuation services.
Principle 24. The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.	BI	All CIS operators are required to be authorized for collective investment business and are subject to a full range of conduct of business and organizational requirements. The authorization requirement also applies to those that market or distribute CIS and to operators of privately placed funds. The on-site examination program of the FSS does not provide sufficient coverage of the small CIS operators. Custodians are subject to limited examinations focusing on their specific responsibilities as CIS custodians (see Principle 25). Periodic and ongoing reporting requirements apply. Delegation is subject to comprehensive regulatory requirements.
Principle 25. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.	BI	CIS can be provided in various legal forms in Korea, although in practice publicly offered funds are either investment trusts or investment companies. They do not need to be registered provided that a registration statement has been approved by the FSS. The assets of a CIS have to be properly segregated, and related party custody is forbidden in the FSCMA. However, sufficient evidence was not available to conclude that compliance with this prohibition is effectively monitored and enforced.



<p>Principle 26. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.</p>	FI	<p>A potential investor in a CIS has to be provided with an investment prospectus that is analogous with the registration statement reviewed by the FSS. The FSS can demand a corrective registration statement to be issued in case of any false or misleading information. There are comprehensive requirements on advertizing and periodic and ongoing reporting both to investors and the FSS, and investment strategy and information on asset valuation have to be disclosed.</p>
<p>Principle 27. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.</p>	BI	<p>There are detailed regulatory requirements on the valuation of CIS assets, subscription and redemption of CIS securities, and circumstances when redemptions can be suspended. Each collective investment business entity has to set up a valuation committee responsible for valuing the CIS assets, and services of bond pricing agencies are to be used for valuing fixed income instruments. However, money market fund assets are permitted to be valued at book value, without sufficient safeguards. Pricing errors above a certain level have to be disclosed. There is no automatic obligation to compensate investors that have suffered from the error, but the market practice is that of voluntary compensation.</p>
<p>Principle 28. Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.</p>	BI	<p>Operating a hedge fund requires the same authorization as operating a regular CIS. Hedge funds can be offered only as private placements to qualified investors. Hedge fund operators are subject to periodic reporting requirements to the FSS, and their investor reporting obligations are based on KOFIA guidelines. Hedge funds are not required to be audited. The FSS has not yet conducted any on-site examinations of hedge funds.</p>
<p>Principle 29. Regulation should provide for minimum entry standards for market intermediaries.</p>	FI	<p>The licensing requirements for all financial investment business entities are comprehensive and include fitness and propriety vetting for executives and large shareholders, minimum capital requirements based on the type of business units authorized, requirement for a business plan and appropriate resourcing with properly registered personnel, a facilities inspection, including IT, a requirement for internal controls, risk management and management of conflicts of interest, and a period of exposure of the application for public comment.</p>
		<p>In some cases an on-site visit is performed at the time of application, but commencement of financial investment business is not necessarily a factor that leads to an early full scope inspection. Banks and insurance companies that offer securities products must also have appropriate licenses, though some requirements relative thereto may differ from those applied to financial investment business entities.</p>

**Table 5. Summary Implementation of the IOSCO Principles—Detailed Assessments (continued)**

Principle	Grade	Findings
<p>Principle 30. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.</p>	FI	<p>There is a minimum initial capital requirement and an ongoing risk-based requirement calculated as a net operating capital ratio that incorporates “reserve requirements” based on the risk/quality of assets held. This requirement is supported by extensive, sometimes difficult to interpret, guidance. When firms reach an early warning level of 150 percent of the minimum amount, the FSS issues a recommendation or order for corrective action and a requirement for a financial performance improvement plan, reflective of the firm’s risk rating and capital level. Capital is calculated daily and reported as of month end, within 30 days, as well as quarterly. The time frames for filing periodic capital reports and for implementing suggested corrective actions are longer than best practice within such a volatile market. In mitigation, material event reporting and early warning reports must be made immediately (see also Principle 32). Broker loans as margin are permitted to the extent of 100 percent of a broker’s equity. There is limited evidence on what group risk information is available to securities companies within a group, particularly non-financial holding company groups.</p>
<p>Principle 31. Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.</p>	BI	<p>Financial investment business entities are required to have risk management, internal control and compliance functions and to establish policies and procedures related to business conduct, including order handling, documentation of accounts and trading authority, disclosure, suitability and risk warning requirements, sales representations and practices, trading practices, and requirements for the treatment of customer funds and securities. The FSS operates a well-designed and documented examination program. The level of monitoring of order allocation and handling by brokers of customer securities and funds held by a broker as trustee or nominee, however, could not be substantiated. The KRX is not able to monitor settlement positions of individual customers in indirect holding systems.</p>

**Table 5. Summary Implementation of the IOSCO Principles—Detailed Assessments (continued)**

Principle	Grade	Findings
Principle 32. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.	BI	The FSS uses various processes aimed at giving it an early warning of a financial investment business entity's deteriorating financial situation. The authorities have intervention powers that include the capacity to transfer accounts and other business, requirements for settlement guarantee and compensation funds, provisions for appropriate margin and margin collection, resolution procedures and deposit insurance to mitigate the potential damage and losses due to default. Information on what constitutes events of default and the resources for redress are not readily available, although there are rules and guidance in place and the KRX CPSS-IOSCO self-assessment that contains some of this information was posted in July. The authorities do not have a documented contingency plan (see also Principle 37). The period for rectifying a capital deficiency can be longer than is consistent with best practice.
Principle 33. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.	FI	The KRX was established by merging previously established exchanges as provided by law. It is a for-profit stock company primarily owned by trading members. The requirements for the establishment and organization of the operations and regulatory functions of the exchange are consistent with the IOSCO requisites for authorization related to resources, reliability of systems, surveillance capacity and other matters. Certain rules and information are insufficiently specific and accessible (see Principles 32 and 37). ATS or MTF were not operative at the time of the assessment mission, but have been permitted as of June. Trading organized by KOFIA is considered to be OTC.
Principle 34. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.	FI	The FSS conducts oversight of the exchange and the exchange system through off-site and on-site monitoring. It reviews trading on a batch, not a real time basis. It also receives reports from the exchange that operates its own real time trading surveillance program. Exchange rules are approved by the FSC, as are products in the case of structured products and derivatives. The exchange oversees the provision of continued disclosure of material price sensitive information required under its own rules.

**Table 5. Summary Implementation of the IOSCO Principles—Detailed Assessments (continued)**

Principle	Grade	Findings
Principle 35. Regulation should promote transparency of trading.	FI	The KRX system provides largely sufficient pre-and post-trade information. Minimum block size and the use of volume weighted average prices for block trades are specified by rules. The block size is very small, and only the volume of block trades and not the price is reported. However, since the value of block trades is less than 1 percent of the total trading value and there is a pricing model, the impact on transparency is limited. Outside the scope of the IOSCO Principle, KOFIA Freeboard contains significant information. Prices for OTC bond trades are also to be reported within 15 minutes of execution, but enforcement is difficult as the trades are typically done by voice or messenger and reporting is related to time of settlement. For bond trades to be settled, prices must be reported as all bonds are dematerialized.
Principle 36. Regulation should be designed to detect and deter manipulation and other unfair trading practices.	FI	The exchange rules prevent the acceptance of trades that could be for the purpose of manipulation and prohibit specific market practices, such as wash trades. Exchange staff undertakes real time trade monitoring and conduct yearly inspections of all members with respect to trading practices. The exchange can bring its own actions against its members and request its members to suspend offending employees. The KRX has taken disciplinary actions in a significant number of cases, but does not make its actions systemically public. It has also referred unfair trading cases to the FSS for further investigation, so that the majority of market abuse actions by the public prosecutor's office originate from KRX referrals.
Principle 37. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.	BI	The exchange has a broad range of requirements and arrangements to mitigate and manage default risk, market disruption, and futures, short, and other open exposures. However, the definition of events of default, the waterfall of resources to redress them, and the resources accessible to the exchange to complete settlement are not clearly described and easily accessible to the public. Further, while the KRX performs scenario testing, it is not clear how existing mitigation and recovery arrangements will be applied in practice as they have yet to be tested with respect to securities companies.

**Table 5. Summary Implementation of the IOSCO Principles—Detailed Assessments (concluded)**

Principle	Grade	Findings
		The impact of the recent introduction of continuous net settlement (CNS) may achieve improvements in certainty, but the CNS and the expected introduction of CCP clearing for OTC derivatives trades will require careful ongoing monitoring and adaptation of risk management systems to meet international standards.
Principle 38. Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.	N/A	
Fully Implemented (FI), Broadly Implemented (BI), Partly Implemented (PI), Not Implemented (NI), Not Applicable (N/A)		

**Table 6. Recommended Action Plan to Improve Implementation of the IOSCO Principles**

Principle	Recommended Action
Principle 1	<ul style="list-style-type: none"> <li>• The authorities should increase the transparency of their mandates and related allocation of regulatory and decision-making responsibilities by e.g. posting an organigram and related decision making flow chart on the website of each authority.</li> <li>• The authorities should continue to augment the practical arrangements for cooperation, e.g. by a written protocol.</li> <li>• The FSC and FSS ensure that the investor protection requirements in place for securities-related activities conducted within banking and insurance entities are transparent and readily accessible to the public.</li> </ul>
Principle 2	<ul style="list-style-type: none"> <li>• The FSC should exclude the MOSF representative from the administrative sanctioning process and individual supervisory decisions or at least remove his voting powers in those cases.</li> <li>• The FSC should identify certain financial safety and soundness and business conduct regulations that should be exempted from the RRC process, though subject to general administrative review under the APA.</li> <li>• The participating authorities should clarify the RRC decision-making process, when it is reviewing regulations proposed by the FSC.</li> </ul>
Principle 3	<ul style="list-style-type: none"> <li>• The FSC and FSS should assess whether their staffing levels in the capital markets area are sufficient.</li> <li>• The government should consider whether there needs to be a specific dedication of governmental resources to facilitate the execution of powers provided under the FSCMA to the SFC to combat market abuse.</li> </ul>
Principle 4	<ul style="list-style-type: none"> <li>• The FSC and FSS should consider providing a feedback statement on consultations (see also Principle 2 regarding the RRC process).</li> </ul>
Principle 5	<ul style="list-style-type: none"> <li>• The FSC and FSS should ensure timely communication of guidance on personal trading restrictions and property registration affecting staff and Commissioners/Board members.</li> <li>• The FSC and FSS should document their monitoring programs for compliance with the trading restrictions.</li> </ul>
Principle 6	<ul style="list-style-type: none"> <li>• The authorities should heighten the awareness that problems in the securities sector could precipitate runs or other problems with systemic effect.</li> <li>• The authorities should continue to identify with more particularity the information that should be shared among the authorities to</li> </ul>

	address risks originating from each sector that could adversely affect other sectors (see also Principle 1).
Principle 7	<ul style="list-style-type: none"> <li>The FSC and FSS should develop a more formal top down process to review emerging risks of misconduct and products or services that do not appear to be sufficiently supervised/regulated and a related escalation process.</li> </ul>
Principle 11	<ul style="list-style-type: none"> <li>The FSC, SFC and FSS should ensure credible use of their existing investigative powers.</li> <li>The FSC should explore the possibility of increasing the range and level of administrative pecuniary sanctions.</li> </ul>
Principle 12	<ul style="list-style-type: none"> <li>The FSS should ensure that its on-site examination program provides sufficient coverage of all supervised entities (see also Principles 19 and 24).</li> <li>The FSS, SFC, FSC and the public's prosecutor's office should work jointly to aim at improving the effectiveness of the criminal enforcement process, including through increased information sharing on the outcome of the cases referred to the public prosecutor's office.</li> </ul>
Principle 16	<ul style="list-style-type: none"> <li>The FSC should consider whether the current prescriptive material event disclosure regime is the most efficient and effective manner to ensure sufficient disclosure to investors.</li> <li>The FSC should consider proposing a change to the deadline for material event disclosures.</li> </ul>
Principles 19–21	<ul style="list-style-type: none"> <li>The FSC should pursue its plans to strengthen the quality control requirements for the audit firms that audit listed companies and financial institutions.</li> <li>The FSS and KICPA should ensure that their audit oversight programs are sufficiently comprehensive and address the risks of non-compliance identified in the market.</li> <li>The SFC should ensure that there is robust enforcement of the violations of the independence and quality control requirements.</li> </ul>
Principle 24	<ul style="list-style-type: none"> <li>The FSS should ensure that its on-site examination program provides sufficient coverage of all collective investment business entities.</li> <li>The FSS should ensure that its on-site examinations on custodians cover sufficiently their specific responsibilities as CIS custodians.</li> </ul>
Principle 25	The FSS should ensure that compliance with the prohibition of related party custody is effectively monitored and enforced.

**Table 6. Recommended Action Plan to Improve Implementation of the IOSCO Principles (concluded)**

Principle	Recommended Action
Principle 27	<ul style="list-style-type: none"> <li>The FSC should require the use of market or fair value also for the valuation of MMF assets as required by the IOSCO Policy Recommendations on Money Market Funds.</li> <li>The FSC should assess whether the regulatory framework applicable to the treatment of pricing errors is sufficient to enforce the obligation to compensate investors.</li> </ul>
Principle 28	<ul style="list-style-type: none"> <li>The FSC should consider the appropriateness of exempting hedge funds managers from the requirement to have the fund audited.</li> <li>The FSS should ensure that it launches its on-site inspection program in hedge fund managers as planned.</li> </ul>
Principle 29	<ul style="list-style-type: none"> <li>The FSS should consider early on-site “nursery visits” to newly licensed firms.</li> </ul>
Principle 30	<ul style="list-style-type: none"> <li>The FSS should consider simplifying its guidance on capital compliance.</li> <li>The FSS should review whether performance improvement plans related to capital deficiencies should be more expeditiously implemented (see also Principles 32 and 37).</li> </ul>
Principle 31	<ul style="list-style-type: none"> <li>The FSS should increase the focus of its examination activities on customer funds and order allocations, especially within brokers acting as trustees.</li> </ul>
Principle 32	<ul style="list-style-type: none"> <li>The authorities should document their contingency plan for addressing financial disruption and firm failures.</li> <li>The authorities should further document and make readily available to participants and the public the definition of events of default, existing default mitigation arrangements and the order by which available resources to redress defaults will be used by the financial investment business entity, the KRX, the KSD and any future CCP.</li> </ul>
Principle 35	<ul style="list-style-type: none"> <li>The FSC, FSS and KRX should consider whether the current KRX practice for reporting block trades provides sufficient information to the market.</li> <li>The FSC, FSS and KOFIA should consider whether further guidance (and enforcement) is necessary with respect to reporting OTC bond trades.</li> </ul>
Principle 37	<ul style="list-style-type: none"> <li>The authorities should request an assessment of the securities settlement system.</li> </ul> <p>The KRX and KSD should better describe the arrangements for the completion of settlement in the event of default, even assuming the insolvency of a clearing member, and keep the sufficiency of these arrangements under continuous review.</p>



## AUTHORITIES' RESPONSE TO THE ASSESSEMENT

25. **The Korean authorities would first like to thank the IMF and the World Bank for their work on the assessment of Korea's securities regulation and welcome the recommendations and suggestions made by the assessment team.** While we are very much appreciative of this opportunity to review and enhance our supervisory and regulatory framework for the securities sector, there are certain areas in the assessment report where we do not fully agree with and thus, would like to provide further comments.

26. **In relations to principle 2, the report states that the Ministry of Strategy and Finance's participation in the Financial Services Commission enables collaboration and adequate balance between relevant authorities but may weaken independence of the regulatory authority.** However, the Commission is a representative system, comprising of 9 commissioners representing relevant organizations as well as experts, which makes it difficult to make decisions in favor of any one of the 9 commissioners. Moreover, the rules governing the Commission clearly stipulates that any commissioner shall be excluded or may file application for challenge or withdraw from resolution and deliberation on matters in which he/she has either direct or indirect interests to ensure fair resolution and deliberation.

27. **With respect to principle 12 on effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program, the assessment report suggests that the on-site examination program is relatively robust with the exception of smaller collective investment business entities and audit firms/teams, which are subject to less frequent examinations.**

28. **While the Korean authorities believe sufficient time is a necessary component for ensuring sound quality of investigation and enforcement, we also highlight the authorities' steady efforts to innovate and expedite the investigative process in an effort to minimize consumer complaints and investor harm.** For instance, the Financial Services Commission (FSC), the Financial Supervisory Service (FSS) and the prosecutors' office are working together in a joint task force since May 2013 to fast-track the criminal enforcement process.

29. **In the meantime, the FSC is in the process of consulting with the Ministry of Justice to introduce civil money penalty in the punishment of unfair trading cases, including market abuse, in an effort to recover unlawful gains and allow timely punishment.** Introduction of civil money penalty is expected to reduce reliance on criminal procedures and provide more diversity in the enforcement process.

30. **We also note that the recently revised Financial Services and Capital Markets Act (FSCMA) introduces civil money penalty to punish violations of requirements to disclose large holdings of securities.** In addition to the civil money penalty, the revised FSCMA also introduces fines ranging from 100 percent up to 300 percent of the amount of unlawful gains from unfair trading to discourage such unlawful activities and recover ill-gotten gains more effectively.

**31. In August 2013, the FSS has also launched a team dedicated to the management of unfair trading cases.** The team works to enhance the quality and effectiveness of investigation and enforcement of unfair trading by following up and collecting information on indictment and conviction rates of the unfair trading cases that have been referred by the FSS to the prosecutors' office. In an effort to bolster information sharing, the FSC, the FSS, and the prosecutors' office have already set up a permanent consultative body for information exchange.

**32. The FSS would also like to underscore our continuous effort to ensure the effectiveness of on-site examination process for smaller asset management firms.** For instance, not only have we increased the number of examiners for on-site examinations by 55 percent in 2013 compared to 2012, we select timely and emerging issues for our on-site visits, such as partial examinations of newly established asset management firms. For 2014, wide-ranging factors, like exam frequency, will be considered in putting together annual examination plans. For example, small asset management firms that have never been subject to on-site examinations since inception will be subject to partial examinations in the first quarter of 2014 with a special focus on areas and issues that have been identified to be deficient during the general full-scope examination of large asset management firms.

**33. In terms of the inspection of smaller audit firms, we believe supervisory risk associated with small audit firms tend to be small because of their small size and relatively small impact on the overall financial market.** Thus, in order to achieve the most efficient supervision with limited resources, the FSS allocates more supervisory resources to the inspection of large accounting firms with greater significance in investor protection. For instance, audit teams<sup>3</sup> undertake audits not of large listed securities firms but mostly of small non-listed securities firms with relatively limited impact on the overall financial market. Similarly, smaller audit firms conduct audits mostly of non-listed firms.<sup>4</sup> Thus, the regulatory risk stemming from smaller firms and teams is limited. On the other hand, mid and large audit firms,<sup>5</sup> which audit 86 percent of listed companies have the most influence on financial markets and thus warrant the most supervisory resources.

## DETAILED ASSESSMENT

**34. The purpose of the assessment is primarily to ascertain whether the legal and regulatory securities markets requirements of the country and the operations of the securities regulatory authorities in implementing and enforcing these requirements in practice meet the standards set out in the IOSCO Principles.** The assessment is to be a means of identifying potential gaps, inconsistencies, weaknesses and areas where further powers and/or

<sup>3</sup> Audit teams together audit 15 percent of all companies subject to external audits and the quality of audit conducted by audit teams is inspected by the KICPA.

<sup>4</sup> Only 14 percent of total listed firms are audited by small audit firms and the quality of audit performed by small audit firms are also inspected by the KICPA.

<sup>5</sup> Audit quality inspection for mid- and large audit firms are directly conducted by the FSS.

better implementation of the existing framework may be necessary and used as a basis for establishing priorities for improvements to the current regulatory scheme.

**35. The assessment of the country's observance of each individual Principle is made by assigning to it one of the following assessment categories:** fully implemented, broadly implemented, partly implemented, not implemented and not applicable. The IOSCO assessment methodology provides a set of assessment criteria to be met in respect of each Principle to achieve the designated benchmarks. The methodology recognizes that the means of implementation may vary depending on the domestic context, structure, and stage of development of the country's capital market and acknowledges that regulatory authorities may implement the Principles in many different ways.

- A Principle is considered fully implemented when all assessment criteria specified for that Principle are generally met without any significant deficiencies.
- A Principle is considered broadly implemented when the exceptions to meeting the assessment criteria specified for that Principle are limited to those specified under the broadly implemented benchmark for that Principle and do not substantially affect the overall adequacy of the regulation that the Principle is intended to address.
- A Principle is considered partly implemented when the assessment criteria specified under the partly implemented benchmark for that Principle are generally met without any significant deficiencies.
- A Principle is considered not implemented when major shortcomings (as specified in the not implemented benchmark for that Principle) are found in adhering to the assessment criteria specified for that Principle.
- A Principle is considered not applicable when it does not apply because of the nature of the country's securities market and relevant structural, legal and institutional considerations.

**Table 7. Detailed Assessment of Implementation of the IOSCO Principles**

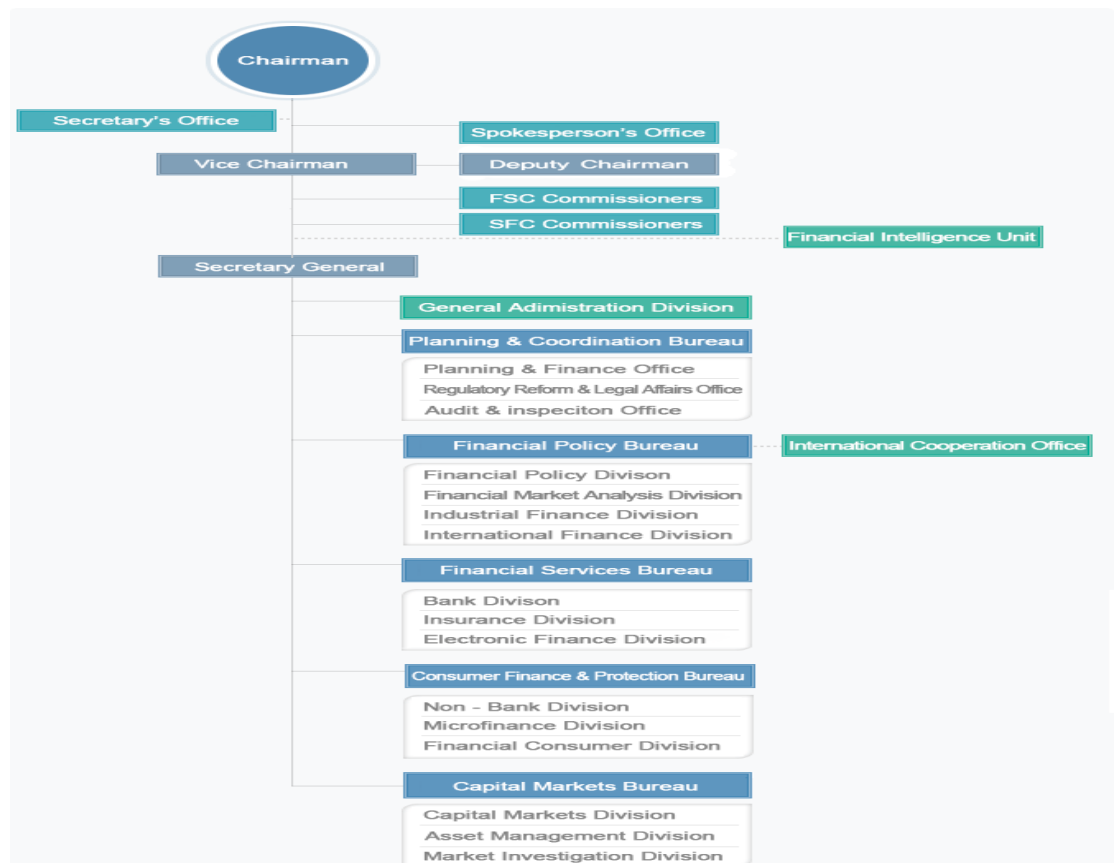
<b>Principles Relating to the Regulator</b>	
<b>Principle 1.</b>	The responsibilities of the regulator should be clear and objectively stated.
Description	<p><b>Allocation of Regulatory Responsibilities</b></p> <p>The key financial regulatory and supervisory authorities in Korea are: the FSC at <a href="http://www.fsc.go.kr/eng">http://www.fsc.go.kr/eng</a>, the FSS at <a href="http://english.fss.or.kr/fss/en/main.jsp">http://english.fss.or.kr/fss/en/main.jsp</a>, the SFC, which is a Board of five members located within FSC, and does not have its own staff or website, the BOK at <a href="http://eng.bok.or.kr/eng/engMain.action">http://eng.bok.or.kr/eng/engMain.action</a>, the KDIC at <a href="http://www.kdic.or.kr/english/index.jsp">www.kdic.or.kr/english/index.jsp</a>, the FTC at <a href="http://eng.ftc.go.kr/">http://eng.ftc.go.kr/</a> and the MOSF at <a href="http://english.mosf.go.kr/">http://english.mosf.go.kr/</a>. The Financial Intelligence Unit is located within the FSC.</p> <p>Additionally, the system makes extensive use of SROs, which have statutorily mandated functions, responsibilities delegated by statutory authorities, and contractual duties assigned under regulatory services agreements.</p> <p>More specifically, a bottom up description follows:</p> <p><i>Self-Regulatory Organizations</i></p> <p>Self-regulatory functions are currently primarily consolidated in the KRX and KOFIA, which oversee the exchange markets for all products and the OTC markets for “unlisted” equities and bonds, enforce compliance by their members with the SRO rules, and provide data, educational, and other services (see Principle 9). KRX and KOFIA have a degree of private rule making authority over their members and markets, subject to the FSC approval. The KSD also has private rulemaking authority as a matter of law subject to the FSC approval. Additionally, the decision to list securities or admit them to trading is taken by the KRX, although the FSS must approve prospectuses under delegation from the FSC. The SROs also run dispute resolution forums and, while the FSC licenses (authorizes or registers) institutions conducting financial investment business, KOFIA certifies individual professionals who are employed by such institutions.</p> <p><i>Financial Supervisory Service</i></p> <p>The ongoing supervision and inspection/examination/surveillance program for financial investment business and securities issues is vested in the FSS, a non-governmental entity. The Governor of the FSS is a Board Member of the FSC, but effectively the Governor is comparable to a CEO or Executive Director in charge of managing the operational supervisory work of the FSS. The FSS has a professional staff that, at approximately 1750 persons, exceeds that of the FSC by 300 percent. The FSS has 31 departments, four regional offices, three district offices and four overseas representative offices in New York, London, Beijing and Tokyo.</p> <p>The AEFSC statute charts the FSS as a private “non-capital special corporation”. As such, it is funded primarily by fees from regulated financial market participants, with examination/inspection powers both mandated by statute and delegated from the FSC (AEFSC, Article 24(2)). The FSS is accountable to the FSC (“to perform duties relating to the inspection and supervision over financial institutions, under the instruction and supervision of the FSC”) (AEFSC Article 24, see also Article 18). In addition, the FSC supervises the KDIC, which is also a non-capital special corporation (see Article 27 of the Depositor Protection Act).</p>

*Financial Services Commission*

The FSC is a “central administrative agency” established at the ministerial/Cabinet level under Article 2 of the GOA—with a nine member board and related Secretariat. Central administrative agencies are under the authority of the President, who may delegate his authority to the Prime Minister under Chapters II and III of the GOA and Article 3 and 4 of the AEFSC. By law, the FSC Chairman is appointed by the President of the Republic of Korea, on recommendation of the Prime Minister, for a fixed term of three years, extendable once; and the Vice Chairman is appointed for a similar term on recommendation of the FSC Chairman. The Chairman must undergo personnel hearings before the National Assembly (AEFSC Article 4(2)). The Vice Minister of the MOSF, the President of the KDIC, the Deputy Governor of the BOK and the Governor of the FSS by law are all ex officio commissioners. The FSC commissioners also include two financial experts recommended by the FSC Chair and one industry representative recommended by the Chair of the Korea Chamber of Commerce, currently filled by an academic. In addition to presiding over the FSC, the FSC Chairman may attend and speak at the State Council (AEFSC Article 4 (6)). All of the currently sitting commissioners at both the FSC and the SFC are either ex officio, government servants, or academics.

The FSC’s governmental powers are set forth by the AEFSC and the related Enforcement Decree. The FSC is responsible for supervisory policy and its implementation for all financial market participants, including banks, insurance companies, and other financial institutions (such as mutual savings banks, credit unions, and credit finance companies), as well as securities issuers, companies and markets, and such additional participants as may be prescribed by the Enforcement Decree of the AEFSC.

The FSC organization chart is as follows:



*Securities and Futures Commission*

Although it has an independent mandate and Board under the AEFSC, the SFC is a governmental entity that sits within the FSC structure. It relies on staffing from the FSC and must use the FSS to undertake supervisory activities under its specific remit, as it does not have its own staff or Secretariat or an independently approved budget. The SFC is chaired by the Vice Chairman of the FSC and has a five member Commission/Board. The four remaining commissioners (one of which is a standing commissioner, who must be a public official in special service and member of the Senior Civil Service) are appointed by the President on recommendation of the Chair of the FSC. They must include persons who have relevant financial sector experience in the government at the Senior Civil Service level or who have majored in law, economics, business administration or accounting and have at least 15 years academic experience at the level of an associate professor or at a research institute.

*Bank of Korea*

BOK is a central bank, which has a financial stability mandate under the Bank of Korea Act and related Enforcement Decree. BOK does not do day-to-day supervision of banks, but it has the power to require the FSS to examine banking institutions at its request, to include BOK personnel in the inspection/investigation team and process, and to reconsider a supervisory decision of the FSS if that decision would have a bearing on monetary and credit policies (AEFSC, Article 62). By law, the FSS must comply within one month with a request for inspection (see Enforcement Decree of the AEFSC Article 22-3).

The authorities also have interlocking governance arrangements. For example, the Vice Chairperson of the FSC serves as chairperson of the SFC and the Governor of the FSS serves on the board of the FSC. The Vice Minister of the MOSF, the President of the KDIC and the Deputy Governor of the BOK are by law commissioners of the FSC. The Vice Chair of the FSC, the Vice Minister of the MOSF and the Vice Governor of the BOK are members of the KDIC Deposit Insurance Committee (see a more extended discussion of independence issues in Principle 2).

**Evolution**

The existing structure is the product of a multi-step consolidation of separate institutional regulators that began in 1998 in response to the Asian crisis, which mirrored an international trend to consolidate supervision of multiple institutions within an integrated supervisory authority. Framework changes were refined in 2004 and 2008 and the overall structure continues to evolve.

The current structure preserves certain historic vestiges of past structures, for example, the MOSF retains an ex officio seat on the Board of the FSC. Further, the SFC retains a special mandate related to capital markets including setting and overseeing compliance with the accounting and auditing standards and detecting, investigating and sanctioning unfair trading practices/market abuses, such as insider trading, manipulation and fraud. The FTC has functions relative to anticompetitive conduct, including manipulation of prices generically.

**Specific Mandates of the Financial Services Commission and Securities and Futures Commission**

The FSC has the following competences (Article 17 AEFSC):

- Development of policies and systems related to finance;
- Supervision, inspection, and sanctioning of financial institutions;

- Authorization of the establishment, merger, conversion, acquisition and transfer of business of financial institutions;
- Management<sup>6</sup>, supervision and monitoring of capital markets;
- Creation and development of a financial hub;
- Enactment, amendment and repeal of Acts, subordinate statutes and regulations regarding the foregoing;
- Bilateral and multilateral negotiations and international cooperation over financial institutions and foreign exchange; and
- Supervision of soundness of institutions handling foreign exchange.

The SFC has the following competences (Article 19 AEFSC):

- Investigation of unfair trade in the capital market;
- Accounting and auditing standards and oversight;
- Preliminary deliberation on important matters relating to the management, supervision, and monitoring of capital markets within the FSC; and
- Matters delegated by the FSC related to management, supervision and monitoring of capital markets.

The SFC can partially or entirely revoke or suspend a disposition made by the FSS with regard to any matter specified in Article 19, if the SFC finds that the disposition “is illegal or substantially inappropriate” (see Article 61).

There is a broad range of matters that the FSC may refer for deliberation to the SFC, that include for example guidelines for inspection, production of documents with respect to tender offers and other matters, including financial management (FSCMA Article 439 and the Articles referred to therein, including Articles 131(1), 146 etc.). The hierarchy of law adds additional complexity.<sup>7</sup>

All of the laws and guidance governing the financial system are publicly available on various websites, although not always in English (for more information, see Principle 4).

### **Powers of Interpretation**

The Framework Act of Administrative Regulations states that: “No administrative agencies may limit the rights of citizens or impose duties on citizens pursuant to regulations that are not based on Acts”. In this regard, the FSC and the SFC may partially delegate<sup>8</sup> to the Governor of the FSS either’s authority under

<sup>6</sup> Management under the relevant law should be read to mean “oversight.”

<sup>7</sup> The hierarchy of law is as follows: Acts of Parliament, Enforcement Decrees, which typically are Presidential Decrees, Ordinances of the Prime Minister or other Ministers, Regulations, which may be adopted by the FSC, Detailed Regulations, which may be adopted by the FSS, as well as other informal, non-binding guidance that may be issued by various entities with respect to the implementation of their specific operational mandates—for example, the Governor of the FSS has the authority under Article 39 of the AEFSC to “establish rules, where necessary in connection with the performance of the business affairs of the FSS”.

<sup>8</sup> Such delegation implies a retained oversight of the delegated activities within the FSC or SFC as the case may be.

the AEFSC or any other Act or subordinate statute (Article 71 AEFSC). The APA explicitly requires an administrative agency to provide an interpretation or clarification upon request (Article 5). All of the specific delegations (there are more than 100) are documented and public.

The APA explicitly requires that interpretations of general applicability be made public (Article 51). Market participants and FSS staff reported however that it is not always apparent, who has the authority to interpret what, which can lead to forum shopping by market participants. They, however, did not report that interpretations are unfair or that the discretion to interpret is abused.

### **Principal Laws**

For purposes of securities, the principal laws, in addition to the AEFSC are the FSCMA and the related Enforcement Decree, the Commercial Act, the APA, the Depositor Protection Act, the Act on the Structural Improvement of the Financial Industry, the Act on Rehabilitation and Bankruptcy, the CPA Act, the Act on External Audit of Stock Companies, the Use and Protection of Credit Information Act, and multiple other pieces of legislation.

### **Gaps and Duplication**

The law is intended to provide uniform coverage of institutions and products. But the law is very complex—one member of the public described its format as “prescriptive ambiguity”. Further, although the integrated regulatory structure is intended to be comprehensive, gaps could still occur. For example, anecdotal evidence indicates that in practice schemes have been designed, taking account of the description of the scope of securities products, to attempt to evade the strict requirements of the securities law through the use of trusts or deposits. According to the FSC and FSS, all types of financial services entities engaging in securities business must “obtain approvals” of the regulator and are subject to the conduct of business rules pertaining to securities companies, or largely similar rules. Banks and insurance companies however observe the governance requirements for those categories of institutions, certain insurance products linked to securities may not be securities, and there is an area of business that is described as “concurrent business.” (Articles 22 and 37 FSCMA, see also Principles 29 and 31). In this regard, bank branches increasingly are an important distribution channel for collective investment schemes provided by management companies related to the bank.

Additionally supervisory responsibility for particular institutions, such as financial market infrastructures (for example the newly permitted CCP) has not been fully articulated nor has the ultimate responsibility for the effectuation of macro-prudential policies.

### **Requirement to Cooperate**

The law permits the various authorities with responsibilities affecting the same institution or related institutions to share oversight. This is accomplished both via participation in the Board of the FSC or by joint inspections or access to data permitted under the law. The law specifically permits certain inter-authority requests and requires compliance. For example, the law requires the FSS to examine financial institutions at the direction of the BOK (see Bank of Korea Act Articles 87-89 and AEFSC Article 65). The law also permits the FSC to request the cooperation of the key related agencies and “any other institution or organization” with respect to inspections, data provision or rectification measures (Articles 65 and 65-2 AEFSC). Under the same Act, the KDIC may request the inspection of an insured institution or of a financial holding company that has the insured institution as a subsidiary or affiliate. The Act also allows any employee of the KDIC to share the report or to take any necessary measures based on its results and the FSC must comply (Article 66). When deemed necessary to execute policies any of the MOSF, the FSC and the Monetary Policy Committee of the BOK may request the others to share data



	<p>with respect to any institution, and the agencies requested must comply except in extenuating circumstances (Article 65 AEFSC). The Governor of the FSS also has an independent power by law to request the cooperation of any institution (Article 67 AEFSC).</p> <p>In September 2012, an MoU was executed among the MOSF, FSC, BOK, FSS and KDIC related to information exchange on a routine periodic basis and deferred exchange of ad hoc information in a manner consistent with respecting the duties and discretion of each authority and the principle of mutual cooperation and reciprocity. The MoU provides for dispute resolution through the Macroeconomic Financial Meeting (MEFM), which is headed by the Vice Minister 1 of the MOSF, and specifies the composition of the working level group from each participant. The MPEM working level group assembles on an ad hoc basis to discuss emerging macro-prudential issues. However, discussions with the authorities indicate that more specific agreements/protocols designating information that should be shared across sectors on a “top-down basis” to identify problems and responsibility have not been explicitly articulated. Issues emerging from the securities sector in particular are not identified (see also Principles 6, 7, 32 and 37).</p> <p>The SFC must rely on the FSS, subject to the FSC control over allocation of resources, to execute its mandate. See for example Article 22, according to which the rules and organization of the SFC must be as prescribed by the FSC, except as otherwise explicitly provided by law (i.e., Article 23, according to which the SFC shall instruct the FSS in matters committed to SFC under Article 19). According to Article 61 the FSC may override the SFC and FSS, and the SFC may override the FSS in matters related to Article 19. Anecdotally, the Secretariat of the FSC controls the flow of business to the FSC, which would provide an opportunity to discourage sanction recommendations.</p>
Assessment	Broadly Implemented
Comments	<p>The existing structure of financial services regulation in Korea is uniquely complex. It combines the competence and resources of multiple authorities with different powers, resources and mandates derived from different legal sources. The structure is intended to separate the operational day-to-day supervisory function from policy making at both the regulatory level and governmental level. The structure, while complex, nonetheless attempts to provide credibility and norm setting powers to the regulator by giving it ministerial status and to implement an integrated system across all financial institutions, while retaining functional specialization.</p> <p>A clearer, more detailed organigram/flow chart of the various functions, particularly decision-making functions, performed by each of the relevant authorities separately, and the authorities in conjunction, would assist the public in better understanding the responsibility of each authority for the implementation of the regulatory framework and how, when and by whom the law is applied in practice. Such an organigram could clarify with precision who has the ultimate decision-making power on specific issues and identify the authority that can render interpretations in specific cases, which the public and indeed the authorities believe is subject to doubt. More transparency on how/when banks, insurance companies and other institutions engaged in securities transactions must meet securities requirements would also be desirable.</p> <p>Korean law contains a very broad direction to the relevant authorities to cooperate with respect to sharing data, information generated in the course of inspections, and opinions on remedial measures, albeit sometimes on a delayed basis. The recently executed MoU documents the intention of the signatories to share certain specific periodic and ad hoc information generated under the respective reporting requirements and supervisory regimes of each agency. An internal agreement/protocol among the authorities further illustrating the decision-making responsibilities with respect to specific regulated institutions where cooperation is required or encouraged in ordinary and crisis circumstances would</p>

	<p>enhance the ability to address emerging problems and promote further efficiency in cooperation and coordination practices. In any event, the effectiveness of cooperation arrangements in practice should be kept under continuous review by each competent authority (see also Principles 6 and 32).</p> <p>A recent legislative proposal submitted to the National Assembly is intended to give additional prominence to consumer protection issues and augment the existing consumer protection delivery structure. The most efficient framework for providing adequate consumer protection across all sectors, however, remains subject to ongoing debate. One challenge going forward will be to make clear how the consumer protection function fits with other existing supervisory functions, particularly business conduct functions. This will require consideration of how to balance the following interests: designing inspection programs that appropriately weigh the potential impact of mistreatment of customers on financial and market integrity; avoiding potential conflicts between the objectives of stability, financial integrity and proportionate and dissuasive sanctions for misconduct; and evaluating the role of responsiveness to consumer concerns in maintaining public confidence.</p>
<b>Principle 2.</b>	The regulator should be operationally independent and accountable in the exercise of its functions and powers.
Description	<p><b>Operational and Political Independence</b></p> <p><i>Impact of the regulatory structure</i></p> <p>The bottom-up description of the responsibilities of the various regulatory, supervisory and self-regulatory bodies provided in Principle 1 demonstrates how the Korean system attempts to achieve independent but accountable and collaborative operations. It also highlights the multiple inter-relationships among political and commercial participants within that structure that could be susceptible to abuse, if they are not transparent and kept under review. As noted above, the financial services regulatory structure affecting securities products, institutions and markets in Korea is intended to provide for a layer of independent decision-making that insulates day-to-day operations from political or commercial interference and provides ministerial level credibility to the securities function. Under the structure, the FSC (a governmental entity) has the ultimate licensing authority, but the FSS (a private entity) processes licenses and undertakes the day-to-day examination and oversight program of those institutions that are under the FSC remit. The SFC has some special powers with respect to the oversight of accounting and auditing and the sanctioning of market abuses, subject to the oversight of the FSC. Special deliberation committees with outside industry and academic participants hear sanction cases and therefore provide third party input into the “probable cause” part of the sanctioning process (see Principle 4). However, the Minister of Strategy and Finance continues to participate as a voting member with respect to supervisory and sanctioning as well as normative decisions made at the FSC Board level. Although a majority of Board members can take action, it is more typically taken by consensus.</p> <p>Even though the FSS is accountable to the FSC, it is free from the broader accountability within the government that applies to the issuance of norms and policy making. This enables the FSC to play an important role in influencing the issuance of norms affecting customer protection and market integrity, while the FSS can undertake day-to-day supervision without the governmental oversight applicable to proposing secondary legislation. This multi-tiered structure, while unusually complex, reflects the practical differences between the FSC policy role and the FSS role of performing examinations, surveillance, investigations and certain enforcement functions, recognizing the difficulty of total separation. In practice, the structure appears to achieve the intended level of protection from day-to-day political and commercial interference taking into consideration the particularities of the legal system in Korea, with the exception of the taking of sanctioning and supervisory decisions against individual entities and persons.</p>

The prescriptive legal framework in Korea may to some extent legally circumscribe the potential for undue interference. However, the inter-locking governance structure, which permits the Minister to sit and vote on the Board of the FSC, the participation of industry nominees on the Board and in the various deliberation committees, and the lack of transparent deliberations could potentially jeopardize independence depending upon actual practice.

*Political independence more broadly*

Regulations adopted by the FSC and detailed regulations adopted by the FSS are not reviewed directly by the MOSF. However, the Minister of Strategy and Finance is a voting member of the FSC Board, which has the final say on policy and enforcement actions, except with respect to less severe disclosure and unfair trading cases (see Principle 11). Additionally MOSF is represented in the RRC (see below), which reviews all substantial legislation and regulations through an apparently non-transparent deliberative process and whose recommendations must be taken into account by the FSC and FSS.

The Vice Minister of the MOSF is also an ex officio member of the Deposit Insurance Committee of the KDIC. The KDIC and resolution processes are relevant to all financial institutions within the Korean structure. The MOSF can also appoint a member to the BOK MPC. Separately, the MOSF has a role with the BOK in addressing the stability of the exchange rate and managing foreign exchange reserves under the Foreign Transaction Law, which activities are intended to proactively avert instabilities. The MOSF also has a key role in crisis management in that it is the governmental unit that has the capacity to raise money through the issuance of bonds and to provide government guarantees for bonds issued with respect to the resolution activities. Its leadership is part of closed door highest level "Blue House" meetings on urgent matters. The MOSF at the First Vice Chairman level also sits on the Board of the Korea Center for International Finance (KCIF) together with equal level representatives of the FSC and BOK, the Chairman of the Korea Federation of Banks and two other dignitaries. The KCIF (<http://www.kcif.or.kr>) is a "think tank" initially formed during the Asian crisis known also as the "Watch Dog". Among other things, it provides global daily real-time market monitoring and issues alerts and early warnings to the financial services agencies and the government more generally (see also Principle 6).

Beyond the potential MOSF political influence, the overlay of the responsibility of the Chair of the FSC to the President could also have an indirect chilling effect on the FSS.

*Terms of office and criteria for appointment and dismissal*

The AEFSC sets fixed terms of office for the Chairman and Commissioners of the FSC and for all members except the Chairman of the SFC, who is also the Vice Chairman of the FSC and protected under the terms of that appointment. The law also specifies bases for removal for cause (see Article 10 for the FSC and Article 32 for the SFC). As a matter of practice the Chairman of the FSC resigns upon the election of a new President (though as a matter of law the person could continue his/her term as a Commissioner).

**Accountability**

*To the Regulatory Reform Committee*

The RRC (at <http://www.rrc.go.kr/>) was originally formed in 1998. It is co-headed by the Prime Minister and a civilian co-chair, and has 22 members, six of which are representatives of designated government ministries (MOSF, Ministry of Trade and Industry, Ministry of Security and Public Administration, Ministry of the Office of Government Policy Coordination, FTC, and Ministry of Government Legislation) and the remainder of which are largely academics. The Committee makes an analysis of all new regulations

except some that are not considered important (based on number of people affected or amount of costs), within a 45 day period<sup>9</sup>. The review is in the nature of a regulatory impact/feasibility review, which assesses costs and benefits of regulatory initiatives, legal validity, results of consultation, and makes a recommendation. The proposing agency must take account of the RRC determination (see Framework Act on Administrative Regulations Article 14 and discussion under Principle 4). The relationship to the APA and the process and the criteria by which the RRC may override an FSC regulation, however, are not fully transparent.

*To the National Assembly*

The FSC must report quarterly to the National Assembly and must present and defend its budget annually. The National Audit Board conducts the budget review.

**Administrative and Judicial Recourse**

The APA contains a comprehensive set of procedures intended to protect the interests of the affected public and to ensure fairness and consistency (Article 1). Articles 22 through 24 of the APA require that decisions must be reasoned and that dispositions must be provided in writing to affected individuals, except in times of emergency, wherein reasons may still be requested ex post. An affected person has an opportunity to be heard either on the papers or orally (Article 27). The FSS also has an Enforcement Review Committee that acts like a probable cause committee and permits both the investigation staff and the regulated entity against whom a charge is being lodged to be heard. The Committee pre-hears the case before a sanction is proposed to and approved by the FSC.

There is also a process whereby individuals aggrieved by a process can file a complaint with the Administrative Review Committee in the Office of the Prime Minister. Judicial review of administrative actions is also available in the courts. In the case of securities licenses, which are granted based on objective criteria, bases for appeal would however be relatively limited (see also Principle 29).

**Budget Oversight and the Capacity to Reallocate Funds**

The budget of the FSC is part of the governmental budget and subject to review by the National Assembly and the Board of Audit and Inspection of the government. The FSC budget must be proposed prior to the commencement of the FSC fiscal year and is reviewed by the FSC, subject to external audit and review by the FSS's internal audit function, and published in the FSC Annual Report and on its website. Both the FSC and FSS have the capacity to reallocate the FSC budget, should such reallocation be necessary, subject to rules relative to the payment of civil servants.

**Confidentiality**

The FSC and its employees are subject to a duty of confidentiality with respect to any information acquired in the course of their duties or the use of such information for any purpose other than the performance of their duties (AEFSC Article 35). Faithfulness, integrity and duty of trust are all obligations of administrative agencies and their employees under the APA (see e.g., Articles 1 and 4).

<sup>9</sup> Less important regulations may be reviewed within a 10 day period.

	<p><b>Immunity</b></p> <p>There is no protection from criminal liability for the FSC, SFC, FSS and their employees for actions taken in performance of their duties which intentionally infringe penal law, and there is explicit civil liability for gross negligence. The State may itself compensate applicants for damages caused by public employees or private persons charged with public duties. Such officials may, however, have individual liability to the State if the damage is ultimately deemed to be intentional or grossly negligent (see State Compensation Act, Articles 2(1) and (2)). Therefore, though further clarification would be welcome, there is a process for indemnification of employees which is not based explicitly on good faith but on whether the employee engages in intentional misconduct or gross negligence, which would appear to protect most actions taken in good faith. As a matter of nuance, however, gross negligence may not be the equivalent of bad faith. Nonetheless, although there has been litigation, there has been no case in which employees have been required to compensate a third party for damages within the last five years.</p> <p>In regard to the criminal law affecting government officials, non-career personnel of the FSC and private persons with public duties are subject to the criminal law as if they were public officials and to the disciplinary processes affecting government employees (see State Public Officials Act and AEFSC).</p> <p><b>Multiple Objectives and Commercial Interference</b></p> <p>The structure described above also reflects that the FSC has a dual developmental and regulatory mandate. Article 2 of the AEFSC provides that the FSS and the FSC “shall endeavor to keep fairness, ensure transparency, and refrain from disturbing the autonomy of financial institutions in performing their affairs” (emphasis added). This injunction and overall powers that include developing a financial hub further demonstrate the mixed objectives of the regulatory scheme.</p>
Assessment	Partly Implemented
Comments	<p>The Korean system employs a complex, interwoven system of checks and balances. Since the initial FSAP, the Korean authorities have increased the level of transparency of many of their operations and the ability of the public to comment on regulatory and supervisory activities. However, the Minister of Strategy and Finance continues to participate as a voting member with respect to normative and individual supervisory and sanctioning decisions made at the FSC Board level. Although a majority of Board members can take action, it is more typically taken by consensus and the political presence and accountability regime could potentially have a chilling effect on decision-making. The overall decision making process among the FSC, SFC and FSS is not transparent, although procedures of each are clear and documented (see also Principle 1). Additionally the RRC process for taking normative actions and for overriding potential norms proposed by the FSC is not itself transparent.</p> <p>As a result, it is difficult to analyze whether, and if so, the extent to which, the balance of measures adopted to assure cooperation, coordination and accountability could improperly compromise independence. The design has the admirable purpose of giving the FSC ministerial power and related credibility to adopt regulations and operational independence in control of the budget and of the ongoing examination program. However, there are some indications that the FSC takes a very hands-on role in directing FSS activities. Thus there is a potential that the political participation on the FSC Board can impact the examinations and their follow-up processes. While the integrity of the structure is not questioned by market participants, the level of independence of the FSC and FSS would be improved by removing the MOSF representative at least from voting on and potentially altogether from the supervisory and sanctioning process. This would ensure that political objectives do not conflict with enforcement and supervisory objectives. The independence of the FSC would also be enhanced by providing it with more authority to ignore the RRC recommendations in cases of regulation committed to its particular authority. Finally consideration could be given to advocating the use of public meetings to reach normative conclusions.</p>

<b>Principle 3.</b>	The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
Description	<p><b>Powers</b></p> <p>The FSC, SFC and FSS, between them, have a broad complement of powers to license financial institutions, markets and market infrastructures, to adopt secondary legislation, to address financial deterioration and market disruption, including through the transfer of accounts and performance improvement plans, and to obtain and share information. They can also take a range of remedial and enforcement actions, as described in more detail in Principles 10-12 and in the functional parts of this report including:</p> <ul style="list-style-type: none"> <li>• Issuance of cautions and warnings;</li> <li>• Suspension of trading;</li> <li>• Restriction of business;</li> <li>• Removal of management;</li> <li>• Requirement of additional equity contributions;</li> <li>• Requirement to correct a financial statement or an offering document;</li> <li>• Rescission of profits in the event of misleading disclosure;</li> <li>• Publication of information on short swing profits by an insider;</li> <li>• Suspension of redemptions;</li> <li>• Transfer of funds or securities;</li> <li>• Imposition of monetary penalties;</li> <li>• Withdrawal, conditioning or revocation of a license;</li> <li>• Delisting; and</li> <li>• Referral for criminal process.</li> </ul> <p>The exercise of these powers is dependent on the violation in question—for example there is a wider set of administrative measures to address disclosure violations than market abuses, which are currently treated primarily as criminal offenses under the FSCMA. Also, to the extent that the SFC has some special investigative powers, the resources to use them must be obtained from the FSC or the FSS.</p> <p>The FSC, SFC and/or FSS oversee the SROs, receive ongoing disclosures from issuers, supervise financial investment services companies (see p. 11), oversee accounting and auditing practices and audit firms and practitioners, and have some responsibility for various entities with securities functions within financial holding company groups. They also have some responsibility to prevent unauthorized business (see Principle 7).</p> <p><b>Boards</b></p> <p>Both the Board of the FSC and the SFC are very active. During 2011 and 2012, both Boards met regularly twice a month. In 2011, the FSC also held 14 ad hoc meetings. In 2012, it held three ad hoc meetings and processed seven seriatim resolutions. The SFC also had one ad hoc meeting in 2011 and three in 2012.</p>

**Staff**

The Capital Markets resources are about 10 percent of the FSC staff and 23 percent of the FSS staff.

**Financial Services Commission**

The FSC Capital Markets Bureau is very small and is comprised of approximately 30 out of 287 overall staff. The FSC budget is part of the overall governmental budget. The FSC salaries are constrained by civil service pay scales and rules, but include government benefits. Under the Enforcement Decree of the FSCMA alone, there are 160 delegations to the FSS.

**Securities and Futures Commission**

The SFC has no separate staff, secretariat, or budget. It must conduct operations using staff that is loaned or seconded from other parts of the regulatory structure.

**Financial Supervisory Service**

The FSS budget is approved by the FSC and its fiscal year is aligned with that of the FSC. The FSS is permitted by law to raise funds from the industry in accordance with a formula set forth in the Enforcement Decree of the AEFSC. It also receives support from the BOK and can receive governmental support by loan or otherwise if necessary. The FSC can permit the FSS to accrue budget surplus over a year end (AEFSC Article 50). The FSS salaries are competitive with private sector salaries for the same disciplines. According to staff about 400 of the total FSS staff of 1700 are dedicated to capital markets and securities products and professionals. The FSS designates one Deputy Governor to Capital Markets, underneath which an Assistant Governor is dedicated to each of supervision of financial investment business entities and corporate disclosure; examination of financial investment business entities and capital markets investigations; and accounting and auditing.

<b>FSS Budget (USD)<sup>10</sup></b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
Total	259,146,715	249,061,206	232,826,283
Contribution from regulated financial institutions	178,267,327	177,545,455	168,081,908
Contribution from the BOK	9,000,900	9,000,900	9,000,900
Fees for securities issuance	71,280,828	61,975,698	55,157,516
Others	597,660	539,154	585,959

FSS staff committed to securities functions (404 out of 1700) is as follows:

<sup>10</sup> Values were converted using the exchange rate of KRW 1,111/USD 1.

Area	Specific Tasks	Staff
Licensing and supervision of securities companies and other related companies in the capital market.	<ul style="list-style-type: none"> <li>• Licensing, authorization;</li> <li>• Business conduct, prudential regulation; and</li> <li>• Supervision of secondary markets.</li> </ul>	79
Examination of securities companies and other related companies in the capital market.	<ul style="list-style-type: none"> <li>• Examination, sanctions; and</li> <li>• Risk analysis</li> </ul>	80
Investigations into possible violations of securities laws, enforcement actions.	<ul style="list-style-type: none"> <li>• Investigation into possible violations of securities laws; and</li> <li>• Enforcement actions.</li> </ul>	88
Corporate disclosure.	<ul style="list-style-type: none"> <li>• Corporate disclosure rules; and</li> <li>• Review of corporate disclosure filings.</li> </ul>	77
Accounting and auditing standards, audit engagement review.	<ul style="list-style-type: none"> <li>• Review of corporate accounting standards;</li> <li>• Review of audit engagements; and</li> <li>• Review of audit quality.</li> </ul>	80

### **Self-Regulatory Organizations**

KRX indicated that it has more than 600 staff. 121 of them are dedicated to member supervision and market surveillance, while 100 are responsible for the listing and disclosure review. KOFIA has 36 employees whose role is to conduct random inspections of branch distribution practices, pre-review advertising, accept electronic registration of OTC trades, certify specified securities professionals, and develop guidance and best practices for engagement contracts and other matters such as suitability. KOFIA also monitors risk management practices. These oversight staff operate under a special oversight committee in each case. The KSD oversees the settlement process pursuant to its business, deposit and settlement rules.

### **Reliance on Economic Crime Unit Support**

The prosecutorial staff responsible for prosecuting economic crimes related to financial services (which include market abuses) number about 17 (including those in charge of tax crimes) out of 184 staff in the Seoul Central District public prosecutor's office. The criminal process is protracted (see also Principles 11 and 12).

### **Disciplines Represented**

The FSC has 287 staff, which includes 242 active professionals, 6 active administrative personnel and 39 persons on overseas training secondments or otherwise on leave. 193 have bachelor's degrees and 69 have graduate degrees. The FSS has 1681 professional staff and 71 administrative staff. Their professional qualifications are listed below. Neither provided statistics for staff dedicated to capital markets activities in that personnel are rotated on a three year cycle.



FSC Degree	Number of Staff
Law	20
Economics	90
Finance	1
Business	49
Accounting	26
Other	8

FSS Qualification	Number of Staff	FSS Qualification	Number of Staff
CPA	281	Financial Risk Manager	96
Lawyer	61	Certified Internal Auditor	10
Certified Financial Analyst	31	Ph.D.	48

**Turnover**

Between 2010 and 2012 the average turnover rate varied from 0.8 to 4 percent for the FSC and FSS in the aggregate.

**Technology**

The FSC has the Data Analysis Retrieval and Transfer (DART) system, which is a fully electronic system for the electronic filing of registration statements, prospectuses, and material event and periodic disclosures. With respect to surveillance of the market, the FSC has access to KRX terminals to observe trading in real time and can perform analysis using proprietary systems, but performs batch surveillance primarily. One staff member is committed to liaison with the KRX and KOFIA. 88 staff are committed to surveillance and investigation for securities violations and other oversight activities.

**Ongoing Training**

The FSS conducts a professional career development program, which permits staff to undertake training to obtain enhanced expertise, such as MBAs in finance, CFA certification, and legal or accounting qualifications with (partial) financial support from the FSS. KOFIA conducts multiple training programs and FSS staff may attend these.

**Internal Audit and Governance**

The FSS has an internal audit function and the FSC and SFC are subject to governmental audit procedures. The FSC is subject to the accountability requirements for a central administrative agency, and therefore must be reviewed by the National Audit Board. The Board of the FSC contains outside experts. In addition to the Chairman, three members of the Board can convene a special meeting. Complex internal policies exist, but they are not particularly accessible (see Principle 1).

	<p><b>Investor Education</b></p> <p>The FSS has an educational/informative blog on its website. It also publishes investor alerts and a newsletter as does the FSC. The FSS operates an education program known as the Public Financial Educational Department. KOFIA also runs investor education programs and has trained over 240,000 individuals.</p>
Assessment	Broadly Implemented
Comments	In view of the size and complexity of the Korean market, and the demands of a complex banking system, the resources dedicated to the capital market have not been demonstrated to be as sufficient as desirable considering the allocation of various operational functions, even taking into consideration the use of self-regulatory resources to augment those of the statutory regulators. The FSC Capital Markets Bureau only has approximately 30 personnel out of a staff of 287. The SFC is a board of five members with no independent secretariat, budget or staff, and within the FSS the capital markets area has approximately 400 staff without agency wide data bases, with the exception of DART, or dedicated access to IT support systems for market surveillance and other activities. Effectively, the sanctioning of market abuses is not staffed with dedicated personnel at the authorities. Neither, per Principles 11 and 12, are they capable of promptly imposing sanctions intended to combat market abuses even with the assistance of otherwise occupied prosecutorial authorities.
<b>Principle 4.</b>	The regulator should adopt clear and consistent regulatory processes.
Description	<p><b>Transparent and Consistent Processes</b></p> <p>The various regulatory authorities in Korea are subject to the APA, the objective of which is to ensure that administrative agencies exercise their mandates in a manner consistent with fundamental fairness. The APA requires the pre-publication of proposed legislation and secondary regulations or amendments to regulations for at least 20 days with an opportunity for public comment. Additionally, in certain circumstances, the law permits a hearing on regulatory actions of general applicability (Articles 43 and 44). The law also provides for notice of a proposed action, an opportunity to be heard, and reasoned decisions in writing with respect to administrative decisions, except emergency, trivial or repetitive actions (see e.g., APA Articles 22, 23, and 24). Judicial review is available for material actions, but if the matter is licensing or reporting the scope would be limited, as the decisions are made using objective non-qualitative criteria.</p> <p>The FSS and/or the FSC consult with the industry, in particular the SROs and trade associations with respect to the development of policy. Regulations that could impact more than 1 million people or result in incurring more than KRW 10 billion (USD 1 million) of costs must be submitted to the RRC, described above in Principles 1 and 2, which conducts a regulatory impact analysis, considers the costs and benefits of the proposal, and evaluates the regulations' implications for government policies more broadly than the proposing agency may, pursuant to the RRC's mandate to "deliberate upon and coordinate the Government's regulation policies" (Article 23). The review period ranges from 10 to 45 days and the final results are gazetted, published in the media and by the internet, and can bind the securities authorities if they conflict with normative proposals made by FSC.</p> <p><b>Commercial Independence and Accountability</b></p> <p>As noted above, the Framework Act on Administrative Regulations requires that important regulations (as determined by the RRC within 10 to 45 days after submission by an agency head) be modified or improved, if the RRC so recommends absent special circumstances to the contrary. Improved regulations</p>

must be resubmitted following the changes. Regulations are initially submitted in draft, coupled with a regulatory impact analysis, an independent analysis of propriety, and a review of comments from interested parties, including other agencies, civic groups, research institutes, and the general public gathered via public hearings and pre-announcement procedures (see the APA). In the case of legislation, this process must precede submission to the Minister of Government Legislation (see Articles 7 through 14 APA). The review/decision-making by the RRC itself, however, is not transparent. Separately, any person may submit an opinion on the abolishment or amendment of an existing regulation (Article 17).

**Other Consultative Mechanisms**

The FSC has five standing expert committees upon which senior members of the regulated industry sit, which have existed since the early 1990s. These committees, which were previously organized under the MOSF, are intended to improve communication between the industry and the FSC. The committees each meet quarterly and their membership is composed in each case of 20 percent of the FSC staff and 80 percent of private sector members. The Committees and some of the issues that they have considered are as follows:

Committee	Recent Considerations
Financial Policy Committee	Major policy issues (household debt, European sovereign debt; segregation of industrial conglomerates and banks)
Service Committee	Improvement of quality of financial services (e.g., insurance annuity products, social responsibility)
General Public Committee	Customer protection, access to finance
Securities Industry Committee	Improvement of the capital market (rating agencies, amendment to the FSCMA, improvement of mutual savings banks)
Global Financial Committee	G-20 commitments, OTC CCP, trade repositories, Basel III, shadow banking

In 2012, the FSS established similar committees under its aegis. The Korean Chamber of Commerce and KOFIA also organize comments on various regulatory initiatives.

**Feedback**

Although the authorities do not necessarily provide a feedback statement indicating their disposition of the comments received in a rulemaking procedure, the FSS publishes a handbook, updated yearly, and available on its website that explains many of its policies and procedures in lay terms. The FSS annual handbook also contains one section that summarizes the rule changes made during the prior year and their rationale. For important changes, the FSC must provide the rationale required by the Framework Act for Administrative Regulations—that Act also requires frequent regulatory review and publication of an agenda of planned revisions or reforms.

**Licensing Process**

The FSS handbook contains information on the process (and criteria) for obtaining a license and explains the then current regulatory framework in layman's terms. Applications for licenses are posted on the FSC website, which permits objections to be filed with the FSC (FSCMA Article 13). Interestingly, the overall number of securities companies however has not materially changed since the 2002 FSAP assessment.

The criteria for granting a license include specific fitness criteria, including a standard of financial soundness and disqualification for a record of misconduct.

**Sanctions Deliberation Committees**

The decision to undertake a post investigation sanctions proceeding is made by the FSC and in some cases the SFC. There are two SFC committees that act as "sanctions-support, pre-deliberation" type committees prior to decision by the SFC: (i) the Committee for Deliberation on Investigations of Capital Markets (Article 21 of the Regulations on Investigation of Capital Markets) that deliberates on disposition of investigations on unfair transactions and disclosure violations, and (ii) the Accounting Oversight Deliberative Committee (Article 23 of the Regulations on External Audit and Accounting) that deliberates on measures on audit reviews and inspections. These Committees are partially composed of outside experts<sup>11</sup>. The FSS has an Enforcement Review Committee on which sits the Deputy Governor for Planning & Management Support, the Deputy Governor who raised the enforcement matter, a legal advisor, the director of the FSC related to the subject matter of the alleged violation, and four outside experts. This committee reviews sanctions recommended for regulated entities and their executives and employees on the basis of inspections, and is intended to ensure the fairness and equity of the process.

The SROs also have disciplinary panels, which are comprised of individuals who do not represent members but who have market experience. These disciplinary panels hear the presentation of evidence with respect to the proposed disposition of sanctions by the exchange for violation by members of its rules, and report to the KRX Market Oversight Commission, which is composed of independent members of the Board. Upon request, an aggrieved defendant can request a rehearing by the disciplinary panel.

The purpose of the above processes is to promote consistent and equitable administrative treatment. Further review can be taken through the judicial system. Matters referred to the criminal prosecutor are subject to the protections accorded defendants in a criminal proceeding.

**Transparency in General**

All the laws, legislation, decrees, regulations, detailed regulations and any guidance of general applicability must be made public. The contents of these are available on the Internet at one or more sites, including the KRX, KSD, KOFIA, FSS and FSC, among others. The legal framework is frequently, but not always, available in English as well as Korean. See for example: <http://www.kofia.or.kr/kofia/index.cfm?event=eng.rul.page01> (rules available in English on KOFIA site), and <http://english.fss.or.kr/fss/en/laws/securities/list.jsp?bbsid=1289368624482> (link to FSS regulations). See especially the Regulations on Financial Investment Business with respect to conduct of business, and Regulations on Investigations of Capital Markets that relate to the procedures for investigatory proceedings. In addition, standards for imposing penalties are available (see e.g., Regulations on Examination and Sanctions Against Financial Institutions).

<sup>11</sup> The first Committee has four ex officio members and three external members, while the second committee has four ex officio members and five external members.

	<p>Additionally the DART system retains all electronically filed information, which is accessible to the general public. Minutes of the meetings of the Boards of the FSC and the SFC must be maintained as a matter of law, and can be reviewed by the appropriate audit entities.</p> <p>The FSS also publishes a biweekly Newsletter with informative contents. The FSC publishes a weekly economic publication and a blog. Additionally, inspection manuals and the Risk Analysis and Management System (RAMS) guidance (see Principles 6 and 30) is provided to each financial institution to which it applies.</p> <p>The agencies' Annual Reports and financial statements are also available on their Internet sites, as is the FSS Handbook.</p> <p><b>Reports on Investigations</b></p> <p>Reports on investigations are not made public and not all sanctions imposed are made public, as the reputational impact of publishing a sanction is considered an augmentation of the penalty. In addition, the SROs do not appear to systematically publish the results of their disciplinary proceedings. Non-public information that becomes available to the authorities and their staffs in the course of performing their responsibilities must be treated as confidential (see also Principle 5).</p> <p><b>Conciliation Process</b></p> <p>The Enforcement Decree of the AEFSC provides a process for a mediation or conciliation service for disputes among financial institutions provided for under Article 51 of the AEFSC. The FSS Financial Disputes Mediation Committee must have not more than 30 members drawn from judges, attorneys, prosecutors, former executives of the Korea Consumer Agency, persons with at least 15 years experience in a financial institution or related organization, a Deputy Governor from the FSC, and other members as deemed necessary as appointed by the Governor of the FSS.</p>
Assessment	Fully Implemented
Comments	<p>The FSC, SFC, FSS and the other authorities have well-documented processes, which must be followed to propose, adopt, and implement rules and operations, including multiple templates and manuals. There is a consultation process and guidance on the regulatory program in lay person's language. The processes are subject to a comprehensive administrative law, which provides for review of individual sanctions and requires administrative sanctions to be reasoned and in writing. While the consultation process does not result in a feedback statement as to the consideration of comments, the authorities do discuss emergent issues with the industry and also publish a regulatory calendar and an annual review. The RRC is intended to keep regulation across the government coordinated and to look at regulatory impact—however, the criteria and the deliberative process for determining how the RRC procedure can affect FSS and FSC decision-making are not transparent, a matter addressed in Principle 2. Market participants state that the regulatory/supervisory process has become increasingly transparent, but that some of the comment processes seem merely matters of form. The informal committee system may also leave some stakeholders less well represented than others. The latter matters are addressed in Principle 2. The authorities should continue to appropriately increase the transparency of their processes.</p>
<b>Principle 5.</b>	The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.
Description	<p><b>Professional Conduct</b></p> <p>Both career officials and non-career employees are subject to the ethical provisions of the State Public Officials Act related to the duty of loyalty, disqualification for criminal activity, removal from office for</p>

disciplinary action, duty to perform duties with impartiality and religious neutrality, prohibition on receipt of gifts or gifts to superiors or subordinates, and duty to maintain confidential information both during and after the tenure of office. Prohibition and/or restrictions also apply to political participation and engagement in profit-making business (Articles 56–66). The FSC and the FSS also have internal Codes of Conduct and investigators are subject to a Code related to on-site investigations (Annex of the Detailed Regulations on Investigation of Capital Markets).

Additionally, the FSC and the FSS both have differently constituted internal audit and inspection functions. At the FSC, the function is under the Bureau of Planning and Coordination, which itself is under management. The Audit and Inspection unit conducts the following activities per the FSC website:

- Manages matters relating to audit and inspection;
- Conducts audit and inspection on the FSC and its affiliates;
- Registers and inspects the wealth<sup>12</sup> of public officials and manages matters relating to the employment of retired public officials consistent with post employment requirements; and
- Investigates and handles petitions and corruption charges.

The FSS also has a Chief Auditor (see Article 29(4) AEFSC) appointed by the President on recommendation of the Chair of the FSC and an Internal Audit and Inspection Function that reports to the Chief Auditor and is not under management. The SFC does not have any such function independent of the FSC, and the FSC is accountable to the national authority with respect to proper accounting for its budget and resources.

#### **Conflicts of Interest and Other Matters**

The AEFSC has specific provisions providing that the non-ex officio members of the FSC Board, i.e., the two financial expert Commissioners, the Chairman, the Vice Chairman, the head of the FSC Secretariat and the Governor of the FSS may not concurrently engage in profit-making business and be appointed as state officials in public service. The AEFSC also provides that where the Governor is conflicted with the FSS, the Deputy Governors should act on his behalf in the order of precedence set forth in the articles of incorporation of the FSS (Articles 9, 31, and 34). All the foregoing persons are subject to limitations on other public officials related to integrity and loyalty.

Employees of the FSC and the FSS are subject to general rules relating to the avoidance of conflicts of interest. Employees and members of the Boards are subject to legal provisions against conflicts of interest and also to a Code of Conduct, which are intended to prevent an employee or commissioner from taking action where they would have a personal interest.

All personnel of the authorities are subject to the Act on Real Name Financial Transactions and Guarantee of Secrecy. Persons who are non-public official commissioners of the FSC or SFC and officers and employees of the FSS are deemed public officials for purposes of the penal provisions of the Criminal Act or any other Act such as civil servant law (AEFSC Article 69), in particular, treatment of certain employees as public officials for purposes of applying anti-bribery provisions of Articles 129-130 of the Penal Code by the Enforcement Decree of the AEFSC. Similarly, the FSS is a government chartered private entity, whose employees will be deemed to be government servants with respect to penal laws

<sup>12</sup> This refers to the registration of property and related provisions.

	<p>prohibiting certain conduct in exercising their inspection and other functions. Duties may be delegated to FSS personnel by both the FSC and the SFC respectively.</p> <p><b>Holding and Trading Securities</b></p> <p>The FSCMA states in Article 441 that the limitations of trading and the requirement for quarterly reporting of aggregate transactions above the value specified in relevant guidance (now KRW 10 million), apply to all members of the FSC and public officials under its control as well as members of the SFC and the Governor, Deputy Governors, Assistant Governors, Auditor and employees of the FSS. The trading restrictions apply to listed equity securities and debt, depository receipts, and derivatives indexed or related to the same. Annual property registration provisions apply to persons above Grade 4. At the FSS, trades cannot be margined, no more than 50 trades can be made per quarter, there can be no conflict with responsibilities or use of non-public information and the annual total value of trades cannot exceed 50 percent of earned income reported for taxation. In the case of the FSC a blind trust may be required under certain circumstances.</p> <p>The Audit and Inspection functions of both the FSC and FSS can conduct inspections as to compliance and required reports are filed with the audit units. However, the processes for the oversight and monitoring of trading restrictions and their application are not documented. Further there was substantial confusion among employees as to the scope and application of the existing limitations, reporting requirements and restrictions.</p> <p><b>Confidentiality</b></p> <p>The personnel of the authorities are required to maintain the confidentiality of information acquired in the course of their duties and may not use such information for financial transactions or otherwise for personal gain (see Article 60 of the State Public Officials Act and Article 35(2) of the AEFSC). Under Article 127 of the Criminal Act and Article 68(1) of the AEFSC, an officer or employee of either the FSC or FSS may be found guilty of a criminal offense punishable by imprisonment or a fine for the disclosure of confidential information. Although the FSS takes strict internal control measures, including mandatory ethics course offered to all FSS employees to prevent such disclosures from happening, there has been one case where an employee of the FSS was criminally prosecuted for breach of these confidentiality provisions in 2012, when the employee unlawfully disclosed information relating to the suspension of mutual savings banks in Korea.</p> <p><b>Monitoring</b></p> <p>The Internal Audit and Inspection Office of the FSS surveys the executives and employees of financial institutions that have recently obtained a license or undergone an on-site examination to identify whether FSS supervisors and examiners engaged in any inappropriate or unethical behavior. Market participants confirmed that visits were made by that function to regulated entities after an inspection to confirm that the exercise was properly conducted. Whistleblowers also can complain to the FSS of such behavior and their anonymity will be protected.</p>
Assessment	Broadly Implemented
Comments	<p>There seemed to be substantial confusion about applicable securities trading restrictions among staff. Monitoring of compliance with securities holding and trading rules is not documented and could not be confirmed. The requesting of information from audited entities about inappropriate behavior while seemingly a benign way of enforcing professional conduct might be viewed, depending on how it was conducted in practice, as a means for the FSC interference with the FSS examination program.</p>

<b>Principle 6.</b>	The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.																																									
Description	<p>The Korean authorities assess systemic risk using prescribed early warning thresholds and real time economic and market reports from the Watch Dog (KFIC). They also evaluate multiple risk indicators, including potential macro-indicators differentiated by sector known as “Handy Indicators of Financial Institutions”. Ten of these relate specifically to securities.</p> <p><b>Micro Factors: Bottom-up Analysis</b></p> <p>Micro-indicators under the RAMS applied to brokers, related systems for banks and insurers, and the Management Evaluation Regulatory Framework (MERF) complement the macro-level analysis. For the most part risk assessments and risk management rely on close monitoring of matters intrinsic to each sector rather than on analyzing interconnections. The following risk indicators provided by the FSS explain some of the factors evaluated on a daily basis and aggregated periodically.</p> <table border="1" data-bbox="347 695 1510 1650"> <thead> <tr> <th data-bbox="347 695 508 825">Sector</th> <th data-bbox="508 695 699 825">Asset Quality</th> <th data-bbox="699 695 899 825">Liquidity, Profitability</th> <th data-bbox="899 695 1092 825">Market Credit-Worthiness</th> <th data-bbox="1092 695 1282 825">Risk Involved with Asset Growth</th> <th data-bbox="1282 695 1510 825">Risk Management</th> </tr> </thead> <tbody> <tr> <td data-bbox="347 825 508 989">Insurance (Life/Non-Life)</td> <td data-bbox="508 825 699 989">Delinquency rate</td> <td data-bbox="699 825 899 989">Balance of fund ratio, claims payment rate</td> <td data-bbox="899 825 1092 989"></td> <td data-bbox="1092 825 1282 989">Increase/reduction of loans</td> <td data-bbox="1282 825 1510 989">Securities valuation loss rate</td> </tr> <tr> <td data-bbox="347 989 508 1152">Securities</td> <td data-bbox="508 989 699 1152"></td> <td data-bbox="699 989 899 1152">Short-term liquidity ratio</td> <td data-bbox="899 989 1092 1152"></td> <td data-bbox="1092 989 1282 1152"></td> <td data-bbox="1282 989 1510 1152">Securities valuation loss rate, derivatives risk rate</td> </tr> <tr> <td data-bbox="347 1152 508 1278">Asset management</td> <td data-bbox="508 1152 699 1278"></td> <td data-bbox="699 1152 899 1278"></td> <td data-bbox="899 1152 1092 1278">NAV reduction ratio &amp; days</td> <td data-bbox="1092 1152 1282 1278"></td> <td data-bbox="1282 1152 1510 1278">Money Market Fund market value differential rate</td> </tr> <tr> <td data-bbox="347 1278 508 1442">Credit-specialized financial institutions</td> <td data-bbox="508 1278 699 1442">Normal payment rate and newly counted</td> <td data-bbox="699 1278 899 1442"></td> <td data-bbox="899 1278 1092 1442">Issuance spread between corporate</td> <td data-bbox="1092 1278 1282 1442"></td> <td data-bbox="1282 1278 1510 1442"></td> </tr> <tr> <td data-bbox="347 1442 508 1650">Mutual savings banks</td> <td data-bbox="508 1442 699 1650">Delinquency rate</td> <td data-bbox="699 1442 899 1650">Short-term borrowing rate, interest rate spread of time</td> <td data-bbox="899 1442 1092 1650">Increase/reduction ratio of deposits</td> <td data-bbox="1092 1442 1282 1650">Percentage of new real estate-related lending/total lending</td> <td data-bbox="1282 1442 1510 1650">Securities valuation loss rate</td> </tr> </tbody> </table>						Sector	Asset Quality	Liquidity, Profitability	Market Credit-Worthiness	Risk Involved with Asset Growth	Risk Management	Insurance (Life/Non-Life)	Delinquency rate	Balance of fund ratio, claims payment rate		Increase/reduction of loans	Securities valuation loss rate	Securities		Short-term liquidity ratio			Securities valuation loss rate, derivatives risk rate	Asset management			NAV reduction ratio & days		Money Market Fund market value differential rate	Credit-specialized financial institutions	Normal payment rate and newly counted		Issuance spread between corporate			Mutual savings banks	Delinquency rate	Short-term borrowing rate, interest rate spread of time	Increase/reduction ratio of deposits	Percentage of new real estate-related lending/total lending	Securities valuation loss rate
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	<p><b>Macro Factors: Top-down Analysis</b></p> <p>Since July 2012, the Vice Minister of the MOSF, the Vice Chair of the FSC, the Deputy Governor of the FSS, the Deputy Governor of the BOK, and the Vice President of the KDIC have convened the MPFM (or Council) on an ad hoc basis. As needed, it considers the emerging macro-prudential issues that could become potential systemic issues, reviews channels for risk transmission and considers the potential</p>																																									



	<p>impact of macro-prudential matters on financial stability, contagion among institutions and general economic health in the real sector. This group executed an MoU in September 2012, in which the participants agreed to share annual business and other periodic reports, including material event reports obtained as part of their regular operations. Various of the advisory committees described in Principle 4 also provide input to the authorities' assessment of systemic risks, including a specialist Macro-Prudential Risk Advisory Committee.</p> <p>An explicit macro-prudential function is also located within the FSS under the Senior Deputy Governor for Planning and Management. According to the information provided by the FSS it is designed to monitor systemic risks in the financial markets on a cross-sectoral basis. The mission did not find evidence that the processes of this function would be reflected in other affected departments, possibly because of the significant hierarchical divisions and siloed operations within the regulatory/supervisory structure.</p> <p><b>Triggers for Heightened Reporting and Stress Testing Across Sectors</b></p> <p>The FSS has also established early warning levels and identified key risk indicators for each financial sector. It reviews reports about financial institutions on daily, weekly, monthly and other periodic bases and undertakes scenario analysis and stress testing. The overall framework incorporates multiple special funds that can be tapped for injecting liquidity, for example Korea Securities Finance Corporation (KSFC), which is owned by financial institutions participating in the market, KRX and KSD. The KSFC holds customer cash deposits and engages in securities financing activities. The FSS also is developing a group of risk specialists, hiring experts with modeling and other risk management skills, and managing its employees in a way that by rotation they become acquainted with multiple parts of the overall financial system. Further, the use of structured debt and other financial instruments that can magnify interconnections between the sectors is relatively limited at this time, stringently managed from issuance to distribution, and not of the type of exotic instruments (e.g., CDO squared) with embedded leverage that multiplied risk in other jurisdictions. Also, leverage has been moderated under recent reforms and legislation permitting establishment of a CCP to address OTC clearing was approved in March 2013.</p> <p><b>Potentially Insufficient Regard to Securities-based Risks</b></p> <p>Nonetheless, there remains some indication that financial investment business entities may attempt to hide exposures and that the potential for risk to migrate from the securities sector to other sectors may be being undervalued. In fact, the mutual savings banks collapse is indicative that liquidity crises can become solvency crises. In this respect the authorities recently evaluated and limited securities companies' access to the short term lending market (call market) to 25 percent of their capital and further reforms are pending. Fairly contemporaneously, with the view to limiting liquidity risks, the BOK Macro-Prudential Analysis Department conducted analysis, for example, of shadow banking and the exchange- traded fund (ETF) markets in Korea. Nonetheless, the existing micro-prudential inspection process appears extremely siloed considering the number of large, integrated financial groups and the advantage of having a single operational entity to manage financial institution inspections and supervision for all sectors.</p>
Assessment	Broadly Implemented
Comments	<p>The MOSF acknowledged that there might be liquidity risks in the system that could impact the financial sector adversely and expressed a concern about European and other exogenous risks. At the same time, it noted that its principal concerns were exchange rate stability (having a long memory for the Asian crisis), and the sustainability of the economic return on financial sector business for demographic and other reasons that might cause overall demand to decline. At all levels, the authorities were candid in stating their judgment that the likelihood that information generated through capital markets would be</p>

	<p>material to a debate on managing, monitoring and mitigating systemic and macro-prudential risks was remote.</p> <p>As the impact of risks generated from one part of the system on another part is difficult to predict reliably, the possibility that risks could emanate from the securities sector or that securities transactions could be used to disguise risks should be considered more seriously. It appears that insufficient work has been done to date on mapping interconnected risks, notwithstanding the advantage of the integrated structure for all financial institutions including banks, insurance companies and securities companies, around which Korean financial market supervision is organized. It is also possible that conduct risks in the securities and derivatives markets have not been factored sufficiently into discussions on systemic risk. As set forth under Principle 7, all these matters need to be assessed on a continuous basis. As the role of clearing is expanded to OTC products, and as new products are permitted and new trading and clearing links are agreed, the related risks should be evaluated and integrated with other risk management and contingency planning activities.</p>
<b>Principle 7.</b>	The Regulator should have or contribute to a process to review the perimeter of regulation regularly.
Description	<p><b>Defining the Perimeter</b></p> <p>The basic rule in Korea is that “fund raising” by any person must be conducted by either an authorized or an exempt entity, even if such entity is not specifically identified as a financial institution as a matter of law. The Act on the Regulation of Conducting Fund-Raising Business Without Permission of 2000 (as amended in 2010) makes it a criminal offence to conduct a fund-raising business without obtaining the appropriate authorization, which is punishable by imprisonment for up to five years and also by a fine of up to KRW 50 million. This Act also prohibits the use of a trade name similar to a financial business and advertisements related to such unauthorized business. See also Articles 11 and 17 of the FSCMA that prohibit engaging in an investment advisory business or a discretionary investment business without registration or other financial investment business without authorization.</p> <p><b>Evaluating the Perimeter</b></p> <p>The FSS has an internal process to evaluate ongoing supervisory performance. It undertakes an annual self-assessment or a 360 degree review process and requires the same of firms. The FSS Internal Audit function also provides feedback about the regulatory/supervisory processes. Additionally there is a process for the review of customer complaints relative to the market and to regulatory services that may surface unregulated activities that should be within the regulatory system, which in practice would be escalated for further review. The industry (KOFIA, the Korean Chamber of Commerce and Industry, and others), the various advisory committees, including the informal committees (see Principle 4), and the media may also bring issues about market evolutions to the attention of the authorities.</p> <p><b>Seeking Legislative and Regulatory Change</b></p> <p>The authorities have a robust ongoing process to seek change necessary to keep abreast of international developments. Through an active process to benchmark the FSS and FSC rules and procedures against other jurisdictions and international standards, Korea has successfully advanced the adoption of IFRS and ISAs (see Principles 18 and 21), obtained legislative approval of an OTC derivatives CCP, and augmented the process for oversight of auditing (Principle 19), credit rating agencies (Principle 22) and other evaluators (Principle 23).</p>

	<p><b>Issue Identification</b></p> <p>Some examples of the bottom up process follow. The FSS examination teams make use of thematic examinations to determine what firms are doing and to test Korea’s exposure to misconduct occurring in other jurisdictions. Not only do these inspections and other supervisory activities result in recommendations or exception reports affecting individual regulated entities, but also they may cause more general guidance to be issued or discussions with the regulated community to be undertaken. Recently, the FSS discovered that the industry was selling loans of up to three years duration as commercial paper and also had designed other collective investment instruments using deposits to attempt to avoid certain regulatory requirements that pertain to collective investment schemes or other regulated instruments. The FSS in consequence issued guidance to constrain such activities. Staff of the FSS reports that they actively review new sales and product activity and are alert to emerging problems within their respective assigned areas, though the results of the overall assessment and performance review process may not be as widely distributed as optimal and internal silos may also prevent the optimal flow of information.</p>
<p>Assessment</p>	<p>Broadly Implemented</p>
<p>Comments</p>	<p>The authorities do have a bottom-up practice of identifying new areas of concern and a routine process for collecting information on market evolutions. However, the means by which results are disseminated and the way that the process feeds into policy responses to and from the top are not documented. Consideration should be given to documenting and refining the existing process for policing the perimeter, for escalating issues for further review, for developing policy related to that process, and for assuring that the efficiencies and information advantages of an integrated system of functional regulation are fully maximized and not adversely affected by silo thinking.</p>
<p><b>Principle 8.</b></p>	<p>The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.</p>
<p>Description</p>	<p>The legal requirements for financial investment business entities clearly specify the various requirements to prevent conflicts of interest. Financial investment business comprises:</p> <ul style="list-style-type: none"> <li>• Investment trading business;</li> <li>• Investment brokerage business;</li> <li>• Collective investment business;</li> <li>• Investment advisory business;</li> <li>• Discretionary investment business: and</li> <li>• Trust business.</li> </ul> <p>Both authorized and registered financial investment business entities must have a system for preventing conflicts of interest as a condition of initial approval (authorization and registration) and policies and procedures for applying this system as part of their ongoing operation. Each type of regulated entity must have a system for preventing conflicts “between the financial investment business entity and investors as well as between a specific investor and other investors,” as detailed by the relevant Enforcement Decree (FSCMA Articles 12(7) and 18(6)). If a firm uses investment solicitors that make investment recommendations as an equity raiser, the authorized entity must control/supervise its agent investment solicitors in good faith so that their activities do not undermine fair practices (FSCMA Articles 51 and 52(4),(5)). Such solicitors cannot handle funds.</p>

**Specific Prohibitions**

From the perspective of issuance and underwriting of securities, research analysts and functions within a financial investment business entity cannot receive remuneration contingent on the success of any underwriting, as such compensation arrangements are prohibited (FSCMA Article 71(3)). Therefore, research compensation cannot be tied to sales. Additionally, an investment broker or trader is prohibited from trading on its own account based on forecasts until 24 hours after they are released or from providing special information to its clients between a contract for an IPO and the actual offering (Articles 71(2) and (4)). A financial investment business entity is required to explore the potential for conflicts between itself (or between its businesses) and any investor and to either disclose the potential conflict, not engage in the related business activity for that investor, or to erect an appropriate Chinese wall (see Articles 44 and 45 FSCMA, related Enforcement Decree Article 31 et seq. and Regulations on Financial Investment Business Chapter II, Article 2-21 and Chapter IV, Conduct of Business regarding investment recommendations and supply of information to affiliated entities among other things).

**Systems and Oversight**

Within each financial investment business entity, the system for prevention of conflicts of interest must be designed to detect, evaluate and manage conflicts of interest and be reflected in guidelines that are reasonable and verifiable. The system must be tested by the financial investment business entity from time to time and updated to reflect issues that arise in the course of carrying on the business and to ensure that the potential for new types of conflicts is a matter of ongoing oversight.

**Additional Provisions Affecting Specialist Entities***Major shareholders*

Additional provisions apply to a major shareholder of a financial investment business entity. Such shareholders are prohibited from exercising undue influence, obtaining special information, or otherwise pursuing their own interests in conflict with the interest of the entity in which they hold shares (FSCMA Article 35).

*Self-Regulatory Organizations*

Separate provisions also apply to SROs (see below) and separate SRO rules on conflicts of interest apply to SRO members, which are required to have their own ethical standards. These standards establish additional requirements for Chinese Walls and contacts between the corporate finance and the research and analysis departments, including: (i) documentation and oversight by a compliance officer; (ii) the exercise of appropriate due diligence; (iii) the general duty of loyalty; (iv) the prohibition of receipt of gifts; and (v) the requirement to verify the reliability of research materials (see KOFIA conduct of business standards or best practices). A list of financial analysts at each firm and information on their years of experience, good standing, and any other affiliations is posted on the KOFIA website.

*Credit Rating Agencies and Other Evaluators*

There is also a full complement of requirements relative to credit rating agencies (CRAs) and to other evaluators whose services have regulatory implications. These include bond rating companies (which are affiliated with the CRAs) and other providers of evaluating services, such as fund rating agencies that rate CIS performance (see related discussions under Principles 22 and 23). Auditors are also subject to conflict of interest requirements (Principle 20).

Assessment	Fully Implemented
Comments	See also Principles 29 and 31, which address ongoing monitoring among other things and Principles 19 and 20 on auditor independence.
<b>Principles for Self-Regulation</b>	
<b>Principle 9.</b>	Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.
Description	<p>The law provides for the following SROs:</p> <ul style="list-style-type: none"> <li>• The <b>KRX</b> at <a href="http://eng.krx.co.kr/m7/m7_2/m7_2_1/m7_2_1_1/UHPENG07002_01_01.html">http://eng.krx.co.kr/m7/m7_2/m7_2_1/m7_2_1_1/UHPENG07002_01_01.html</a>;</li> <li>• <b>KOFIA</b> at <a href="http://www.kofia.or.kr/kofia/index.cfm">http://www.kofia.or.kr/kofia/index.cfm</a>; and</li> <li>• Korea Institute of Certified Public Accountants (<b>KICPA</b>) at <a href="mailto:global@kicpa.or.kr">global@kicpa.or.kr</a>.</li> </ul> <p>Under the FSCMA, the FSC may delegate part of its authority to the KRX or KOFIA (Article 438) and may entrust part of its inspection responsibilities to the KRX and KOFIA (Article 419(8)). The FSC and SFC have delegated certain tasks and responsibilities to KICPA under the Act on External Audit of Stock Companies and CPA Act (see Principle 19).</p> <p>The <b>KSD</b>, owned 70.4 percent by the KRX, is also established with SRO responsibilities by statute. Article 294 of the FSCMA provides for a corporation to serve as a central depository, pursuant to specificities set out by the Enforcement Decree, subject to inspection under Article 419, with the ability to adopt business rules (Articles 302 and 303) subject to submission of its rules and their amendments for the approval of the FSC (Article 305). The Board of Audit conducts financial audits of the KSD, and the MOSF has a role in the appointment and dismissal of any external auditor of the KSD.</p> <p>In fact, each SRO has particular self-regulatory functions, delegated functions and statutory functions and the FSS tailors its oversight to the SRO.</p> <p><b>Korea Financial Investment Association</b></p> <p>KOFIA, established by law as a membership organization (FSCMA Article 283) has 165 regular, 116 associate and 20 special members representing respectively authorized (i) securities companies, futures companies, and collective investment business entities; (ii) providers of financial investment business activities within banks, financial holding companies, insurance companies, and advisors; and (iii) credit rating agencies, bond pricing agencies, CIS administration companies, and others. It conducts the following self-regulatory activities (Article 286):</p> <ul style="list-style-type: none"> <li>• Investor protection—determination of terms of standard account opening documents and review of advertisements;</li> <li>• Registration of qualified individual professionals (in seven different categories);</li> <li>• Issuance of suitability and other business conduct and customer protection rules, such as prohibition of cold calls;</li> <li>• Dispute resolution;</li> <li>• Registration of over-the-counter transactions in bonds; and</li> </ul>

- Assistance of the FSS in performing inspections by a sampling of branches (80 percent/year).

It also adopts regulations for its members. Currently its rulebook (best practices), which covers several areas of securities operations and proper conduct of business, totals 925 pages. Among other things the rules cover standard account opening requirements for different types of accounts (including futures accounts), ethics rules, internal control rules, and business conduct and suitability rules.

KOFIA also registers OTC bond trades in its system, which provides a message board, chat rooms, quotations and yields for eight types of bonds and 51 reference points. It also operates the Freeboard unlisted equity market that is 99 percent retail (see Secondary Markets Principles).

### **Korea Exchange**

The KRX is a stock company provided for by Article 373 of the FSCMA mostly owned by members. It operates the listed equity and bond market, the futures/derivatives market (formerly KOFEX), and the KOSDAQ (SME) market. By law, until the implementation of the pending changes, the KRX has a monopoly position for the trading of securities and derivatives through a central matching facility (FSCMA Article 386). It also conducts both real-time and batch market surveillance, undertakes initial investigations of market abuses, and sells market data. KRX's rule books include operational rules, disclosure rules, pricing rules for block trades, prohibitions on members accepting contracts which appear to violate the market abuse provisions of the FSCMA, and requirements on settlements of accounts, contributions to the compensation fund and other matters. KRX has approximately 696 staff, of which 121 engage in self-regulatory market surveillance and member supervision. It also conducts other self-regulatory activities, such as listings and review of compliance with the requirements for timely, fair and periodic disclosures (to which 100 staff are committed), regulation of the exchange operations, and the detection, deterrence, and disciplinary action relative to aberrant activity in the markets that it operates.

The governance of the market supervision function of the exchange is set by law. The KRX must have a Market Supervision Committee (Commission)<sup>13</sup>, whose Chairman is appointed by the general meeting of shareholders of the KRX (FSCMA Article 402). The membership of the Market Supervision Committee must include two persons recommended by the Chairman of the FSC and two persons recommended by KOFIA. Members of the Committee are appointed for a fixed term of three years. The Market Supervision Committee is responsible for market surveillance, supervision of members, cross market surveillance between the cash and derivatives markets, discipline of members, dispute resolution, and development and refinement of surveillance rules under applicable law (see e.g. Article 403). Committees for KOSPI and KOFEX that hear matters are chaired by the President of the exchange, two independent directors and one investment broker.

Regulations for the KRX markets can be found at [http://eng.krx.co.kr/m7/m7\\_1/m7\\_1\\_1/JHPENG07001\\_01.jsp](http://eng.krx.co.kr/m7/m7_1/m7_1_1/JHPENG07001_01.jsp). Per the KRX website, its membership of 94 includes 57 firms of which seven are futures firms, 20 banks, 16 foreign branches and one national cooperative.

The KRX conducts inspections for members' compliance with market rules two times per year, and has brought multiple disciplinary actions. It does not however systematically publish the results of its disciplinary actions. The KRX reported that during the prior three years it conducted 565 investigations

<sup>13</sup> This Committee is referred to as a Commission (see Organization Chart under Principle 33) and Committee in various translations of the law.

for unfair trading abuses, and concluded 112 disciplinary cases against members, and 70 cases against members' employees.

#### **Korean Institute of Certified Public Accountants**

KICPA is provided for under Article 41 of the CPA Act. Membership by certified public accountants and audit firms and teams is compulsory. KICPA is a juristic person. It can establish rules of ethics and other matters pursuant to bylaws approved by the FSC. KICPA is responsible for registering CPAs pursuant to delegation from the FSC, taking minor disciplinary measures with respect to matters delegated by the FSC, setting and revising audit standards, subject to FSC approval, mediating disputes between CPAs and their clients, and providing training and guidance for its member CPAs as well as career development and continuing education opportunities. 40 hours of annual continuing education is required. KICPA has 16,000 members, of which 10,000 are registered as individual CPAs. There are 125 audit firms, 32 of which are supervised by the FSS and the remainder of which are subject to oversight by KICPA (see Principles 19-21).

#### **Oversight by Financial Supervisory Service**

Articles 292 and 410 of the FSCMA permit the FSS to oversee the self-regulatory activities of KOFIA and KRX and to monitor any regulatory delegation or services undertaken on its behalf. In this regard the FSS can inspect KOFIA and KRX and does so biennially. The FSS also can require KOFIA and KRX to submit rules or rule changes for information and/or approval and to file such reports and respond to such inquiries related to its business operations and property as the FSS or FTC may require (see e.g., Article 412). These oversight powers also apply to the KSD (see, for example, Article 305). The FSS conducted full scope on-site reviews of KRX in 2008 and 2010 and of KOFIA in 2009 and 2011. Each review resulted in exception reports, management recommendations and requests for improvement. Although the FSC delegates various matters to the SROs (for example the oversight of derivatives position limits), the FSC and SFC retain full authority to address market abuse and other matters directly and have greater authority to sanction the employees of member firms and their customers than do KRX and KOFIA.

#### **Oversight by the Fair Trade Commission**

The Fair Trade Commission also has a limited role to prevent anti-competitive conduct by the SROs. This may include review of their contract terms and pricing conduct.

#### **Governance and Ethical Conduct**

The FSCMA sets forth the required governance structure of the KRX, and the terms of service of the directors. The law requires that more than one-half of the directors of the KRX be outside directors (that is independent directors) as defined by law (Articles 380 and 381). The law further requires, among other things, the formation of a Market Supervision Committee that is accountable for market surveillance, including cross-sectoral surveillance, investigation of abnormal trading activity and supervision of members (Article 402).

All the SROs and their executives and employees must maintain and adhere to standards of professional conduct. They are also subject by law to a prohibition on the use or disclosure of information obtained in the course of performing their self-regulatory responsibilities except as consistent with those duties (see Principle 10). Executives and employees must also restrict their trading and business activities and adhere to guidelines and procedures in connection with trading financial instruments and to prevent any unfair conduct or conflicts of interest (see FSCMA Articles 402, 63, and 383).

Assessment	Fully Implemented
Comments	The numbers of members in each category of membership and their current status should be clarified on the public website of each SRO and more systematic information should be available on exchange disciplinary actions. Additionally more information should be available as to what oversight is provided to the operation of the KOFIA Freeboard and OTC bond trading systems.
<b>Principles for the Enforcement of Securities Regulation</b>	
<b>Principle 10.</b>	The regulator should have comprehensive inspection, investigation and surveillance powers.
Description	<p>Since Principle 10 focuses on the powers of the regulator in relation to inspections and investigations of regulated entities, the following discussion focuses on the powers of the FSS. The powers of the SFC and FSC are discussed in more detail under Principles 11 and 12, since they play a bigger role vis-à-vis other persons than regulated entities and have also a more significant role in deciding on the enforcement measures to be taken, whereas the FSS is solely in charge of inspections of regulated entities.</p> <p><b>Financial Supervisory Service Inspection Powers</b></p> <p>Under Articles 37 and 38 of the AEFSC and Article 419 of the FSCMA, the Governor of the FSS is required to perform the inspection of the status of the business and property of financial institutions subject to the FSS' inspections. Upon completion of an inspection, the Governor of the FSS is required to submit a report to the FSC. If there is any violation of the FSCMA or an order or disposition issued or made pursuant to it, his written opinion on the measures against such a violation has to be attached to the report submitted to the FSC.</p> <p>The FSC may determine the methods and procedures for inspection, the standards for measures for the results of inspection, and other matters relating to inspection work (Article 419(9) FSCMA). These are stipulated in the Regulations on Examination and Sanctions against Financial Institutions. The FSC also provides additional informal guidance to the FSS on how to conduct inspections in e.g. regular meetings.</p> <p>In practice the FSS refers to inspections as examinations and, in its capital market area, has established a Financial Investment Examination Department that is responsible for conducting the examinations of all financial institutions that fall under the responsibility of the capital market area of the FSS. Examinations may be either general examinations or partial examinations and may be conducted either on-site or through documentary examination (Articles 8 and 8-2 of the Regulations on Examination and Sanctions against Financial Institutions).</p> <p>Where an on-site examination is conducted, the financial institution concerned has to be given a prior written notice of examination including its purpose and period no later than one week before the commencement of the examination. This does not apply to any of the following cases where the achievement of the purpose of the examination is likely to be difficult if prior notice is given:</p> <ul style="list-style-type: none"> <li>• Where the achievement of the purpose of the examination is expected to be significantly affected by the possibility of forgery or destruction of data, books, documents, etc., or concealment of property of large shareholders;</li> <li>• Where significant adverse effects on financial markets are likely to be caused, such as incurring of serious worries of investors and depositors, if the fact of conducting an examination becomes known;</li> <li>• Where any extenuating circumstances arise due to lack of time for prior notice on account of</li> </ul>



	<p>checking of urgent pending matters, etc.; and</p> <ul style="list-style-type: none"> <li>• Other cases where the achievement of the purpose of the examination is likely to be difficult, as determined by the Governor.</li> </ul> <p>In practice, prior notice is almost always given for on-site examinations, whereas documentary examinations are carried out without prior notice. On-site examinations without prior notice can take place with the approval of the Heads of the FSS Examination Departments. According to the FSS, this possibility has been used in multiple instances in the past.</p> <p><b>Financial Supervisory Service Powers to Obtain Books, Records, and Data from Regulated Entities</b></p> <p>When the FSS Governor deems it necessary, he may request any financial institution subject to the FSS' examination under Article 38 of the AEFSC or any other Act or subordinate statute to submit a report or data about its business affairs or property, or may require a person involved to appear before the FSS to make an oral statement (Article 40 AEFSC and Article 419 FSCMA). Article 9 of the Regulations on Examination and Sanctions Against Financial Institutions further specifies this power by noting that the Governor of the FSS may also require affidavits, testimonies, or books and other documents of relevant persons or parties pursuant to the FSCMA and other relevant statutes.</p> <p>The Governor of the FSS is also expected to make efforts for early detection of potentially problematic financial institutions or weak areas through off-site supervision of financial institutions (Article 7 Regulations on Examination and Sanctions against Financial Institutions).</p> <p><b>Korea Exchange and Financial Supervisory Service Surveillance Powers</b></p> <p>The frontline responsibility for market surveillance lies with the KRX. One of the duties that it is required to perform under Article 377 of the FSCMA is surveillance of abnormalities in trading, including abnormal fluctuation of prices or volumes of securities or exchange-traded derivatives. According to Article 402 of the FSCMA, the KRX is required to establish a Market Supervision Committee in order to conduct market surveillance, investigation of abnormal trading and supervision of members; cross-market surveillance across KOSPI, KOSDAQ, and the derivatives market; and discipline of members or decisions on the requests for disciplinary measures against executives or employees concerned (see Principles 9 and 36). These matters have to be addressed in the Market Surveillance Regulations of the KRX to be established by the Market Supervision Committee.</p> <p>Upon completing an investigation or inspection, the market surveillance staff of the KRX submits to the KRX Market Supervision Committee<sup>14</sup> a written report on the outcomes. When becoming aware of a case violating the FSCMA, the Market Oversight Commission is required to notify such a case to the FSC (§20 of the Market Oversight Regulation of the KRX). In practice the KRX market surveillance staff copies the relevant FSS staff to these notifications to the FSC.</p> <p>In addition to the frontline responsibility of the KRX in market surveillance, the Capital Market Investigation Department 1 of the FSS has a Market Monitoring Team that monitors the market activities. The KRX has provided the FSS with real-time access to the KRX trading system. However, the FSS does not have any electronic market surveillance system, and it analyzes trading on a batch basis. The Market</p>
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<sup>14</sup> The term Market Oversight Commission is used in the KRX rules whereas the FSCMA uses the term Market Supervision Committee.

Monitoring Team feeds its observations to the other teams in the Market Investigation Department so that a decision can be made on whether there is a need to initiate an investigation.

### **Requirements for Record-keeping and Determination of Client Identity**

According to Article 60 of the FSCMA a financial investment business entity is required to keep and maintain records of data related to the operation of its business. This requirement is further specified in Article 62 of the Enforcement Decree of the FSCMA for various types of records (e.g. operations, finance, business affairs, and internal controls), with minimum record retention periods ranging from three to ten years.

The record-keeping requirements include the following specific requirements for transactions made on behalf of clients:

- Data related to investors' trading of financial investment instruments, including records and details of trading orders, and other data related to trading: ten years;
- Data related to management of investors' property, such as the collective investment property, the discretionary investment property, and the trust property: ten years; and
- Data related to contracts signed with investors, including creation of and agreement on trading accounts: ten years.

Further, pursuant to Article 4-13 and Table 12 of the Regulations on Financial Investment Business, every financial investment business entity is required to maintain (i) records of property deposited and withdrawn by investors for five years; (ii) records of safekeeping of property deposited by investors for five years; (iii) records of each investor's orders for ten years; and iv) records of each investor's transactions for ten years.

The records have to kept in the form of writing, electronic data, micro film, or similar.

According to the FSS, it has the authority to have access to the identity of all clients of regulated entities pursuant to Article 6 of the Regulations on Examination and Sanctions against Financial Institutions, according to which an examiner, when necessary for performing his/her examination duties, may take the following measures:

- Request for submission of certificates, confirmations, opinions, answers to inquiries, and other relevant documents and objects;
- Sealing of safes, books, objects and other storage places;
- Request for the appearance and statements of a relevant person of the financial institution concerned; and
- Other measures deemed necessary for the examination.

### **Outsourcing of Inspections to Self-Regulatory Organizations**

The Governor of the FSS may delegate part of the examination work that he is required to undertake to the KRX or KOFIA (Article 419(8) FSCMA). The examinations that the Governor may delegate to KOFIA relate to examinations on investment solicitors, self-regulatory requirements on underwriting of securities, and compliance with the terms and conditions of standardized contracts (Article 372(1))

	<p>Enforcement Decree of the FSCMA). In practice KOFIA also conducts branch examinations on behalf of the FSS.</p> <p>KOFIA is required to observe the guidelines prescribed by the Governor of the FSS for the method, procedure, etc. for an examination carried out by it. It must report the results of its examinations to the FSS Governor without delay upon completion of the examination.</p> <p>Article 14 of the Regulations on Devolution and Entrustment of Administrative Competence requires that the government or a government related entity conducts proper supervision of the delegate and provides instructions to it. According to Article 292 of the FSCMA, KOFIA receives examinations conducted by the Governor of the FSS. The examination powers of the FSS and the requirement for it to report the results of its examinations to the FSC provided in Article 419 of the FSCMA apply also to the examinations of KOFIA.</p> <p>Pursuant to Article 372(3) of the Enforcement Decree of the FSCMA and Article 16-2 of the Regulations on Devolution and Entrustment of Administrative Competence, the Governor of the FSS may order KOFIA to take corrective measures and/or impose disciplinary actions on its executives or employees. He can also terminate the delegation, if KOFIA's performance is improper or conflicts with relevant laws and/or regulations (Article 14-3).</p> <p>The KRX self-regulatory functions are defined in Article 402 of the FSCMA. The KRX may examine business, financial status, books, documents, and other materials related to the members and request a financial investment business entity (limited to a broker or dealer that provides financial investment services for securities or exchange-traded derivatives) to submit relevant data after specifying the reasons in writing. This may be done in order to identify trading circumstances of securities or exchange-traded derivatives in cases where abnormal trading on the securities or derivatives market is suspected, or in order to ensure that members comply with the Business Regulations of the KRX (Article 404(1) FSCMA).</p> <p>According to Article 410 of the FSCMA, the FSC may, if necessary for the protection of investors or sound trade practice, order the KRX to submit reports or references related to its business and property, and have the Governor of the FSS inspect the business, financial status, books, documents, or other materials related to the KRX.</p> <p>The prohibition on the use of job-related information applies also to KOFIA. More specifically, it is not allowed to use information known to it in the course of its business and undisclosed to the public for its own or a third party's interest without a justifiable ground (Articles 54 and 289 FSCMA). With regards to the KRX, similar confidentiality requirements apply. According to Article 402(7) of the FSCMA, any person who serves, or has served, as a member of the KRX Market Supervision Committee is prohibited from using or divulging any confidential information in connection with its duties.</p>
Assessment	Fully Implemented
Comments	The FSS, KRX and KOFIA have sufficient examination, investigation and surveillance powers vis-à-vis regulated entities. The regulators' investigative and enforcement powers applicable to other persons than regulated entities are discussed under Principles 11 and 12. Principle 12 also discusses the effectiveness of the use of the examination, investigation and surveillance powers that the FSS and the SROs have.
<b>Principle 11.</b>	The regulator should have comprehensive enforcement powers.
Description	<b>Power to Require Records, Statements, and Testimony</b>

The powers of the FSS to require records, statements, affidavits, testimonies, books or other documents are covered in Principle 10 above. On the basis of Article 419 of the FSCMA, its powers to require records and statements appear to extend beyond regulated entities. However, both the FSC and FSS are of the view that the FSS does not have powers vis-à-vis other than regulated entities, their executives and employees.

The FSC may, if there is a violation of the FSCMA or an order or disposition issued or made pursuant to it, or if it is deemed necessary for protecting investors or maintaining sound trade practice, order any person concerned to submit a report or materials for reference (Article 426(1) FSCMA). This power is provided to the SFC in case the violation relates to the unfair trading provisions of Articles 172–174, 176, 178, and 180. The FSC and SFC may also demand any person concerned to submit a statement on the facts and status of the case under investigation; attend as witness for a case under investigation; or submit account books, documents, and other materials necessary for the investigation (Article 426(2)). A person who does not comply with a demand made by the FSC or SFC is subject to imprisonment for not more than three years or to a fine not exceeding KRW 100 million. These powers have been delegated to the FSS under the delegations in Attachment 20 of the Enforcement Decree of the FSC.

In addition, under Article 427 of the FSCMA, the SFC may, if deemed necessary for investigating a violation of any provision falling under its area of responsibility, assign investigative officials among those who work for the FSC to interrogate the suspect involved in such a violation, seize goods, or search a place of business, etc. Whenever they conduct a seizure or search for investigating a violation, the officials are required to carry a warrant for seizure and search issued by a judge upon a public prosecutor office's request.

However, according to the FSC staff the above powers have not been exercised in practice for several reasons, including the fact that unfair trading cases have historically been addressed as criminal cases in Korea, the FSC and SFC do not have sufficient resources and expertise to exercise the powers, and they would in the end need to refer the cases to the public prosecutor's office anyway for criminal prosecution.

#### **Power to Take Administrative Measures**

The FSC and SFC have the power to take various administrative measures in certain cases specified in the FSCMA. Taking some of these measures has been delegated to the FSS.

##### *Regulated entities*

In case of certain breaches specified in the FSCMA, the FSC can take the following measures in relation to regulated entities (see e.g., Article 420 of the FSCMA):

- Revoke authorization or registration;
- Suspend the business entirely or partially for up to six months;
- Order to transfer contracts;
- Order to correct or discontinue violation;
- Order to publicly disclose or notify the fact that the entity has become subject to a measure due to its violation;
- Issue an institutional warning;
- Issue an institutional caution; or

	<ul style="list-style-type: none"> <li>• Take any of the measures specified in Article 373(5) of the Enforcement Decree of the FSCMA as necessary, including closing the branch offices or other sales offices or suspending their business completely or partially; demanding or recommending improvement of methods of business management or operation; demanding compensation for losses; filing criminal complaints or informing an investigative agency of violations of the FSCMA; or informing a related agency or an investigative agency of violations of other Acts.</li> </ul> <p>Issuing an institutional warning and caution as well as demanding or recommending improvement of methods of business management or operation and demanding compensation for losses has been delegated to the FSS.</p> <p>The FSC has a limited possibility to impose civil money penalties<sup>15</sup> on financial investment business entities under Article 428 of the FSCMA. A civil money penalty of 20 percent of the violated amount may be imposed in case of a breach of the prohibitions on cross-ownership and related party lending included in Article 34(1) of the FSCMA. The FSC may also impose a civil money penalty on a financial investment business entity in lieu of a business suspension within the limit of the benefits of a period of suspension of business. These civil money penalties can be imposed only when the breach has been intentional or grossly negligent.</p> <p>In addition, the FSC can issue a fine for negligence not exceeding KRW 50 million in the case of violations of certain specific provisions of the FSCMA (Article 449 FSCMA).</p> <p><i>Executives of regulated entities</i></p> <p>The FSC has the possibility to take the following measures against executives of a regulated entity (see e.g. Article 422(1) FSCMA):</p> <ul style="list-style-type: none"> <li>• Request for dismissal;</li> <li>• Suspension from office for up to six months;</li> <li>• Disciplinary warning;</li> <li>• Warning;</li> <li>• Caution; or</li> <li>• Other measures specified in Article 374(2) of the Enforcement Decree of the FSCMA, including filing criminal complaints or informing an investigative agency of violations of the FSCMA or informing a related agency of violations of other Acts.</li> </ul> <p>Making a request for dismissal and issuing a warning or caution to an executive has been delegated to the FSS.</p> <p><i>Employees of regulated entities</i></p> <p>In relation to employees of regulated entities, the FSC may demand the regulated entity to take any of the following measures against any of its employees (see e.g. Article 422(2) FSCMA):</p>
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<sup>15</sup> The FSCMA and its Enforcement Decree use the term penalty surcharge whereas the Regulations on Examination and Sanctions against Financial Institutions use the term civil money penalty that is used in this report.

- Removal from office;
- Suspension from office for six months or less;
- Salary reduction;
- Reprimand;
- Warning;
- Caution; or
- Other measures specified in Article 374(2) of the Enforcement Decree of the FSCMA (see item 6 above for executives).

All the above measures except those noted in items 1 and 7 have been delegated to the FSS.

#### *Breach of disclosure obligations*

With regards to the breach of the public disclosure obligations, the FSC may demand the issuer, seller, underwriter, or other relevant party to restate the disclosed facts; suspend or prohibit the issuance, public offering or sale or any other transaction of such securities; or take any of the measures prescribed in the Enforcement Decree of the FSCMA, if necessary (see e.g. Article 132 of the FSCMA and Article 138 of the Enforcement Decree of the FSCMA). The latter measures can consist of imposing restrictions on the issuance of securities within the limit of one year; recommending the dismissal of executives; filing criminal complaints or informing a competent investigative agency of violations of the FSCMA; informing a related agency or an investigative agency of violations of any other Act; or issuing warnings or cautions. Similar measures apply in case of a failure to notify the acquisition of at least 5 percent of the stocks or other equity securities of a stock-listed corporation (see Principle 17).

The FSC may also impose a civil money penalty within the limit of 3 percent of the value of the public offering or sale or tender offer (with a maximum of KRW 2 billion) in case a person does not comply with the relevant disclosure obligations (Article 429 FSCMA). Similarly, if a corporation breaches the obligations relating to the submission of a business report, the FSC may impose a civil money penalty within the limit of 10 percent of the average daily trading amount of the corporation's stocks during the immediately preceding business year (with a maximum of KRW 2 billion). As noted above, these civil money penalties can be imposed only when the breach has been intentional or grossly negligent. In addition, as in the case of regulated entities, the FSC can issue a fine for negligence not exceeding KRW 50 million in the case of violations of certain specific provisions of the FSCMA (Article 449 FSCMA).

The FSC has delegated the authority to take measures against breaches of disclosure obligations to the SFC except for civil money penalties above KRW 500 million, business suspensions in whole for one month or longer, and closure of branch offices or other sales offices (Article 387(2) Enforcement Decree of the FSCMA). Issuing warnings or cautions has been delegated to the FSS.

#### *Unfair trading*

In the unfair trading cases covered in Article 174 (insider trading), 176 (market manipulation), and 178 (other types of unfair trading) of the FSCMA, the SFC may issue an order to correct or take other measures prescribed in Article 376 of the Enforcement Decree of the FSCMA. In case of regulated entities, their executives and employees, the above measures would apply. In case of other persons, the SFC can issue a caution or warning, file a criminal complaint, inform an investigative agency of a violation of the FSCMA, or inform a related agency or an investigative agency of violations of other acts (Article 376(1) (11) Enforcement Decree of the FSCMA).

In addition, under Article 172 of the FSCMA, if an executive, employee, or a significant shareholder of a stock-listed corporation derives profit by purchasing the securities and then selling them within six months or by selling the securities and then purchasing them within six months, the corporation may require them to return the short-swing profit to the corporation. If the SFC discovers an accrual of short-swing profits, it is required to notify the relevant corporation. This obligation has been delegated to the FSS.

#### *Accounting and auditing*

The administrative measures that can be taken against auditors and CPAs are described in Principle 19 below.

#### **Power to Seek Court or Judicial Orders or Refer Matters to Civil Proceedings**

The FSC or FSS do not have the power to seek court or judicial orders. Civil proceedings are not used by public authorities in Korea.

#### **Power to Initiate Criminal Proceedings or Impose Criminal Sanctions**

The FSC, SFC and FSS do not have the power to initiate criminal proceedings, but the FSC (and in the case of Articles 172–174, 176, and 178 the SFC) can refer matters to the public prosecutor's office. These referrals are made either as charges or notifications, where the former are officially registered as criminal cases upon receipt, whereas the latter are registered as criminal cases only after the investigation has been started. As part of its investigation of the cases, the public prosecutor's office can use the powers available to it under the Act on Criminal Litigation Procedures to seize and search documents and to compel statements.

Criminal sanctions are imposed by courts. The penal provisions relevant to the scope of the IOSCO assessment are in the FSCMA (Articles 443–449), the Act on the External Audit of Stock Companies (Articles 19–21) and the CPA Act (Articles 53–54). In the FSCMA, the violations are included in several different categories, with the theoretical maximum penalty of imprisonment for life or for no less than five years or a fine not exceeding an amount equivalent to three times the profit accrued or the loss avoided by the violation applying to certain unfair trading cases where the profit gained or loss avoided is KRW 5 billion or more. For a violation conducted by a regulated entity or person subject to the disclosure obligations, the theoretical maximum penalty would be imprisonment for not more than five years or a fine not exceeding KRW 200 million.

#### **Power to Order Suspension of Trading**

The FSC may, if it finds that transactions of securities cannot be normally made because of a natural disaster, warfare, disturbance, sudden and significant change in economic conditions or other similar incidents, alter the opening hours of the KRX, suspend transactions or temporarily close the securities market, or take other necessary measures. The FSS does not have a power to suspend trading.

The Securities Market Business Regulation of the KRX has to prescribe, among other things, matters regarding the suspension or temporary closing of the securities market (Article 393 FSCMA). On the basis of §25 of the KOSPI Market Business Regulation, the KRX may suspend trading of all issues in the market, when the KOSPI has declined by 10 percent or more from the previous day's closing value and such situation persists for one minute. The KRX must resume trading after twenty minutes have elapsed since the suspension of trading. In addition, the KRX may suspend trading in the case of a failure or expected failure of its computer system due to the excessive influx of quotations for specific issues.

	<p>The KRX also has the power to order suspension of trading in individual securities in circumstances prescribed in §95 of the KOSPI Market Listing Regulation.</p> <p><b>Private Rights of Action</b></p> <p>The FSCMA includes several provisions on the liability for damages by e.g. the financial investment business entities and other persons that have breached the requirements of the FSCMA. Investors can also seek civil remedies. A class action is also possible in Korea, but it is rarely used.</p> <p><b>Cooperation between Authorities</b></p> <p>The FSS, SFC and FSC can share information obtained in their investigations between themselves and with the public prosecutor's office. The arrangements with the public prosecutor's office are not formal, but exchange of information takes place on a regular basis in the connection of investigations.</p>
Assessment	Broadly Implemented
Comments	<p>Taken as a whole, the FSC, SFC and FSS (under delegation from the FSC or SFC) have the powers to obtain most information, records and statements essential for effective enforcement of securities laws from any regulated entity or any other person. The powers of the FSS are more limited, and the FSC's and SFC's exercise of powers is subject to resource constraints. However, Principle 11 does not require that all such powers are vested on the securities regulator, as long as another competent authority in the jurisdiction is able to obtain the information required. In Korea, the public prosecutor's office has such powers. The impact of this on the effectiveness of enforcement of securities laws is assessed under Principle 12.</p> <p>The powers of the FSC, SFC and FSS to impose administrative sanctions on regulated entities and their executives and employees include a range of measures from caution to cancelling a registration and removing a person from office. Persons subject to the disclosure requirements of the FSCMA can also be subject to some administrative sanctions of the FSC, SFC or FSS. The same applies to auditors and CPAs. Beyond the relatively harsh measures of cancelling or suspending a registration of a regulated entity, the administrative sanctions at the disposal of the FSC, SFC and FSS are not particularly dissuasive. There are no other administrative sanctions applicable to unfair trading cases than warning and caution, except if the violator is a regulated entity or its executive or employee. The ability of the FSC, SFC and FSS to issue pecuniary penalties is limited to specific cases, where the amount of the civil money penalty or fine is limited and does not necessarily reflect the economic benefit gained from violating the legal requirements. The FSS can refer matters to the criminal process through the SFC or FSC, where there is a broader range of sanctions available.</p> <p>On the basis of a general assessment of the Korean authorities' enforcement powers, that although comprehensive, could benefit from additional variety and dissuasiveness, the Broadly Implemented rating has been assigned to this Principle.</p>
<b>Principle 12.</b>	The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.
Description	<p><b>Types of Examinations of Regulated Entities</b></p> <p>The FSS conducts general and partial examinations in financial investment business entities (see Principle 31), collective investment business entities (see Principle 24), credit rating agencies (see Principle 22), auditors (see Principle 19), and KRX and KOFIA (see Principles 9 and 33).</p>



*Risk-based general examinations*

The process for selecting financial investment business entities for examination is described in more detail in Principle 31. As a general rule, the examination type (general vs. partial examination) and cycle vary depending on several factors such as the company's capital position. Financial investment business entities categorized as large and medium-sized ones in terms of their capital are subject to general examinations every three years.

The FSS performs a monthly assessment on each financial investment business entity's risk volumes and risk management system using RAMS. This assessment is used in selecting companies for additional examinations.

*Periodic general examinations*

In contrast to financial investment business entities, the collective investment business entities are not subject to risk-based general examinations, i.e. RAMS is not used to support the selection of collective investment business entities for examination. Instead, the examination cycle varies primarily on the basis of assets under management (AUM) and is approximately six years for entities with AUM of KRW 2.5 trillion or more and seven years or more for entities with AUM of less than KRW 2.5 trillion.

CRA and auditors are examined on a regular basis. Since there are only four CRAs, there are no particular criteria for determining the examination interval; instead all of them are examined every 3–4 years (see Principle 22). In case of audit firms, the FSS audit quality review cycle differs between 2 and 5 years depending on how many companies the firm audits (see Principle 19). The KICPA review cycle is longer, ranging from 5 years for audit firms to 7 years for audit teams.

*Partial examinations*

If FSS on-site examinations reveal specific issues or problems, the FSS may initiate a partial examination. The FSS may also conduct a partial examination based on the information it has obtained from consumer complaints or other sources. A thematic examination is a partial examination where the same topic is covered in several regulated entities.

**Effectiveness of Examinations**

The 69 financial investment business entities (securities and futures companies) have been subject to the following number of examinations in the past two years:

**On-Site Examinations 2011–2012**

	General Examination	Partial Examination			Total
		Ordinary Partial Examination	Thematic Examination	Partial Examination Conducted by KOFIA on Behalf of the FSS	
2011	11	44	43	20	118
2012	5	52	29	19	105

In 2012, the thematic examinations covered six themes, whereas in 2011 they encompassed three themes. The total number of companies subject to at least one examination is lower than the number of examinations since some companies were subject to more than one partial examination. The 2012 examinations related to trading with major shareholders and affiliated companies, adequacy of internal business conduct requirements applicable to interns, short selling and arbitrage transactions conducted by foreign investors, breaches of employees' trading restrictions, compliance with mandatory depository rate for repos, and providing collective management of advisory-type wrap accounts (prohibited under the FSCMA). The focus of the 2011 thematic examinations was on conduct of business and internal controls on derivatives products as well as adequacy of conduct of business in trading a particular government security.

The 85 collective investment business entities have been subject to the following number of examinations in the past three years:

**On-site Examinations: 2010–2012**

	General Examination		Partial Examination		Total
	AUM ≥ KRW2.5 Trillion	AUM < KRW2.5 Trillion	Ordinary Partial Examination	Thematic Examination	
2010	6	2	15	35	58
2011	6	2	10	35	53
2012	4	1	11	26	42

In 2010–2012, the thematic examinations conducted in collective investment business entities included the following themes: adequacy of execution of trust business entity's requests; adequacy of disclosures on exercising voting rights; internal controls and preventive measures for financial incidents; risk management; adequacy of audit committee's role; compliance with reporting requirements on the reference price; and transactions with major shareholders and affiliated companies.

The examinations conducted in credit rating agencies, audit firms, and KRX and KOFIA are described in the respective Principles.

**Effectiveness of Market Surveillance**

The KRX monitors trading on a real-time basis with an automated monitoring system. In 2009-2012, the KRX referred almost 600 suspected unfair trading cases to the FSC (FSS) for further investigation. This represented approximately 64 percent of all cases investigated by the FSS.

**Effectiveness of Investigations**

*Regulated entities*

The FSS and FSC imposed the following sanctions against financial investment business entities in the past three years:

<b>Authority</b>	<b>Type</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>Total</b>
FSC	Revocation of authorization	-	-	-	-
	Suspension of business	-	-	-	-
	Severe institutional caution	4	3	1	8
	Civil money penalty/fine	14	6	1	21
FSS	Institutional caution	8	8	6	22
<b>Total</b>		<b>26</b>	<b>17</b>	<b>8</b>	<b>51</b>
In the case of collective investment business entities, the sanctions were the following:					
<b>Authority</b>	<b>Type</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>Total</b>
FSC	Revocation of authorization	1	-	-	1
	Suspension of business	-	1	-	1
	Institutional warning	-	1	1	2
	Civil money penalty/fine	-	2	-	2
FSS	Institutional caution	-	2	2	4
	Management attention	4	31	31	66
	On-site action	18	13	9	40
<b>Total</b>		<b>23</b>	<b>50</b>	<b>43</b>	<b>116</b>
<i>Executives of regulated entities</i>					
Sanctions against executives of financial investment business entities in the past three years were the following:					
<b>Authority</b>	<b>Type</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>Total</b>
FSC	Request for dismissal from office	-	-	-	-
	Suspension from office	2	-	-	2
	Disciplinary warning	1	1		2
FSS	Warning	6	9	2	17
	Caution	2	5	3	10
<b>Total</b>		<b>11</b>	<b>15</b>	<b>5</b>	<b>31</b>
In the case of collective investment business entities, the sanctions were the following:					

Authority	Type	2012	2011	2010	Total
FSC	Request for dismissal from office	-	1	-	1
	Suspension from office	-	-	-	-
	Disciplinary warning	-	2	-	2
FSS	Warning	-	7	5	12
	Caution	-	4	3	7
Total		-	14	8	22

*Employees of regulated entities*

Sanctions against employees of financial investment business entities in the past three years were the following:

Authority	Type	2012	2011	2010	Total
FSC	Dismissal from office	2	1	1	4
FSS	Suspension from office	3	9	2	14
	Pay reduction	24	31	19	74
	Reprimand	83	67	62	212
	Caution	146	95	34	275
	Other	829	-	2	831
Total		1,087	203	120	1,410

In the case of collective investment business entities, the sanctions were the following:

Authority	Type	2012	2011	2010	Total
FSC	Request for dismissal from office	-	1	-	1
FSS	Suspension from office	-	1	1	2
	Salary reduction	1	6	2	9
	Reprimand	7	13	8	28
	Caution	3	6	5	14
	Request for actions	9	9	17	35
Total		20	36	33	89

*Breach of disclosure obligations*

In the case of disclosure obligations, the FSS' and FSC's investigations led to the following outcome. All measures were decided on by the FSC. No information was available on the status and outcome of the cases notified to the public prosecutor's office.

Type of Sanction	2012	2011	2010
Notification to prosecutors	0	4	18
Civil money penalty	13	16	36
Fine	1	0	4
Disciplinary warning/caution	19	16	20
Restriction on issuance of securities	18	12	13
Total	51	48	91

The outcome of the investigations on compliance with the disclosure requirements of collective investment schemes is covered under Principle 26.

#### *Unfair trading*

The number of unfair trading cases that the FSS, SFC and FSC have been dealing with in the course of the past three years is the following:

	2012	2011	2010
Deferred from previous year (A)	165	152	159
Newly received (B)	271	222	194
Closed (C)	243	209	201
Pending (A+B-C)	193	165	152

In terms of the outcome of the cases, the majority of them have led to referrals to the public prosecutor's office. 80 cases passed by the FSS to the FSC were dismissed without leading to any administrative sanction or referral to the criminal process.

		2012	2011	2010
Unfair trading	Charges to prosecutors	48	34	14
	Notification to prosecutors	7	-	7
	Caution and other administrative actions	-	-	-
	Sub-total	56	34	21
Market manipulation	Charges to prosecutors	69	36	37
	Notification to prosecutors	7	11	8
	Caution and other administrative actions	2	2	4
	Sub-total	78	49	49
Insider trading	Charges to prosecutors	18	19	23
	Notification to prosecutors	21	24	26
	Caution and other administrative actions	2	2	4
	Sub-total	41	45	53
Others	Charges to prosecutors	2	4	1
	Notification to prosecutors	8	24	22
	Monetary fines	-	1	1
	Caution and other administrative actions	30	23	31
	Sub-total	40	52	55
Charges dismissed		28	29	23
<b>Total</b>		<b>243</b>	<b>209</b>	<b>201</b>

At the end of the assessment mission, the status and outcome of the above cases notified or charged to the public prosecutor's office in 2010–2012 has been the following:

Classification	2010	2011	2012	Total
Cases referred to the public prosecutor's office (a = b + c)	138	152	180	470
(Charges and notification to investigative agency)				
Pending (b)	32	99	116	247
Closed (c = d + e)	106	53	64	223
Indictment (d)	85	39	59	183
Non-indictment (e)	21	14	5	40

No information was available on the distribution of the various types of cases in the above categories, i.e. whether particular types of cases (e.g. market manipulation or insider trading) have been indicted or closed without indictment more often than others.

*Accounting and auditing*

The enforcement cases arising from the audit oversight are addressed under Principle 19.

**Effectiveness of the Enforcement Process**

As the information provided in Principle 11 indicates, the division of responsibilities between the FSS, SFC and FSC in deciding on an enforcement action depends on the action proposed. The proposals are made by the FSS. Before its proposal is submitted to the SFC or FSC for decision making, the investigation report and proposed enforcement measures are discussed within the FSS. With regards to proposals for enforcement measures relating to regulated entities and their executives and employees, after departmental approval they are submitted to the Enforcement Review Office of the Planning & Management Support area of the FSS for opinion. After receiving this opinion, the cases are passed to the FSS Enforcement Review Committee for its opinion (with the exception of very minor measures that are not specifically referred to in the FSCMA, such as management attention and onsite action), after which they can be passed on to the FSC or SFC for decision unless the decision-making power has been delegated to the FSS.

The FSS has to send unfair trading and disclosure cases to the SFC Committee for Deliberation on Investigation of Capital Markets for consultation before they can be passed to the SFC for decision-making. According to the information provided by the FSC, the FSC (rather than the SFC) also decides on the unfair trading cases that would lead to the more serious sanctions referred to above for disclosure cases. The authorities were not able to explain what this restriction on the SFC decision making power is based on, given that Article 426 of the FSCMA provides the SFC with the power to decide on measures to be taken in unfair trading cases without any limitations.

As noted above under Principle 11, the Korean authorities have in the past preferred passing the investigation of unfair trading cases to the criminal authorities at an early stage of an investigation rather than using all of the powers provided to them to compel information. One of the reasons mentioned by the FSC was resource constraints at the FSC. However, the public prosecutor's office has all the necessary powers to conduct investigations, and as noted above in Principle 11, the IOSCO Assessment Methodology does not require all the investigative powers to be vested on the securities regulator, as long as the overall investigative and enforcement process remains effective.

To try to assess the effectiveness of the overall investigative and enforcement process involving both the administrative and criminal authorities, the authorities were requested to provide data on the average length of the various stages of the investigative and enforcement process. According to the FSC, due to shortage of examination and investigation personnel at the KRX and FSS, the waiting period is significant before an examination or investigation is actually launched. After that, it takes on average 382 days from the examination by the KRX and investigation by the FSS of an unfair trading case to the decision by the SFC. In disclosure cases, the average time has varied between 95 and 161 days in the past three years. The time needed for the public prosecutor's office to indict, where appropriate, varies depending on the case and on the particular suspect to be indicted in cases where there are multiple suspects. On average, this has taken between 260 and 364 days in the past five years.

Under the Criminal Procedure Act, only prosecutors can prosecute misconduct. After a prosecutor presents the case in a criminal trial, a criminal sanction may be imposed by the criminal court. The Korean authorities were not able to provide any specific information on the normal length of the court process for cases covered by the scope of the IOSCO assessment and how many of the cases indicted in the past three years have been concluded by courts. Neither were the FSC, SFC, FSS or the public prosecutor's office able to provide information on the number and nature of criminal sanctions given. The information received from the Punishment Determination Committee of the Supreme Court indicates that the criminal sanctions have primarily relied on conditional imprisonment sentences.

#### **Probation Rate for Securities Related Crime 2006–2011**

Charge	Imprisonment	Probation
Insider trading	2 (6.3%)	30 (93.7%)
Market manipulation	20 (13.4%)	129 (86.6%)
Fraudulent unfair trading	2 (100%)	0 (0%)

Source: Punishment Determination Committee of the Supreme Court (based on the first trials).

No similar information was available on fines, but anecdotal evidence suggests that at least in the most significant cases they have been largely limited to the value of the illegally obtained profits.

The FSC, SFC and FSS do not receive information on the outcome of the criminal cases (including on the indictment decisions of the public prosecutor's office). This as such can be considered to potentially undermine the effectiveness of the criminal enforcement process, which for the reasons noted above, is the primary means of enforcing compliance with the unfair trading prohibitions of the FSCMA.

#### **Adequacy of System to Receive and React to Market Intelligence**

The FSS has a standardized procedure for dealing with investors' complaints received by internet, telephone, mail, and through in-person visits. Article 384 of the Enforcement Decree of the FSCMA



	<p>includes the guidelines to be observed when informing the FSC or the SFC of violations of the FSCMA. The FSC and SFC have to process the information received within 60 days from the date of receipt, extendable by up to 30 days. The FSC and SFC are required to notify an informant of the results of the disposition related to the information. If the information received leads to detecting a violation of the FSCMA, the FSC and SFC may authorize the Governor of the FSS to pay a reward not exceeding KRW 100 million to the informant.</p> <p><b>Requirements for Compliance Systems</b></p> <p>According to Article 28 of the FSCMA, each financial investment business entity is required to establish appropriate guidelines and procedures that must be complied with when its executives or employees perform their duties (internal control guidelines). A financial investment business entity must have one or more persons (compliance officers), who are responsible for monitoring compliance with the internal control guidelines, investigating violations of them, and reporting to the audit committee or the internal auditors. The FSS monitors compliance with the requirements on internal controls through off-site surveillance, and documentary or on-site examinations.</p> <p>The Market Supervision Committee of the KRX is required to establish market surveillance mechanisms to permit an audit of the execution and trading of all transactions made on the KRX.</p>
<p>Assessment</p>	<p>Partly Implemented</p>
<p>Comments</p>	<p>Although the FSS on-site examination program is fairly comprehensive, there appear to be some gaps in its coverage in particular in relation to smaller collective business entities that are subject to infrequent periodic or thematic examinations. For the smaller audit firms and audit teams, the FSS and KICPA on-site inspection cycle is also relatively long.</p> <p>The process of investigating, prosecuting and reaching a court decision on a suspected unfair trading case has taken a relatively long time. After the assessment mission, the Korean authorities informed that they are in the process of stepping up coordination to expedite the investigative and enforcement process, for example by setting up a joint task force between the FSS, FSC and Public Prosecutor’s Office.</p> <p>During the assessment mission, the FSC and SFC were not able to provide information on the outcome of the cases they had passed to the Public Prosecutor’s Office. This raised a question on the overall effectiveness of the enforcement of unfair trading cases and sufficiency of cooperation between the authorities involved. After the assessment mission, the authorities provided updated data on the number of cases referred to the Public Prosecutor’s Office. Compared to the information presented above, the number of cases referred in 2010–2012 that were still pending in early October 2013 had dropped from 247 to 136, while the number of cases closed had risen from 223 to 334. Out of the 334 closed cases, 278 had been indicted. The authorities were also able to provide previously unavailable preliminary data on the court process that indicates that, out of the 278 cases referred in 2010–12 and subsequently indicted by the Public Prosecutor’s Office, 54 cases were still pending at the courts. The data provided does not include information on the nature of criminal sanctions, and the available evidence on e.g., the probation rates still indicates a lack of dissuasiveness of the criminal sanctions.</p> <p>The authorities also informed that the FSS has set up on August 1, 2013 a specific team that follows up on and manages unfair trading cases that have been referred to the Public Prosecutor’s Office. This together with the increased ability of the authorities to systemically collect and analyze information on the enforcement cases are important steps forward in improving the effectiveness of the criminal enforcement process in Korea. The authorities are also encouraged to continue their efforts to ensure and improve the dissuasiveness of the criminal sanctions.</p>

<b>Principles for Cooperation in Regulation</b>	
<b>Principle 13.</b>	The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
Description	<p><b>Domestic Information Sharing</b></p> <p><i>Financial Services Commission</i></p> <p>According to Article 65 of the AEFSC, when the Minister of Strategy and Finance, the FSC, and the Monetary Policy Committee of BOK deem it necessary to execute policies, any of them may request the others to share data. In such cases, an agency receiving a request is required to comply with it, except in extenuating circumstances.</p> <p>Further, when the FSC deems it necessary to enforce the AEFSC, it may request the head of a related administrative agency or any other institution or organization to conduct an examination, to provide necessary data, or to cooperate as necessary (Article 65-2 AEFSC).</p> <p><i>Financial Supervisory Service</i></p> <p>According to Article 58 of the AEFSC, the Governor of the FSS is required to present data necessary for financial supervision as requested by the FSC or SFC. Also, when the Governor completes an examination or takes disciplinary measures against executives or employees of financial institutions, he is required to report the results to the FSC (Article 59 AEFSC).</p> <p>The Governor of the FSS also has the right to request cooperation from an administrative agency or other related institution when he deems it necessary to perform his duties (Article 67 AEFSC). This provision is used e.g. to request information from the immigration authorities and Ministry of Administration in case of market abuse investigations.</p> <p>Under delegation from the FSC, the FSS also receives information from the SROs. According to Article 426(4) of the FSCMA, the FSC may, if deemed necessary in conducting an investigation, demand the KRX to submit materials as may be necessary for the investigation. The KRX must notify the FSC, if it becomes aware of a suspected violation of the FSCMA or an order or disposition issued or made pursuant to the FSCMA as a result of its inquiry into an abnormal transaction or supervision over members. However, the FSS, SFC or FSC are not empowered to share confidential information with the KRX or KOFIA.</p> <p>The FSS also supports the public prosecutor's office in the investigations of unfair trading cases and other violations of securities markets legislation by passing on all the information it gains in the course of its investigations to the Public Prosecutor's Office through the SFC and FSC.</p> <p>No external approval is needed for information sharing between the FSC, SFC and FSS, or between them and the SROs and the Public Prosecutor's Office.</p> <p><b>Foreign Information Sharing</b></p> <p>According to Article 437 of the FSCMA the FSC may exchange information with foreign financial investment supervisory agencies. More specifically, it (and the SFC if any provision of Articles 172–174, 176, 178, or 180 is violated) may cooperate in an investigation or examination upon receiving a request that states the purpose, scope, etc. of the acts in violation of the FSCMA or foreign acts and subordinate statutes equivalent to the FSCMA. In this case, the FSC may provide the foreign financial investment</p>

	<p>supervisory agency with materials relevant to the investigation or examination or receive such materials from it under the principle of reciprocity.</p> <p>The FSS has been delegated the power to register requests for sharing information from the foreign financial investment supervisory agencies and provide relevant information to them.</p> <p>Article 4 of the Act on Real Name Financial Transactions and Guarantee of Secrecy includes provisions on the guarantee of secrecy of financial transactions preventing a person working for a financial institution from providing or revealing transaction information to other persons unless certain exemptions prevail. One of these exemptions relates to the provision of transaction information necessary for the FSC or the Governor of the FSS to cooperate and exchange information with foreign financial investment supervisory agencies which perform work equivalent to that of the FSC or FSS.</p> <p>As noted above, the FSC, SFC and FSS can share information with foreign counterparts even if the alleged conduct would not constitute a breach of the Korean laws. The FSC and SFC can also make a decision on sharing information with foreign regulators without the government's (such as the Ministry of Justice's) permission.</p> <p><b>Unsolicited Information</b></p> <p>As a signatory to the IOSCO MMoU, the FSC is committed to making all reasonable efforts to provide, without prior request, the foreign authorities with any information that it considers is likely to be of assistance to them in securing compliance with the laws and regulations applicable in their jurisdiction.</p> <p><b>Beneficial Ownership and Bank Record Information</b></p> <p>The FSC and FSS can share with all relevant domestic and foreign counterparts' information and records identifying the person or persons beneficially owning or controlling bank accounts related to securities and derivatives transactions and brokerage accounts as well as the necessary information to reconstruct a transaction, including bank records.</p> <p><b>Confidentiality</b></p> <p>According to Article 60 of the State Public Officials Act and Article 35(2) of the AEFSC, the officers and employees of the FSC and FSS are prohibited to disclose any information acquired in the course of performing their duties or using such information for any purpose other than their duties.</p>
Assessment	Fully Implemented
Comments	
<b>Principle 14.</b>	Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.
Description	<p><b>Power to Enter into Information Sharing Agreements</b></p> <p>The FSC and FSS have the power to enter into information sharing agreements both with other domestic authorities and foreign counterparts. In the latter case, the power is based on the general information exchange power provided in Article 437 of the FSCMA (see Principle 13).</p> <p><b>Existing Agreements</b></p> <p><i>Other domestic authorities</i></p>

	<p>There is an MoU signed between the MOSF, FSC, BOK, FSS, and KDIC on matters related to sharing financial information and the operation of the MPFMs (see Principle 6).</p> <p><i>Foreign authorities</i></p> <p>The FSC and FSS were jointly admitted as Appendix A signatory to the IOSCO MMoU in 2010.</p> <p>The FSC and FSS have jointly signed a memorandum of understanding with foreign regulators in 20 countries for securities regulation related information sharing, cross-border regulatory cooperation, examination assistance, and other purposes.</p> <p><b>Confidentiality</b></p> <p>The information provided to the foreign regulators under Article 437 of the FSCMA must be used as specified by the scope of the purpose of the request. As a signatory to the IOSCO MMoU, the FSC and FSS can maintain the confidentiality of the requests for information received from a foreign regulator.</p> <p><b>Practice</b></p> <p>The following table provides information on the number of requests for assistance received from foreign regulators in the last three years and the average time taken to process such requests.</p> <table border="1"> <thead> <tr> <th></th> <th><b>Fit and Proper Test</b></th> <th><b>Supervision and/or Examination Purposes</b></th> <th><b>Investigation of Illegal Activities</b></th> <th><b>Total</b></th> <th><b>Average Time Taken to Process Such Requests</b></th> </tr> </thead> <tbody> <tr> <td>2010</td> <td>37</td> <td>4</td> <td>2</td> <td>43</td> <td>17</td> </tr> <tr> <td>2011</td> <td>32</td> <td>6</td> <td>-</td> <td>38</td> <td>13</td> </tr> <tr> <td>2012</td> <td>31</td> <td>2</td> <td>5</td> <td>38</td> <td>19</td> </tr> </tbody> </table>		<b>Fit and Proper Test</b>	<b>Supervision and/or Examination Purposes</b>	<b>Investigation of Illegal Activities</b>	<b>Total</b>	<b>Average Time Taken to Process Such Requests</b>	2010	37	4	2	43	17	2011	32	6	-	38	13	2012	31	2	5	38	19
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<b>Principle 15.</b>	The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.																								
Description	<p><b>Assistance to Foreign Regulators</b></p> <p><i>Obtaining records and requesting documents</i></p> <p>According to Article 426(1) of the FSCMA, the FSC (or the SFC in case of Articles 172–174, 176, 178, and 180) may, if there is a violation of the FSCMA or an order or disposition issued or made pursuant to it or if it is deemed necessary for protecting investors or maintaining the sound trade practice, order any person concerned to submit a report or reference materials or require the Governor of the FSS to inspect account books, documents and other materials. The FSC may order any person concerned to submit account books, documents, and other materials necessary for an investigation (Article 426(2) FSCMA). These powers have been delegated to the FSS. It constitutes a criminal offense not to comply with such a demand (Article 445(48) FSCMA). These powers can be used to obtain records and documents requested by foreign financial supervisory agencies. As described under Principle 14, the FSC may exchange information with a foreign financial investment supervisory agency and may provide it with materials relevant to the investigation or examination.</p>																								

	<p><i>Securing compliance with laws and regulations</i></p> <p>The FSC is able to provide assistance to foreign regulators in securing compliance with laws and regulations related to unfair trading under its power to request reporting and conduct investigations under Article 426 of the FSCMA. These powers also extend to issuers, sellers, underwriters, and any related persons. The powers have been delegated to the FSS. The FSS also has the power to conduct examinations in regulated entities, including financial investment business entities (Article 419 FSCMA) and the KRX (Article 410 FSCMA).</p> <p><i>Providing information on regulatory processes</i></p> <p>The FSC and FSS are able to offer assistance to foreign regulators in obtaining information on the regulatory processes in Korea.</p> <p><i>Taking statements</i></p> <p>According to Article 426(2) of the FSCMA the FSC may demand any person concerned to submit a statement on the facts and the status of the case under investigation or attend as a witness for a case under investigation.</p> <p><i>Obtaining court orders</i></p> <p>As noted under Principle 11, the FSC and FSS are not permitted to obtain court orders.</p> <p><i>Providing information on financial conglomerates</i></p> <p>The FSC and FSS are able to provide assistance to foreign regulators regarding information about financial conglomerates subject to their supervision under the general information sharing power of Article 437(1) of the FSCMA.</p> <p><b>Independent Interest</b></p> <p>As noted in Principle 13, the FSC and FSS are able to provide assistance to foreign regulators also with regards to violations of foreign acts (Article 437 FSCMA).</p>
Assessment	Fully Implemented
Comments	
<b>Principles for Issuers</b>	
<b>Principle 16.</b>	There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investors' decisions.
Description	In the following descriptions, as per Article 9(15) of the FSCMA, a listed corporation means a corporation that has issued securities listed on the securities exchange (e.g., KRX) and an unlisted corporation means a corporation other than a listed corporation. A stock-listed corporation is a corporation that has issued stock certificates listed on the securities exchange or stock certificates underlying securities depository receipts listed on the securities exchange. Finally, a stock-unlisted corporation means any corporation other than a stock-listed corporation, i.e. a corporation that has listed fixed income securities would be considered a stock-unlisted corporation.

**Primary Market Disclosure Requirements**

Primary market disclosure requirements apply to public offerings and sales. Public offering means the invitation to at least 50 investors to make offers to acquire securities newly issued. Public sale means inviting offers to purchase securities already issued from at least 50 investors (Article 9(7) and 9(9) FSCMA). Conversely, a private placement means the invitation to acquire securities newly issued without putting them on public offering (Article 9(8) FSCMA).

In calculating whether the fifty person threshold is exceeded, the number of persons who have been invited to subscribe securities of the same class in any manner other than by public offering or sale during the previous six months will be aggregated, excluding professional investors and related persons of the issuer.

*Requirement to file a registration statement*

No securities can be publicly offered or sold, until a registration statement has been filed with the FSC (delegated to the FSS), except in the following cases:

Small offerings and sales, i.e. cases where the aggregate value of securities intended to be publicly offered or sold and that of the securities already publicly offered or sold without filing a registration statement during the past one year is below KRW 1 billion (Article 120(1) Enforcement Decree of the FSCMA);

- Issuance of national bonds, local government bonds, bonds issued by public institutions or special entities established directly pursuant to certain Acts specified in Article 119(1) of the Enforcement Decree of the FSCMA; and
- Issuance of other securities where investors are deemed to be properly protected through sufficient public disclosure in compliance with other Acts or in any other way, as specified in Article 119(2) of the Enforcement Decree of the FSCMA (e.g. debt securities the payment of principal and interest of which is guaranteed by the State or a local government).

An issuer that makes a small public offering or sale of securities without filing a registration statement is required to disclose certain matters concerning its financial status and take measures prescribed in Article 137 of the Enforcement Decree of the FSCMA to protect investors.

According to Article 120 of the FSCMA and Article 12 of the Enforcement Rule of the FSCMA, the securities registration statement will be effective after the expiration of the following time periods, beginning on the day on which it was submitted to the FSS.

		<b>Stock-listed Corporations</b>	<b>Others</b>
Equity securities	Public offering	10 days	15 days
	Guaranteed rights offering		
	Allocation to shareholders		7 days
	Allocation to third parties		
Debt securities	Guaranteed corporate bonds		5 days
	Secured debentures		
	Asset-backed securities		
	Others		7 days
Other securities		15 days	

Well-known, seasoned issuers and certain other issuers defined in Article 121 of the Enforcement Decree of the FSCMA can use shelf-registration. If its shelf-registration statement is accepted by the FSS, the issuer is not required to separately file a registration statement for multiple and similar kind of securities to be offered publicly during a particular period. In such a case, supplements to the issuer's shelf-registration statement have to be submitted each time such securities are publicly offered or sold.

*Content of the registration statement*

The Enforcement Decree of the FSCMA (Article 125) includes the requirements for the descriptions to be included in a registration statement for other securities than collective investment schemes and asset-backed securities for which the relevant requirements are in Articles 127 and 128. The registration statement is comprised of two parts: matters concerning public offering and sale, and matters concerning the issuer.

The matters concerning public offering or sale include, among others, the following:

- Details of rights to securities publicly offered or sold;
- Investment risks ensuing from the acquisition of securities publicly offered or sold;
- The underwriter's opinion on securities publicly offered or sold, where applicable; and
- Purpose of using the funds.

The above requirements also apply to registration statements for asset-backed securities.

The matters concerning the issuer include the following:

- An overview of the company;
- Details of business;
- Matters concerning financial affairs;
- An external auditor's audit opinion;
- Matters concerning the organization of the company, such as the board of directors, and affiliated companies;
- Matters concerning shareholders;
- Matters concerning executives and employees;
- Details of transactions with interested parties; and
- Other matters specified and publicly notified by the FSC, as necessary for protecting investors.

In addition, the following matters are required to be included for asset-backed securities:

1. Matters concerning the asset holder:
  - (a) An overview of the asset holder;
  - (b) Details of business;
  - (c) Matters concerning financial affairs; and
  - (d) Matters concerning executives;

2. Matters concerning securitized assets:
  - (a) A detailed list of securitized assets by type;
  - (b) Details of evaluation of securitized assets; and
  - (c) Methods of transfer of securitized assets and a detailed plan for transfer.
3. Matters concerning the asset-backed securitization plan:
  - (a) The detailed structure of the asset-backed securitization plan;
  - (b) A plan for issuance and repayment of asset-backed securities;
  - (c) The asset manager and the method of management of assets; and
  - (d) A plan for borrowing and management of funds.

*Requirement to file an investment prospectus*

According to Article 123 of the FSCMA, when an issuer publicly offers or sells securities, it also has to file an investment prospectus with the FSC on the day on which the relevant registration statement becomes effective and make it available to the public at the issuer's head office and branches, the FSS, the KRX, and places where subscriptions can be made. An investment prospectus is not permitted to contain any descriptions different from those included in the registration statement or omit any such description. A description may be omitted from the registration statement and investment prospectus, if it is necessary in consideration of the balance between confidentiality in corporate management and protection of investors (Articles 123 and 129 FSCMA). Such description could relate to matters classified as military secrets and matters confirmed by the FSC among those concerning the business affairs or operations of the issuer (Articles 131(5) and 136 Enforcement Decree of the FSCMA). According to the FSS, the latter refers to matters pertaining to business secrets of the issuer. Such descriptions may be omitted from the investment prospectus and registration statement after confirmation by the FSC.

On the basis of Article 120 of the FSCMA, the most recent audited financial information is required to be attached to the registration statement for public offerings.

*Regulatory review of the registration statement*

As noted above, the FSS has a certain time period to review the registration statement before it becomes effective. If a registration statement has not been prepared in conformity with the prescribed form, if there is any false description or representation of a material fact, or if there is any omission, uncertain description or representation of a material fact which might undermine reasonable investment decision of investors or significantly mislead investors, the FSC may demand that the issuer presents the reasons for it and submits a corrective registration statement with correct contents no later than the day before the date set for offering to acquire or purchase the securities stated in the registration statement (Article 122 FSCMA). Filing a corrective registration statement restarts the time period at the end of which the registration statement becomes effective.

According to the information provided by the FSS, it reviews all securities registration statements. 27 staff members are involved in reviewing them and other disclosure documents in the Corporate Disclosure Department, with 5 additional staff members in charge of reviewing the relevant registration statements in the Derivatives, Trust, Structured Products and Pension Department. The number of securities registration statements (including the ones for initial public offering) filed during the last three years and the number of registration statements that the FSS required to be corrected are as follows:



	2010	2011	2012
Equity securities and others	401	226	149
Of which corrected	112	63	52
Debt securities	1553	1578	1267
Of which corrected	7	10	15
ABS	47	45	66

#### *Advertising of public offering outside a prospectus*

According to Article 124(2) of the FSCMA, a person who intends to advertise a public offering or sale of securities required to be registered must use a short-form investment prospectus. A short-form investment prospectus refers to a document, an electronic document, or any other similar description or representation that omits a part of the mandatory descriptions of the investment prospectus or makes an abstract of the important descriptions. It has to be prepared in a manner prescribed in Article 134 of the Enforcement Decree of the FSCMA and published through an advertisement, notice, or leaflet via newspapers, broadcasting, magazines, or electronic transmission media, after the relevant registration statement has been accepted.

#### **Periodic Disclosure Requirements**

##### *Annual business report and other periodic reports*

According to Article 159(1) of the FSCMA, stock-listed corporations and certain other corporations have to submit their annual business reports (accompanied by the consolidated financial statements) to the FSC and the KRX within ninety days of the closing of the business year. Article 167 of the Enforcement Decree of the FSCMA defines the other corporations as follows:

1. Issuers that have listed any of the following securities on the securities exchange:
  - (a) Equity securities other than stocks;
  - (b) Unsecured corporate bonds;
  - (c) Convertible bonds, bonds with warrant, participating bonds, or exchangeable bonds;
  - (d) Instruments representing preemptive rights to new stocks;
  - (e) Securities depository receipts (limited to securities depository receipts related to stocks or the securities under items (a)-(d) above); and
  - (f) Derivative-combined securities.
2. Issuers that do not fall under item 1 but publicly offered or sold (excluding small offerings and sales) any of the following securities:
  - Stocks; and
  - Securities falling under item 1 above.
3. Issuers that are corporations subject to external audit under Article 2 of the Act on External Audit of Stock Companies, if the number of persons who hold securities of the issuer are at least 500 persons.

The above requirements mean that all issuers that have made a public offering or sale or whose securities are listed are subject to the requirement to prepare an annual business report. The FSS adopted the XBRL disclosure system in its Data Analysis, Retrieval and Transfer (DART) system in October

2007, and requires listed companies to submit financial statements by using XBRL in their annual, half-yearly and quarterly business reports. The disclosures are available also through the KRX Korea Investor's Network Disclosure (KIND) system.

The deadline for submitting consolidated financial statements is extended to 120 days for corporations whose total assets are less than KRW 2 trillion as at the end of the latest business year and that do not apply the K-IFRS (see Principle 18 for corporations required to apply the K-IFRS).

A business report must describe the purpose, trade name and details of business of the corporation, the remuneration of executives, the matters concerning finance, and the following matters (Article 159(2) FSCMA and Article 168(1) Enforcement Decree of the FCSMA):

- An overview of the company;
- Matters concerning the organization of the company, including the board of directors, and its affiliated companies;
- Matters concerning shareholders;
- Matters concerning executives and employees;
- Details of transactions with major shareholders (including their specially related persons), executives, or employees of the company;
- Matters concerning financial affairs and annexed statements;
- The external auditor's audit opinion; and
- Other matters specified and publicly notified by the FSC as those of which it is necessary for investors to be informed.

A corporation obligated to submit an annual business report is required to submit a half-yearly report and quarterly reports for three months and nine months both to the FSC and the KRX within 45 days of the closing of each term, with an extension to 60 days in case of consolidated financial statements for the first and second business years (Article 160 FSCMA). The FSC and the KRX are required to keep the annual business reports and half-yearly and quarterly reports for three years and to disclose them to the public.

The half-yearly and quarterly reports do not have to include an external auditor's audit opinion. However, the half-yearly report has to always include the external auditor's review report. In the case of quarterly reports, the external auditor's review report is required for financial institutions subject to the FSS examinations under Article 38 of the AEFSC and for stock-listed corporations whose total assets reached or exceeded KRW 500 billion as at the end of the latest business year.

Disclosure of related party transactions is addressed in Articles 10(1) (1)–(5) of the Guidelines on Corporate Disclosure Filings. If a company engages in direct and indirect transactions with credit risk; asset transfers, exchanges, or gifts; or transactions in excess of certain threshold amount with a large shareholder of the company, a person specially related to a large shareholder, or an executive or employee of the company, it must disclose it in its annual business report and half-yearly and quarterly reports.

*Regulatory review in relation to periodic disclosure obligations*

According to the information provided by the FSS, the Corporate Disclosure Department reviews the important sections of all annual business reports that fall under its area of responsibility. The financial information is reviewed by the Accounting Supervision Department.

### **Ongoing Disclosure Requirements**

#### *Material event disclosures*

Under Article 161 of the FSCMA, a corporation obligated to submit a business report is required to submit a report on the details of any of the following events (material fact report) to the FSC by the day immediately following the day on which such an event occurs:

- When a bill or check issued by the corporation is returned or its check account transactions in a bank are suspended or banned;
  - When its business activities are completely or partially suspended;
  - When there is an application filed for commencement of proceedings for rehabilitation under the Debtor Rehabilitation and Bankruptcy Act;
  - When a cause or event occurs that triggers the corporation's dissolution under the FSCMA, the Commercial Act, or any other Act;
  - When the corporation's board of directors adopts a resolution to increase or reduce its capital;
  - When the company becomes a subsidiary or parent company or a resolution on a merger is adopted (Articles 360-2, 360-15, 522, or 530-2 Commercial Act);
  - When a resolution to transfer an essential business or asset or to have such business or asset transferred, is adopted;
  - When a resolution to acquire or to dispose of treasury stocks, is adopted; or
  - When there occurs any other cause or event that may produce a significant impact on the management, assets, etc. of the corporation, as specified further by the Enforcement Decree of the FSCMA:
- (a) Where any measure under Article 7(1) or 7(2) of the Corporate Restructuring Promotion Act is taken by a principal creditor bank under Article 2(3) of the same Act;
  - (b) Where any lawsuit that is likely to have a material impact on the securities is filed;
  - (c) Where stock certificates are, or are decided to be, listed or de-listed on foreign securities markets, or where de-listing of stock certificates, suspension of transactions or other measures are taken by foreign financial supervisory agencies or foreign exchanges;
  - (d) When a decision on the issuance of convertible bonds, bonds with warrants or exchangeable bonds has been made;
  - (e) When a decision has been made on a contract that grants a put back option for a predetermined value to a person who acquires equity securities or other assets of another corporation; and
  - (f) When any other event specified and publicly notified by the FSC occurs, as an event having a significant impact on the management, property, or other matters of the corporation.

In addition to the regulatory requirements, listed companies are subject to the detailed material event disclosure requirements under the KRX regulations.

#### *Shareholder voting decisions*

Pursuant to Article 363 of the Commercial Act, when a company convenes a general meeting of shareholders, it must give written notice or notice in electronic form to each shareholder at least two weeks prior to the date set for such general meeting. There is no general requirement to disclose shareholder voting decisions beyond the specific material event disclosure requirements highlighted above.

#### *Ways to ensure equal access to disclosures*

According to Article 174 of the FSCMA certain persons becoming aware of material non-public information of a corporation are prohibited from using such information in trading or any other transaction involving specific securities, or allowing another person to use it. These persons include the corporation itself (including its affiliated companies) and its executives, employees, agents and significant shareholders. A person violating this prohibition will be liable for the damages sustained by a person who makes any transaction in the relevant securities.

In addition, pursuant to Article 172 of the FSCMA, if a listed corporation's executive, employee that is in a position to acquire material non-public information, or a significant shareholder derives profit by purchasing specific securities and then selling them within six months or by selling specific securities and then purchasing them within six months, the corporation may require such person to return the profit to it.

#### *Regulatory review of material event disclosures*

According to the information provided by the FSS, all material fact reports are reviewed by it. If the review reveals that the report includes material misstatements or lacks material information, the issuer may be required to make necessary changes and to file the report again.

#### **Liability for Disclosures**

According to Article 125 of the FSCMA and Article 135 of the Enforcement Decree of the FSCMA, the following persons are liable for damages inflicted upon any person as a result of acquiring securities, if a false description or representation of any material fact has been included in a registration statement or investment prospectus or a material fact has been omitted from them.

- The registrant of the relevant registration statement and directors of the issuer at the time of filing the registration statement;
- A person who instructed or executed the preparation of the registration statement;
- A person who holds an officially recognized qualification and the organization to which he/she belongs, including a CPA, a certified appraiser, a specialist in credit rating, an attorney-at-law, a patent attorney, and a tax accountant, who certified with his/her signature that the descriptions of the registration statement are true and correct;
- A person who consented to include and confirmed his/her statement of the evaluation, analysis, or verification in the descriptions of the registration statement;
- A person who executed a contract for underwriting the securities, referring to the underwriter who determines the terms and conditions of underwriting upon direct request for underwriting of

	<p>securities from an issuer or seller, if there are two or more persons who signed such underwriting contract;</p> <ul style="list-style-type: none"> <li>• A person who prepared or delivered the investment prospectus; and</li> <li>• The holder of the securities for sale at the time the registration statement for sale was filed.</li> </ul> <p><b>Enforcement of Disclosure Requirements</b></p> <p>The number of sanctions imposed as a result of violations of disclosure rules for the last three years is as follows:</p> <table border="1" data-bbox="521 558 1341 764"> <thead> <tr> <th></th> <th>2010</th> <th>2011</th> <th>2012</th> </tr> </thead> <tbody> <tr> <td>Material fact report</td> <td>17</td> <td>22</td> <td>18</td> </tr> <tr> <td>Periodic report</td> <td>26</td> <td>12</td> <td>19</td> </tr> <tr> <td>Report on new issuances</td> <td>18</td> <td>11</td> <td>13</td> </tr> <tr> <td>Others</td> <td>30</td> <td>3</td> <td>1</td> </tr> <tr> <td>Total</td> <td>91</td> <td>48</td> <td>51</td> </tr> </tbody> </table> <p><b>Cross-Border Matters</b></p> <p>The number of securities registration statements filed by foreign issuers with the FSC during the past three years is as follows. All of them were filed for initial public offering.</p> <table border="1" data-bbox="699 961 1166 1052"> <thead> <tr> <th></th> <th>2010</th> <th>2011</th> <th>2012</th> </tr> </thead> <tbody> <tr> <td></td> <td>8</td> <td>3</td> <td>3</td> </tr> </tbody> </table> <p>According to Article 176(2) of the Enforcement Decree of the FSCMA, foreign corporations may submit a business report within 120 days (instead of 90 days) of the closing of the business year, and may also submit a half-yearly or quarterly report within 60 days (instead of 45 days) of the closing of each term. In addition, if a foreign corporation has submitted any document equivalent to a business report to its home country, it may submit it along with a Korean translation within ten days (or five days in case of a report on material facts) from the day on which it submitted such a document. Foreign corporations are also subject to somewhat modified periodic and material event disclosure obligations.</p>		2010	2011	2012	Material fact report	17	22	18	Periodic report	26	12	19	Report on new issuances	18	11	13	Others	30	3	1	Total	91	48	51		2010	2011	2012		8	3	3
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	8	3	3																														
Assessment	Fully Implemented																																
Comments	<p>The Korean disclosure requirements are very prescriptive, in particular with regards to the material event disclosures. The views of market participants on the content of the current disclosure requirements were somewhat mixed. Some were of the view that despite some duplication in the statutory and KRX requirements, the compliance burden is acceptable given the underlying investor protection objective. However, others considered that there is already too much information, and it is difficult to filter the essential information.</p> <p>The prescriptive material event disclosure requirements are not necessarily the most effective manner to ensure that investors are best informed of all matters relevant to the price of the security. Even though compliant with the minimum requirement of the IOSCO Assessment Methodology, the following day deadline for material event disclosures is not in line with international best practice.</p> <p>The disclosures are made efficiently and transparently through the FSS DART and KRX KIND systems that are interlinked.</p>																																

<b>Principle 17.</b>	Holders of securities in a company should be treated in a fair and equitable manner.
Description	<p><b>Possibility to Issue Different Classes of Shares</b></p> <p>According to Article 344 of the Commercial Act, a company may issue different classes of shares which are different in respect of their particulars as to the dividends, distribution of surplus assets, exercise of voting rights at a general meeting of shareholders, repayment, conversion etc. In such cases, the articles of incorporation are required to provide the particulars of each class of shares. However, according to Article 369(1) of the Commercial Act, a shareholder will always have one vote for each common stock.</p> <p><b>Shareholders' Meetings</b></p> <p><i>Voting on election of directors</i></p> <p>According to Article 382 of the Commercial Act, directors have to be elected at a general shareholders' meeting.</p> <p>On the basis of Article 382-2 of the Commercial Act, in case where a general meeting of a company is convened to elect at least two directors, shareholders who hold at least three percent of the total outstanding shares other than non-voting shares may request that the company elect directors by means of a concentrated vote, except as otherwise provided by the articles of incorporation. Such request has to be made in writing at least seven days prior to the date set for the meeting. Each shareholder will then have voting rights per share in the same number as the number of directors to be elected, and the voting rights may be exercised by means of a concentrated vote for one or several candidates for directors.</p> <p><i>Voting on changes affecting the terms and conditions of securities</i></p> <p>According to Article 435 of the Commercial Act, if a company has issued different classes of shares and a certain class of shareholders is to be prejudiced by the amendment of the articles of incorporation, a resolution of a general meeting of such specific class of shareholders is required for effecting the amendment in addition to that of a general shareholders' meeting. Such resolution has to be adopted by the affirmative votes of at least 2/3 of the voting rights of the shareholders present at the general meeting and of at least 1/3 of the total outstanding shares of such class. The same applies where special provisions are to be made with regard to each class of shares in accordance with Article 344 and where the shareholders of certain class of shares are to be prejudiced by a division or merger of the company or a swap or transfer of shares (Article 436 Commercial Act).</p> <p>A resolution adopted by the affirmative votes of at least 2/3 of the voting rights of the shareholders present at the general meeting and of at least 1/3 of the total outstanding shares is sufficient to effect the following (Article 374 of the Commercial Act):</p> <ul style="list-style-type: none"> <li>• Transfer of the whole or a substantial part of the business of the company;</li> <li>• Takeover of the whole business of another company; and</li> <li>• Takeover of parts of business of another company which significantly affects the company's business.</li> </ul> <p>According to Article 374-2 of the Commercial Act, a shareholder who dissents with the above mentioned decisions or has notified the company in writing of his intention of such dissent before the general shareholders' meeting may request the company in writing to purchase his shares. Such a request has to be made within twenty days after the resolution is adopted at the general meeting. Similar requirements</p>

apply to share exchanges and simplified share exchanges under Articles 360-3, 360-5 and 360-9 of the Commercial Act. The company is required to purchase the shares within two months after receiving the request. The purchase price of the shares will be determined through a negotiation between the shareholder and the company. Where the negotiation has not been concluded within 30 days since the receipt of the request, the company or the shareholder requesting the purchase of shares may request a court to determine the purchase price. Where the court makes a decision on the purchase price of shares, it has to compute it using the fair value of the assets of the company, taking into account other relevant matters.

#### *Notice of general shareholders' meetings and voting decisions*

According to Article 363 of the Commercial Act the notice for convocation of a general meeting must be dispatched in writing or by an electronic document to each shareholder at least two weeks prior to the date set for the meeting. The written notice has to state the subject matters of the meeting. If the company has issued bearer share certificates, it has to give public notice stating its intention to hold a general meeting and the subject matters of the meeting at least three weeks prior to the meeting.

Pursuant to Article 542 of the Commercial Act, if a listed company convenes a general meeting of shareholders, it may give public notice to shareholders who own stocks not exceeding 1 percent in two or more daily newspapers on two or more occasions or by disclosing such information in the DART system.

#### *Use of proxies or voting instructions*

According to Article 152 of the FSCMA, a person who intends to solicit a person to exercise voting rights by proxy (a proxy solicitor) has to deliver a proxy form and reference documents to the solicited voting right holder. The proxy form has to be prepared in such a manner as to allow each solicited voting right holder to express whether he/she approves or not each item on the agenda of the general meeting of shareholders. No proxy solicitor may exercise a voting right in contravention of the solicited voting right holder's intention expressed on the proxy form.

#### **Ownership Registration and Right of Transfer**

Article 396 of the Commercial Act requires the directors to keep the register of shareholders and the register of bonds at the principal office of the company. If there is a transfer agent, the register of shareholders or duplicates of it may be kept in the business office of the transfer agent. The following information on registered shares has to be entered in the register of shareholders (Article 352 Commercial Act):

- The name and address of each shareholder;
- The classes and number of shares held by each shareholder;
- The serial number of share certificates when such certificates have been issued for shares held by each shareholder; and
- The date of acquisition of each share.

If bearer share certificates are issued, the register of shareholders has to state the class, number, serial number, and issuance date of such certificates.

According to Article 335 of the Commercial Act, shares are required to be transferrable to other persons. However, the articles of incorporation of a company may subject the transfer of shares to the approval of the board of directors.

#### **Shareholder Rights for Dividends**

As noted above, a company may issue two or more classes of shares that are different in respect to, among other things, dividends. The articles of incorporation have to provide for the particulars of each class of shares.

#### **Shareholder Rights in Bankruptcy or Insolvency**

As noted above, the share classes can also be different with respect to the distribution of surplus assets in the case of a bankruptcy or insolvency.

#### **Accountability of the Company, its Directors, and Senior Management**

Article 402 of the Commercial Act provides that if a director commits an act in contravention of the relevant acts, subordinate statutes or the articles of incorporation and the act is likely to cause irreparable damage to the company, the auditor or a shareholder who holds at least 1 percent of the total outstanding shares may demand on behalf of the company that the director stop such act. Further, any shareholder who holds at least 1 percent of the total outstanding shares may demand the company to file an action against directors to enforce their liability (Article 403 Commercial Act).

According to Article 385 of the Commercial Act, a director may be dismissed from office at any time by a resolution at a general shareholders' meeting, provided that in case where the term of office of a director was fixed and he is dismissed without cause before the expiration of such term, he may claim damages. If the dismissal of a director is rejected at a general shareholders' meeting notwithstanding the existence of dishonest acts or any grave fact in violation of the relevant acts, subordinate statutes or the articles of incorporation in connection with his duties, any shareholder who holds at least 3 percent of the total outstanding shares may demand the court to dismiss the director within one month from the date on which the above resolution of the general meeting was made.

#### **Regulation of Takeover Bids and Other Change of Control Transactions**

According to Article 133 of the FSCMA and Articles 139 and 140 of the Enforcement Decree of the FSCMA, a public tender offer is a public invitation or offer to purchase the voting stocks (including certificates representing preemptive rights, convertible bonds, certificates of bonds with warrants, and exchangeable bonds) from a number of unspecified people outside the KRX. A person, who together with his/her specially related persons intends to acquire at least 5 percent of the total number of voting stocks and other securities from 10 or more shareholders in a 6-month period has to make a public tender offer.

According to Article 134 of the FSCMA, a person who intends to make a public tender offer has to provide a public notice of tender offer on the:

- Person who intends to make the tender offer;
- Issuer of the stocks and securities subject to the tender offer;



- Purpose of the tender offer;
- Class and number of stocks and other securities subject to the tender offer;
- Terms and conditions of the tender offer, including the period, price, and payment date of the tender offer; and
- Details of the purchasing fund and other matters prescribed in the Enforcement Decree of the FSCMA as necessary for the protection of investors.

The tender offeror is also required to file a public tender statement with the FSC and the KRX on the day on which such public notice of tender offer is provided. On the basis of Article 146 of the Enforcement Decree of the FSCMA, the tender offer period cannot be less than 20 days and more than 60 days.

In addition, Article 137 of the FSCMA requires a tender offeror to prepare a prospectus for tender offer, submit it to the FSC and KRX on the public notice date of the tender offer, and make it available to the public. No prospectus for tender offer is allowed to contain a description different from the relevant tender offer statement or omit any such description.

On the basis of Article 141 of the FSCMA, a tender offeror is required to purchase without delay all the stocks and other securities tendered according to the purchasing terms, conditions and manners stated in the tender offer statement on and after the day following the expiry date of the tender offer period. The purchasing price at the time of purchase has to be uniform. The tender offeror can include a condition in the public notice of tender offer and the tender offer registration that if the total number of tendered stocks and securities exceeds the proposed number for the tender offer, he/she will buy the stocks pro rata within the limit of the proposed number of stocks and other securities subject to the tender offer.

### **Disclosure of Changes in Substantial Holdings**

#### *Registration statements and annual business reports*

The term major shareholder is defined in Article 9 of the FSCMA as a shareholder who falls under any of the following:

- A principal who together with his/her specially related persons holds the greatest number of stocks (including securities depository receipts that are related to the stocks) out of the total number of outstanding voting stocks; and
- A person who falls under any of the following items (referred to as a significant shareholder):
  - (a) A person who holds 10 percent or more of the total number of outstanding voting stocks (including securities depository receipts that are related to the stocks) of a corporation; and
  - (b) A shareholder who exercises de facto control over major matters of a corporation through appointment and dismissal of executives or in any other way.

As noted under Principle 16, each registration statement and annual business report have to include information on matters concerning shareholders. According to the information provided by the FSS, this is interpreted to require the presentation of information on the largest shareholder and significant shareholders at the beneficial owner level.

	<p><i>Ongoing disclosure obligations</i></p> <p>A person who acquires at least 5 percent of the stocks and other equity securities of any stock-listed corporation is required to report the aggregate number of its and its specially related persons' holdings and the purpose of those holdings to the FSC and KRX within five days from the date of acquisition (Article 147 FSCMA). The purpose of the holding refers to whether the acquirer has any intention to exercise influence on the issuer's business control or whether the acquisition has been made only for investment purposes. The details of a change of at least 1 percent also have to be reported to the FSC and KRX within five days from the date on which such change occurs if the purpose of the acquisition is to exercise influence on the issuer's business control. When a person subject to the 5 percent rule files a report as "investment only" purpose, the reporting deadline is changed from within 5 days from the date of occurrence of the reporting obligation to the tenth day of the following month.</p> <p><b>Holdings of Voting Securities by Directors and Senior Management</b></p> <p>The executives of a stock-listed corporation are required to report to the SFC and KRX the status of equity securities held by them within five days from the day on which they became executives or within five days from the day on which any change occurred in the status of the equity securities (Article 173 FSCMA). The SFC and KRX have to keep such reports for public inspection for three years, and disclose them through their Internet homepages.</p> <p>According to the information provided by the FSS, the requirement to include matters concerning executives and employees in the annual business reports of issuers (see Principle 16) covers information on their holdings of voting securities.</p> <p><b>Cross-border Situations</b></p> <p>The FSC requires that foreign issuers that intend to be listed at the KRX disclose in their registration statements information on whether they intend to comply with the relevant laws and regulations of their home jurisdiction rather than the Korean requirements (Article 129 Enforcement Decree of the FSCMA).</p>
Assessment	Fully Implemented
Comments	
<b>Principle 18.</b>	Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.
Description	<p><b>Requirement to Include Audited Financial Statements in Disclosures</b></p> <p><i>Primary market disclosures</i></p> <p>As noted in Principle 16, the securities registration statements are required to include information on matters concerning financial affairs and an external auditor's audit opinion. According to Article 125(2) of the Enforcement Decree of the FSCMA and Article 2-6(8) of the Regulation on Issuance, Public Disclosure, Etc. of Securities, each registration statement for a public offer of equity securities also has to be accompanied by, among other things, the following documents.</p> <ul style="list-style-type: none"> <li>• An external auditor's audit report;</li> <li>• An external auditor's consolidated audit report;</li> <li>• An external auditor's semi-annual audit or review report; and</li> </ul>

- An external auditor's quarterly audit or review report.

The above requirement applies also to most other types of securities, with the exception of guaranteed and secured bonds. The documents accompanying the registration statement are published in the DART system together with the registration statement.

#### *Annual business reports*

As noted in Principle 16, the issuer's annual business report has to include information on matters concerning the issuer's financial affairs. According to Article 168(6) of the Enforcement Decree of the FSCMA, each annual business report also has to be accompanied by, among other things, the conglomerate's consolidated financial statements and the external auditor's audit reports on both the corporation's and consolidated financial statements (see Principle 16 for the filing deadlines).

#### *Requirement to have the financial statements audited*

According to Article 2 of the Enforcement Decree of the Act on External Audit of Stock Companies, a stock company falling under any of the following is subject to external audit by an independent auditor (see Principle 19 on the requirements for the auditor):

- A stock company whose total assets as of the end of the immediately preceding business year amounted to at least KRW 10 billion;
  - A stock-listed corporation or a stock company that intends to become a stock-listed corporation during the current business year or the following business year;
- A stock company whose total liabilities and total assets amount to at least KRW 7 billion respectively as of the end of the immediately preceding business year; and
- A stock company whose number of employees exceeds 300 as of the end of the immediately preceding business year and whose total assets amount to at least KRW 7 billion.

The audit requirement also applies to the financial statements of issuers that have issued and/or listed fixed income securities (Article 169(1) FSCMA and Articles 167(1) and 189(1) Enforcement Decree of the FSCMA).

#### **Content of Financial Statements**

According to Article 1-2 of the Act on External Audit of Stock Companies and Article 1-2 of the Enforcement Decree of the Act on External Audit of Stock Companies, a financial statement includes:

- Balance sheet;
- Income statement;
- Statement of changes in stockholders' equity;
- Statement of cash flow; and
- Footnotes.

### **Accounting Standards Applied in Korea**

The Enforcement Decree of the Act on External Audit of Stock Companies determines that the following companies have to prepare their financial statements and consolidated financial statements in accordance with the K-IFRS:

- A stock-listed corporation;
- A stock company that intends to have its stocks listed during the current or following business year;
- A financial holding company under the Financial Holding Companies Act;
- A bank under the Banking Act;
- An investment trader, an investment broker, a collective investment business entity, a trust business entity, or a merchant bank under the FSCMA;
- An insurance company under the Insurance Business Act; and
- A credit card business entity under the Specialized Credit Financial Business Act.

The use of K-IFRS by the above mentioned companies has been compulsory since 2011, and voluntary since 2009. In particular smaller companies are apparently still struggling to comply with the new requirements.

The other companies (e.g. companies that have only issued and/or listed fixed income securities or whose stocks are not listed) can apply Korean GAAP.

### **Standard Setting and Interpretation**

The FSC is required to determine the accounting standards after going through a deliberation of the SFC (Article 13 of the Act on External Audit of Stock Companies). In Article 7-3 of the Enforcement Decree of the Act on External Audit of Stock Companies, this duty has been further entrusted to the Korea Accounting Institute (KAI)/Korea Accounting Standards Board (KASB), including interpretations of accounting standards and replies to inquiries about them. When preparing new or revised standards, the KASB applies a public exposure period of 30 days before it votes on the standards. The proposed standards are delivered to the Accounting Policy Deliberation Committee of the SFC (see Articles 23, 24, and 26 of the Regulation on External Audit and Accounting) before being submitted to the FSC for approval, after which the revised standards are published.

The KAI is an association established with the approval of the FSC pursuant to the Civil Act. It is required to have a committee comprised of competent experts to deliberate and resolve matters regarding accounting standards. The FSC is required to grant the KAI an amount equivalent to 5 percent of the fees collected by it as a subsidy. The KAI in turn must set aside an amount equivalent to at least 30 percent of the subsidies granted by the FSC as a reserve separate from its working capital that can be used only in specific cases, subject to the prior approval of the FSC.

The FSC (taking into account the advice of the SFC) may ask the KAI/KASB to change the details of the accounting standards when deemed necessary to protect interested parties and to conform to the international standards (Article 13 of the Act on External Audit of Stock Companies). In such cases, the KAI/KASB must comply with the request unless justifiable grounds exist that make it impossible for it to do so.

### Supervision and Enforcement of Compliance with the Accounting Standards

The SFC is assigned with the duty to conduct supervision over the audit reports. It may delegate matters concerning examinations on account books and documents related to accounting of a company or investigations of the current status of business and property of a company to the Chairperson of the SFC (Articles 8 and 9 of the Enforcement Decree of the Act on External Audit of Stock Companies). The review of the audit reports and related financial statements has been further delegated to the FSS and KICPA.

The SFC may, if necessary for the purposes of performing its duties to supervise the audit reports, request a company or its related company and an auditor to submit data, state opinions or make reports, or may have the Governor of the FSS inspect the accounting books and documents of the company or its related company, or investigate its business and financial status (Article 15-2 Act on External Audit of Stock Companies). If necessary, the FSS may also review the external auditor's audit report. For the purpose of conducting an audit report review, the FSS may review auditor's working papers and interview those involved in the audit engagement (see Principle 19 for further details).

When the FSS reviews the audit engagements of external auditors (including their audit reports), it also assesses issuers' compliance with accounting standards. As a rule, this assessment primarily consists of the analysis of public disclosures made by issuers. If needed, the FSS may demand access to issuers' books and other records, order issuers to submit documents and data, or order their executive officers and/or employees to be available for an interview or statement. In addition, the FSS may initiate an on-site visit to issuers' office, factory, or any other business premises.

On the basis of the above, the Korean authorities approach the enforcement of accounting standards primarily through their audit oversight function. However, this approach has led to some measures against issuers as well, as demonstrated by the sanctions imposed by the SFC in 2010-2012 for issuers' non-compliance with the accounting standards ("issuers" here include both listed and non-listed companies):

#### Sanctions Imposed on Issuers for Non-compliance with Accounting Standards

	2012	2011	2010
Notification to prosecutors	11	11	25
Civil money penalty	22	17	27
Fine	0	1	1
Disciplinary warning/caution	9	13	13
Restriction on issuance of securities	27	26	41
Recommendation for the dismissal of relevant executive officers	20	17	22
Letter assuring no recurrence of misconduct	1	0	0
Designation of outside auditor by the regulatory authority	46	43	67
Correction action demanded	11	11	18
Total	147	139	214

Note: As there may be companies subject to several sanctions simultaneously, the total number of sanctions may differ from the total number of companies sanctioned.

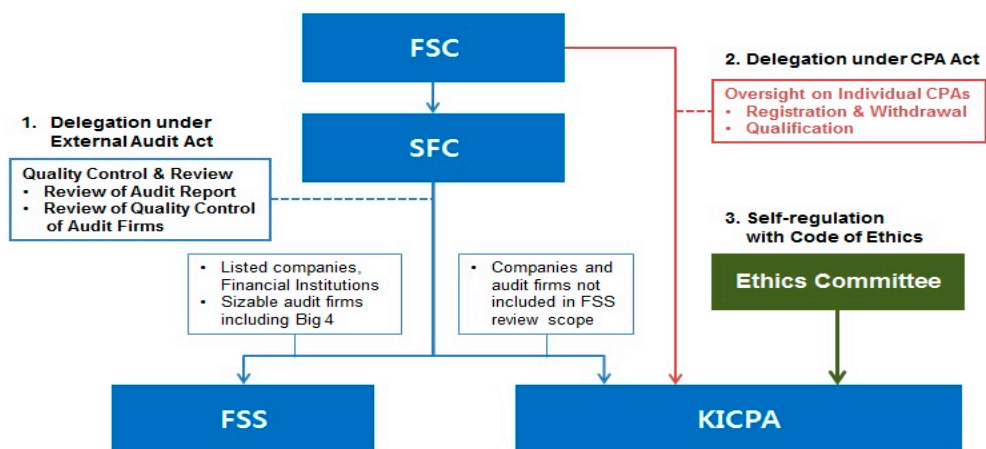
	<p><b>Foreign Issues</b></p> <p>According to Article 176(6) of the FSCMA, financial statements or consolidated financial statements described in or attached to annual business reports, half-yearly reports and quarterly reports of foreign corporations that have listed equity securities at the KRX are required to be prepared based on any of the following accounting standards:</p> <ul style="list-style-type: none"> <li>• K-IFRS;</li> <li>• IFRS; or</li> <li>• Generally Accepted Accounting Principles of the United States.</li> </ul>
Assessment	Fully Implemented
Comments	<p>The infrastructure for establishing and interpreting the K-IFRS and supervising and enforcing compliance with them is in place. However, according to the FSC press release published shortly before the end of the assessment mission, accounting fraud by top management of companies continues to be a problem, and there is a need to strengthen enforcement powers in this area by, among others, introducing the possibility to restrict the eligibility for an executive of a listed company for up to two years. Such measures are planned to be taken in connection with measures targeted at auditors (see Principle 19). The enforcement challenges in the area of compliance with accounting standards have been taken into account in the ratings of Principles 19 and 20.</p>
<b>Principles for Auditors, Credit Ratings Agencies, and Other Information Service Providers</b>	
<b>Principle 19.</b>	Auditors should be subject to adequate levels of oversight.
Description	<p><b>Auditor Qualification Requirements</b></p> <p>According to Article 3 of the Act on Certified Public Accountants (CPA Act), each person who has passed the certified public accountant (CPA) examination will be admitted as a CPA. The CPA examination is administered by the FSS with delegation from the FSC. If a person qualified as a CPA intends to render audit and other services defined in Article 2 of the CPA Act (including as an employee of an audit firm), he/she needs to apply for registration as a CPA after completing an apprenticeship training of not less than one year. The FSC has delegated the registration of CPAs to KICPA.</p> <p>Any CPA may establish an accounting corporation<sup>16</sup> in order to systemically and professionally render audit and other services (Article 23 CPA Act). Any such audit firm is required to register with the FSC. A registrant has to satisfy the following main requirements:</p> <ul style="list-style-type: none"> <li>• Have at least three directors who are CPAs;</li> <li>• Have at least ten CPAs among its directors and employees; and</li> <li>• Have capital of at least KRW 500 million.</li> </ul> <p>In Korea, an individual CPA can be the auditor of stock companies, with the exception of stock-listed corporations (i.e. corporations whose shares have been listed on KOSPI or KOSDAQ). Article 3 of the Act</p>

<sup>16</sup> Accounting corporations are referred to below as audit firms for consistency with the IOSCO terminology and market practice.

on External Audit of Stock Companies requires that an auditor conducting an audit of a stock-listed corporation has to be either an audit firm (as defined in Article 23 of the CPA Act) or an audit team registered with KICPA.

**Responsibility for Audit Oversight**

The following diagram summarizes the responsibilities of the FSC, SFC, FSS, and KICPA in audit oversight.



Source: KICPA.

*Legal responsibility of the Securities and Futures Commission*

Under Article 15 of the Act on External Audit of Stock Companies and Article 8 of the Enforcement Decree of the Act on External Audit of Stock Companies, the SFC is assigned with the responsibility

To review the audit reports in order to ensure a fair auditing and to review whether the audit has been made in compliance with the auditing standards.

The SFC is also required to perform the supervisory activities related to the quality control environments of auditors (Article 8(3) of the Enforcement Decree of the Act on External Audit of Stock Companies).

*Legal responsibility of the Financial Services Commission*

The legal responsibility for registering CPAs lies with the FSC (Article 7 CPA Act). It is also responsible for refusing and withdrawing a registration (Articles 8 and 9 CPA Act) and disciplining registered CPAs (Article 48(1) CPA Act).

*Delegated responsibility of the Financial Supervisory Service*

The SFC has entrusted the Governor of the FSS with the responsibilities for audit oversight (Article 9(2) of the Enforcement Decree of the Act on External Audit of Stock Companies and Article 75 of the Regulation on External Audit and Accounting). In particular, the FSS has been delegated the responsibility for the supervision of the audit reports on stock-listed corporations and on financial institutions subject to its examinations. Further, it is charged with the supervision of the following external auditors:

Auditors that audit more than 1 percent of the total number of stock-listed corporations as of the end of April each year;

- Auditors that audit any stock-listed corporation whose total amount of assets is at least KRW 1 trillion as of the end of April each year;
- Auditors with more than 30 registered CPAs; and
- Auditors for which direct supervision of the FSS is required due to the parallel supervision by a foreign supervisory agency and the request of the auditor.

In addition, in accordance with Article 49(2) of the Regulation on External Audit and Accounting, at the request of the FSC or if the FSC or SFC's performance of their duties or a tip from related parties reveals that an auditor has performed its work inappropriately, the FSS may initiate a for cause audit quality review.

#### *Delegated responsibility of Korean Institute of Certified Public Accountants*

KICPA is responsible for the supervision of those audit reports and auditors that are not the responsibility of the FSS (Article 67 of the Regulation on External Audit and Accounting). The responsibility for registering CPAs as well as rejecting or withdrawing their registration has also been entrusted to KICPA (Article 52 CPA Act and Article 38 of the Enforcement Decree of the CPA Act).

KICPA is required to establish a committee necessary for carrying out the business affairs entrusted to it and to establish regulations on the organization and operation of this committee and supervisory guidelines (Article 9(4) of the Enforcement Decree of the Act on External Audit of Stock Companies). When KICPA intends to establish or amend its regulations, it has to obtain the approval of the SFC. It is also required to report to the SFC on the results of the affairs entrusted to it.

#### *Outcome of the delegations*

In practice, the above delegations have led to the FSS being in charge of the supervision of 32 out of a total of 125 audit firms, whereas KICPA is responsible for the rest (including any audit teams and individual CPAs that act as auditors). The 32 firms supervised by the FSS audit about 85-90 percent of stock-listed corporations. Through its supervision of audit reports of stock-listed corporations, the FSS is involved in the oversight of a broader group of audit firms. However, if a small auditor audits only corporations that have listed or publicly offered only other securities than stocks, it is subject only to KICPA supervision. The same would apply to auditors of corporations that have only made public offers of stocks without having them listed. As a result of this, firms providing audit services to issuers whose shares are traded on the Freeboard of KOFIA would be excluded from the FSS oversight.

### **Practice in the Review of Audit Reports and Quality Control of Audit Firms**

#### *Financial Supervisory Service*

As noted above, the FSS is responsible for reviewing the audit reports of stock-listed corporations and financial institutions. It conducts this primarily through sampling by reviewing approximately 10 percent of all audit reports falling under its responsibility. Further, it reviews additional 5 percent of the reports on a for cause basis due to suspected disclosure deficiencies by issuers.



With regards to audit quality reviews, the FSS conducts them on a periodic basis, and the review cycle varies depending on the number of stock-listed corporations an audit firm audits. More specifically, if an audit firm audits 100 or more stock-listed corporations, it is subject to the FSS' audit quality review every two years. The review cycle is three years for audit firms auditing 20 or more but less than 100 publicly-held companies, and three to five years for audit firms auditing less than 20 publicly-held companies.

In its examinations, the FSS reviews whether the auditors comply with the independence requirements of the Act on External Audit of Stock Companies and Section 290 of the KICPA Code of Ethics that pertains to the independence of audit firms (see Principle 20). The FSS also verifies whether the audit firm complies with the quality control policies and procedures included in the Korean International Standard on Quality Control (ISQC) 1.

#### *Korean Institute of Certified Public Accountants*

KICPA has put in place a mechanism to review the audit reports and quality control systems of audit firms falling under its responsibility. KICPA's Audit Quality Control Supervisory Committee reports the results of its review to its Audit Quality Review Committee that determines any disciplinary measures on auditors and individual CPAs, except in the cases that have to be decided by the SFC or FSC (see below).

The team responsible for the reviews of audit reports and quality control of audit firms in KICPA has 11 members. The focus of the activities is in the review of audit reports that KICPA reviews by sampling on the basis of certain criteria (both risk-based and random). It also reviews the quality control of audit firms through on-site visits every five years (seven years for audit teams).

The main objective of the KICPA audit report reviews is to summarize the findings and communicate them to all auditors as an input for discussions on how to improve audit quality. The KICPA quality control reviews of audit firms also follow a somewhat different approach from that applied by the FSS, by focusing more on guiding the firms and preparing recommendations on the basis of the findings of the on-site visits.

#### **Enforcement Powers**

##### *Securities and Futures Commission and Financial Services Commission*

According to Article 52 of the Regulation on External Audit and Accounting, when the chairman of the SFC considers that it is necessary to recommend improvement of the quality of audit as a result of an examination of an auditor, he will submit a proposal to the SFC to advise the auditor to achieve improvement of the operation or quality control system within a year. In order to ensure that the recommendations for improvement will be implemented, the SFC may require an auditor to report details of its performance within one month after the end of the period given for compliance with the recommendation (Article 64(3) of the Regulation). According to the information disclosed by the FSC this power is currently not used effectively.<sup>17</sup> In addition, these types of recommendations are not allowed to be disclosed to the public due to a specific prohibition in Article 52(2) of the Regulation<sup>18</sup>.

<sup>17</sup> See the FSC press release of April 16, 2013, which notes that no follow-up is currently made. The FSC proposes in the press release that, in the future, if an audit firm's quality control system has serious defects, it would be disclosed to the public immediately and follow-up would be made within 1 year from the notification of recommended improvement.

According to Article 16 of the Act on External Audit of Stock Companies, if the requirements of the Act are breached, the SFC may either itself take or recommend that the FSC take certain measures. The measures against auditors are specified in Article 53 of the Regulation on External Audit and Accounting, according to which the SFC may impose one of the following measures against an auditor for violations:

- Suggestion of following measures to the FSC:
  - (a) Cancellation of registration of the audit firm or team; and
  - (b) Suspension of part or entire operations of the audit firm for up to one year.
- Restriction on providing audit services for specific companies for up to five years;
- Additional contributions to the joint fund for damages;
- Warning or caution; and
- Other necessary measures, such as a correction order or a request for submission of a memorandum (in which the auditor promises to comply faithfully with the auditing standards).

On the basis of Article 15 of the Act on External Audit of Stock Companies, the SFC may delegate certain of its tasks to the FSS. However, none of its enforcement powers have been delegated to the FSS. Before the SFC takes a decision on enforcement measures against auditors, the cases are deliberated by its Accounting Oversight Deliberation Committee (see Articles 23, 25, and 26 of the Regulation on External Audit and Accounting).

Certain enforcement measures may also be taken under the CPA Act. The FSC may cancel the registration of an audit firm that does not meet the requirements specified in Articles 26(1), 26(2), or 27(1) of the Act and fails to supplement them within three months, that has made a registration in a false or unlawful manner, or that has rendered the services in violation of a suspension order. The FSC may also suspend the services of an audit firm that has violated the CPA Act on an order made under the Act.

The FSC may also impose a civil money penalty in lieu of a business suspension under Articles 39(1)(5) or 48(1)(2) of the CPA Act, if such a suspension is feared to have a serious impact on interested persons, etc. or harm the public interest. The penalty cannot exceed KRW 500 million on audit firms and KRW 100 million on CPAs.

#### *Korean Institute of Certified Public Accountants Enforcement*

The Audit Quality Review Committee of KICPA may take appropriate in case of non-compliance, depending on the result of the review of audit reports (Article 9.1 of the Terms of Reference on the Operation of the Audit Quality Control Review Committee). The measures that can be taken by KICPA are the same as those that can be taken by the SFC under Article 16 of the Act on External Audit of Stock Companies.

The Ethics Committee of KICPA may also take or propose appropriate disciplinary measures against auditors or CPAs that have violated the CPA Act (Article 48(2) of the CPA Act and Article 38(2) of the Enforcement Decree of the CPA Act). Minor disciplinary measures provided under Article 48(2) of the CPA

<sup>18</sup> This part of the regulation has been mistranslated to English, but the Korean version prohibits publication of individual measures. However, statistics and summary of key findings of auditor examinations are published in yearly press releases.

Act (i.e., reprimand or suspension of part of practicing for one year or less) can be taken by KICPA, whereas the FSC itself decides on cancellations of registrations and longer suspensions of practicing (for maximum of two years) for CPAs.

In addition, there are measures against CPAs that were involved in a violation conducted by an audit firm (Article 54 of the Regulation on External Audit of Stock Companies):

- Suggestion of following measures to the FSC:
  - Cancellation of registration; and
  - Suspension of license for up to two years.
- Restriction on audit services for specific stock-listed corporations and companies whose auditor is designated by the SFC;
- Restriction of audit services for specific companies for up to five years;
- Completion of KICPA professional education program for up to twenty hours;
- Warning or caution; and
- Other necessary measures, such as a correction order or request for submission of a memorandum (in which the auditor promises to comply faithfully with the auditing standards).

#### *Korean Institute of Certified Public Accountants Self-Regulatory Measures*

The Ethics Investigation and Review Committee of KICPA may also take disciplinary measures against auditors or CPAs that violate KICPA's regulations, including a failure to complete the required training programs (Articles 19.3–19.4 of the Terms of Reference of the Ethics Committee and the Ethics Investigation and Review Committee).

#### *Criminal sanctions*

The penal provisions are in Article 53 of the CPA Act. They include the following applying to CPAs (including directors, affiliated CPAs, and foreign CPAs of audit firms):

- Imprisonment with prison labor for not more than three years or a fine not exceeding KRW 10 million for a person who has intentionally concealed truth or made a false report or a person who has divulged confidential matters learned in the course of providing services;
- Imprisonment with prison labor for not more than one year or a fine not exceeding KRW 5 million for a person who has audited or attested financial statements in violation of the independence requirements of Articles 21(1) and (2) and 33(1) and 33(2) of the CPA Act (see Principle 20); and
- A fine not exceeding KRW 5 million for any CPA who has provided audit and other regulated services without registration or renewal of registration.

Type of Sanction		2010	2011	2012
	Cancellation of registration	2	0	0
	Suspension of business	0	0	0
	Monetary fine	6	5	4
Audit firms	Disciplinary warning	15	12	10
	Caution	11	9	6
	Additional payment to the joint fund for	40	32	40
	Restriction of audit of particular companies	43	33	38
	Total	69	54	57

#### Enforcement Measures Taken<sup>19</sup>

##### *Violation of auditing standards*

In practice, the FSS, KICPA, SFC and FSC<sup>20</sup> have taken the following measures against audit firms and CPAs in the past three years due to the violation of the auditing standards.

Type of Sanction		2010	2011	2012
	Charge to prosecutors		5	-
	Notification to prosecutors		1	-
	Cancellation of registration		2	-
	Suspension of duties		22	10
CPAs	Disciplinary warning		25	15
	Caution		34	27
	Restriction of audit of particular companies		73	56
	Mandatory completion of training program		92	71
	Total number of sanctions on CPAs		126	98

##### *Violation of independence requirements*

With regards to the violation of the independence standards, the measures taken by the FSS, KICPA, SFC, and FSC<sup>21</sup> are the following:

<sup>19</sup> The total numbers of sanctions in the tables below may be lower than the sum of the various types of individual sanction, because several types of sanction may have been imposed on the same violation.

<sup>20</sup> Statistics separating the sanctions of KICPA from those imposed by the FSS, SFC, and FSC were not available.

<sup>21</sup> Statistics separating the sanctions of KICPA from those imposed by the FSS, SFC and FSC were not available.

		Type of Sanction			
		2010	2011	2012	
	Audit Firms	Additional payment to the joint fund for damages	2	0	2
		Restriction of audit of particular companies	2	0	2
		Total	2	0	2
		Type of Sanction	2010	2011	2012
		Charges to prosecutors	1	0	0
		Disciplinary warning	1	0	1
	CPAs	Restriction of audit of particular companies	3	0	2
		Mandatory completion of training program	4	0	2
		Total number of sanctions	4	0	2
Assessment	Broadly Implemented.				
Comments	<p>Shortly before the end of the assessment mission, the FSC published a press release announcing that the proposed amendments to the Act on External Audit of Stock Companies had been passed at a Cabinet meeting. The amendment bill was planned to be submitted to the National Assembly in April 2013 in order to be passed in the course of 2013. The key purpose of the amendments is to root out accounting fraud and poor auditing and promote the establishment of sound and credible accounting systems. The press release and its accompanying document provide extensive information on the deficiencies identified in the quality control reviews of audit firms, emphasizing the fact that on average audit reviews in small/medium-sized audit firms discovered almost twice as many issues as those made in large audit firms.</p> <p>Although the IOSCO Methodology does not impose specific requirements on the qualifications of those that provide audit services for issuers whose securities are listed or publicly offered, the significant quality control and independence deficiencies identified in the Korean market indicate that there is room for improvement in the requirements for auditors that provide such services. From that perspective, the recently proposed introduction of tightened quality control requirements for audit firms is important.</p> <p>The FSS oversight program appears to be fairly robust, but the recurring misconduct cases raise the question on whether it should be further strengthened along the changes to the regulatory requirements on quality control and independence. This applies in particular to the smaller audit firms that are inspected only every three to five years. Further, the KICPA oversight program focuses on the review of audit reports, and audit firms (audit teams) falling under its responsibility are inspected only every five (seven) years. No information was available distinguishing the number and nature of enforcement measures taken by the FSS and KICPA, respectively. Along with robust oversight, it is important that the existing enforcement powers available to the authorities (including KICPA) are used effectively.</p>				
<b>Principle 20.</b>	Auditors should be independent of the issuing entity that they audit.				
Description	<p><b>Regulatory Requirements on Independence</b></p> <p>Auditor independence is addressed in several regulatory requirements in Korea.</p> <p><i>Act on External Audit of Stock Companies and CPA Act</i></p>				

Article 3 of the Act on External Audit of Stock Companies provides that an audit firm cannot audit a company with which it has financial interests or an employment relationship as prescribed in Article 33(1) of the CPA Act. A member of an audit team cannot audit a company with which one or more of the audit team's CPAs have a relationship prescribed in Article 21(1) of the CPA Act.

According to the Enforcement Decree of the CPA Act, a CPA (including audit firms, partners of audit firms or their spouses, or engagement team members or their spouses) is not entitled to perform audits on entities with which he/she has financial interests or an employment relationship. Financial interests refer to owning stocks or equities, having credits or liabilities worth at least KRW 30 million (KRW 100 million in case of an audit firm), or being continuously given remuneration for what are not considered as usual audit services. An employment relationship is described as serving as an executive member of the entity in question or holding an equivalent position including being in charge of financial matters.

An audit firm is not allowed to have the same director perform the audit business of a company for six consecutive business years (four in the case of a stock-listed corporation). Further, in case of a stock-listed corporation, an audit firm cannot have a director who has audited the stock-listed corporation for three consecutive business years conduct any audit of such corporation for the whole period of the next three consecutive business years (Article 3(4) of the Act on External Audit of Stock Companies).

If an audit firm has had its CPAs perform the audit of a stock-listed corporation as assistants for three consecutive business years, such audit firm is required to replace at least two thirds of the assistants in the next business year. The same rule applies to audit teams performing the audit of a KOSDAQ listed corporation.

Any CPA, who is contracted to perform the business of auditing or certifying the financial statement of a particular company, is prohibited from performing the following business for the company during the contract term:

- Making accounting records and compiling financial statements;
- Conducting internal audit;
- Creating or operating the financial information system; and
- Other business conflicting with the business of auditing or certifying the financial statement, including conducting certain valuation services (Article 14(2) of the Enforcement Decree of the CPA Act).

For performing any other business, a CPA is required to consult with the internal auditor and audit committee of the company and receive their consent on such business.

*Korean Standards on Auditing and Korean Institute of Certified Public Accountants Code of Ethics*

The Korean Standards on Auditing (KSAs) mandate conformity with the KICPA Code of Ethics for Professional Accountants, which has incorporated the international code of ethics published by the International Ethics Standards Board for Accountants (IESBA) in 2005. According to §290 of the Code of Ethics, the auditor is required to reject the auditing offer where there is no tool, such as clearance of financial interests, which would remove or decrease the factors compromising the independence of the auditor.

In order not to compromise its independence, an auditor is not allowed to provide an audited corporation with non-auditing services that may create circumstances of self-interest, self-review, advocacy, familiarity, or intimidation (§290.158–290.205 of the Code of Ethics).

### **Requirements for Monitoring, Identifying, and Addressing Threats to Independence**

Pursuant to §18 and 19 of the KICPA Audit Quality Control Standards, an auditor and any person who is obliged to comply with the independence requirements (including the experts who are involved in the audit and the network auditor's members) should establish and implement policies and procedures providing confidence that the requirements for maintaining independence are observed.

An auditor should (i) make it easy to confirm compliance with the independence requirements; (ii) update all the documents on independence; and (iii) take action where it detects any compromise of independence by providing to all the members involved in the audit the information necessary for maintaining independence.

#### *Role of the audit committee*

According to Article 4 of the Act on External Audit of Stock Companies, in selecting and appointing an auditor, any stock-listed corporation is required to get the approval of the auditor selection and appointment committee. If an audit committee has been established pursuant to the Commercial Act, it will be considered to be the auditor selection and appointment committee.

A stock-listed corporation with at least KRW 2 trillion in total assets is required to establish an audit committee (Articles 542-11 and 542-12 Commercial Act). In this case, shareholders having voting rights exceeding 3 percent of the total number of voting rights cannot vote with those excess voting rights at the general shareholders' meeting for the appointment or dismissal of the audit committee members.

#### *Governance standards for monitoring and safeguarding independence*

Pursuant to §290.29 of the Code of Ethics, the internal auditor or audit committee is required to monitor the independence of the external auditor. The internal auditor is required to exchange information on the independence of the external auditor with the audit committee. According to §290.33 of the Code of Ethics, an external auditor is required to cooperate with or get approval of the internal auditor or audit committee when seeking to provide non-auditing services other than those that are prohibited.

#### *Disclosure of the resignation, removal or replacement of an auditor*

According to Article 4-4 of the Act on External Audit of Stock Companies and Article 4-3 of the related Enforcement Decree, if a company appoints or replaces an auditor, it has to submit a report to the SFC within two weeks of the date of the contract. Article 4-2 of the Act provides that any stock-listed corporation has to appoint an auditor within four months from the initial date of the first business year and allow such auditor to conduct an audit for three consecutive business years. Where an auditor falls under any cause specified in Article 3(5) of the Enforcement Decree, such as a breach of duty, the company may dismiss the auditor upon approval from the auditor selection and appointment committee within three months from the end of each business year even during the period of three consecutive business years. In such cases, the company is required to report the dismissal without delay to the SFC.

### **Enforcement**

See Principle 19 above for the various types of enforcement measures that can be used and have been used to enforce compliance with the auditor independence standards. According to the information provided by the authorities, the reason for the total of four independence related enforcement measures taken in the last three years was that the same audit firm partner conducted audits of non-listed corporations for six consecutive years. Principle 19 also provides information on the enforcement

	measures taken against CPAs for violation of the independence requirements. During the mission, the FSC published a press release expressing concerns about auditors' compliance with the various independence requirements. Most importantly, some auditors do not apparently comply with the prohibition to compile the financial statement of the companies that they audit.
Assessment	Broadly Implemented
Comments	The independence requirements included at the regulatory and self-regulatory level in Korea incorporate the key issues addressed in Principle 20. However, despite the low number of enforcement cases in the past three years, there have been challenges in enforcing compliance with the independence requirements. This is likely to be related to the broader challenge on how to ensure sufficient availability and use of high quality and independent audit services (see also Principles 19 and 21).
<b>Principle 21.</b>	Audit standards should be of a high and internationally acceptable quality.
Description	<p><b>Audit Standard Setting in Korea</b></p> <p>The requirements for including audited financial statements in the registration statements, annual business reports and half-yearly and quarterly reports are described in Principle 18 above.</p> <p>Article 5 of the Act on External Audit of Stock Companies provides that an auditor has to conduct an audit according to the standards for external audit generally accepted as fair and reasonable. KICPA is authorized to set these standards after having obtained the prior approval of the FSC. In practice, the Korea Auditing and Assurance Standards Board (KAASB) established under KICPA sets the auditing standards applied in Korea.</p> <p>The current KSAs, which are based on the former ISAs issued by the International Auditing and Assurance Standards Board (IAASB) before 2004, focus more on audit procedures than the new clarified ISAs that are characterized by a risk-based approach. While the current KSAs include elements of a risk-based approach, the underlying approach is still different from the clarified ISAs.</p> <p>One of the additional differences between the KSAs and clarified ISAs is that the KSAs still allow a group auditor to divide the responsibility for audit work between the audit team, while the primary auditor is responsible for the component auditors' work to render the audit opinion under the clarified ISAs. In December 2008, KICPA published its International Federation of Accountants (IFAC) Part 3 Action Plan, in which it announced that the KAASB and FSC plan to approve the clarified ISAs in Korean as new statutory auditing standards. The new KSAs were issued in December 2012, and will take effect from the period commencing January 1, 2014. In practice the large Korean audit firms already apply the clarified ISAs/KSAs.</p> <p>The KAASB's tasks in relation to the KSAs are to establish, revise and interpret:</p> <ul style="list-style-type: none"> <li>• KSAs;</li> <li>• Details of the KSAs, such as the practical guidance;</li> <li>• Standards for non-audit assurance services;</li> <li>• Standards for quality control; and</li> <li>• Standards for and practical guidance on audit, excluding those subject to the Act on External Audit of Stock Companies.</li> </ul>



	<p>The process for adopting or revising a standard includes exposure for public comments (normally for 30 days), final decision making and vote by the KAASB, approval by the FSC, and publication by KICPA. Before the approval of the FSC, the proposed standards are first approved by the Accounting Policy Deliberation Committee of the SFC (Article 26 Regulation on External Audit and Accounting).</p> <p><b>Enforcement</b></p> <p>The disciplinary measures provided in Article 16 of the Act on External Audit of Stock Companies apply to cases where an auditor has violated the requirement in Article 5(1) of the Act to conduct the audit according to the required standards. There have been a significant number of cases where auditors and CPAs have been sanctioned due to the violation of the auditing standards.</p>
Assessment	Broadly Implemented
Comments	The KSAs are currently not fully in line with the clarified ISAs, but will become so from the beginning of 2014. In line with the other Principles covering enforcement of various requirements on accounting, auditing and auditors, there appears to be a challenge in enforcing compliance with the auditing standards.
<b>Principle 22.</b>	Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.
Description	<p><b>Registration</b></p> <p>Obtaining a credit rating from at least two credit rating agencies is mandatory in Korea in the case of public offers of corporate bonds and issuance of commercial papers. If a CIS intends to invest in a privately placed security, such a security also has to have a credit rating.</p> <p>Article 2(12) of the Use and Protection of Credit Information Act defines a credit rating service as assessing the probability of repayment of the principal and interest in connection with financial instruments, credit facilities, etc. and the credit worthiness of companies, legal entities, indirect investment vehicles, etc. for the purpose of protecting investors. Credit rating business is one type of credit information business, and any person who intends to engage in credit information business is required to obtain a license from the FSC (Article 4).</p> <p>According to Article 6(1) of the Use and Protection of Credit Information Act, any person who intends to obtain a license for credit information business has to satisfy the following requirements:</p> <ul style="list-style-type: none"> <li>• The applicant has to have sufficient human resources and physical facilities, including computer equipment, to carry out credit information business;</li> <li>• The applicant has to have reasonable and sound business plans;</li> <li>• Major investors of the applicant have to have sufficient investment capacity, viable financial standing and social credibility; and</li> <li>• The applicant has to have a sufficient level of expertise to perform credit information business.</li> </ul> <p>Any person who intends to be licensed to engage in credit rating business has to possess capital of at least KRW 5 billion (Article 6(2) (1)).</p> <p>There are currently four licensed credit rating agencies (CRAs) in Korea, although one of them is not authorized to provide credit ratings for corporate bonds. No foreign CRAs provide credit rating services in Korea, but three of the four Korean CRAs are majority owned by foreign CRAs.</p>

According to Article 5(2) of the Use and Protection of Credit Information Act, a corporation is prohibited from being licensed to provide credit rating services if at least 10 percent of its capital is invested by a company that is part of a conglomerate or a financial institution or its affiliates.

The FSC may cancel the license of a credit information company in certain cases (Article 14). It may also issue an order to wholly or partially suspend business for a specified period of not more than six months, if a credit information company does not continue to satisfy the requirements of sufficient human resources and physical facilities (Article 6(4)), or violates Article 11 or 28 of the Act.

### **Ongoing Supervision**

A credit rating agency is required to submit to the FSC documents to identify its rating capabilities, including a credit rating performance report, etc., and provide such documents to the KRX and KOFIA to make them available to the public (Article 29(5) Act on Use and Protection of Credit Information).

According to Article 45(1) of the Act, the FSC supervises whether a credit information company complies with the Act and orders under it. The FSC may, if necessary, order a credit information company to report in relation to its business, financial standing, etc. The Governor of the FSS may have the personnel of the FSS inspect the business and financial standing of a credit information company. The Governor may, if deemed necessary for an examination, request a credit information company to submit data and have persons concerned attend meetings and state their opinions. The Governor has to report the findings of an examination to the FSC.

In practice, the FSS conducts a regular on-site examination in the CRAs every three or four years.

### **Oversight Requirements: Quality and Integrity**

A CRA is required to prescribe the appropriate standards and procedures to be observed by its executives and employees (internal control standards) and verify compliance with them. The internal control standards have to address the following matters (Article 29(7) Use and Protection of Credit Information Act and Article 26(2) related Enforcement Decree):

- Separation of the rating and sales organization;
- Prohibition of conflicts of interest;
- Prohibition of unfair practices;
- Introduction of credit rating criteria appropriate for the nature of rated entities;
- Recording and storage of rating related data;
- Development of internal procedures to review the adequacy of credit ratings;
- Examination of compliance with the internal control standards for executives and employees; and
- Procedures for the establishment and amendment of the internal control standards.

The CRAs should have an appropriate rating methodology requiring that a credit rating team composed of professional analysts carries out the credit rating business. The credit rating process should be consistent and the methodology should be periodically updated. The CRAs should continue to monitor the rated entities and regularly publish the results even after completing the credit rating.

	<p>The CRAs are required to adopt a guideline on collecting, treating and using internal corporate information, and to monitor the storage and management of the materials used for the credit rating. Materials relating to the credit rating business must be recorded and stored in the form of documents, electronic materials, micro film, etc. for the minimum period of time determined by the CRA.</p> <p><b>Oversight Requirements: Conflicts of Interest</b></p> <p>Article 29 of the Act requires that, in assessing the credit worthiness of a client, a credit rating agency has to consider in a comprehensive manner both the client's current status, including its financial standing and business performance, and its outlook, including business, management and financial risk. No credit rating agency may perform credit rating activities on any person that is in a special relationship with the credit rating agency, including a person having an investment relationship exceeding a given ratio. In other cases of investment relationships, the credit rating agency is required to specify in the credit report the matters relating to the investment relationship.</p> <p>The CRAs are also prohibited from providing a credit rating on a person who contributed more than 10 percent of the CRA's total revenue during the last fiscal year. An analyst of the CRA who owns shares of the rated company, has an important business relationship such as discussing the commission, or has received a gift or treatment from the borrowers of the rated company, issuers of the securities or underwriters, is prohibited from providing a credit rating.</p> <p><b>Oversight Requirements: Transparency and Timeliness</b></p> <p>CRAs are required to disclose through their internet homepage or publicly when an important part of the credit rating methodology, practices or processes has been changed.</p> <p><b>Oversight Requirements: Confidential Information</b></p> <p>According to Article 29(9) of the Use and Protection of Credit Information Act no person who is or was an executive or employee of a credit rating agency is permitted to disclose any client's trade secrets obtained during the course of business except in the following cases:</p> <ul style="list-style-type: none"> <li>• If the trade secret is provided and used for purposes agreed by the client;</li> <li>• If the trade secret is provided subject to a court order or a warrant issued by a judicial officer; or</li> <li>• If the trade secret is provided pursuant to other Acts.</li> </ul> <p>The trade secrets are permitted to be used only for CRAs' rating activities.</p>
Assessment	Fully Implemented
Comments	Credit rating agencies have been subject to regulation and supervision in Korea since 2000. A bill that is currently being considered by the National Assembly is intended to transfer the legal provisions applicable to credit rating agencies from the Use and Protection of Credit Information Act to the FSCMA. This change, although largely technical, is expected to give more emphasis on investor protection rather than protection of privacy which is the focus of the current Act.
<b>Principle 23.</b>	Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.
Description	<b>Sell-side Analysts</b>

The description under Principle 8 covers the legal framework intended to prevent conflicts of interest, and the overall requirements relative to the duty of loyalty, fairness and honesty required from those who perform evaluative or analytical services to financial investment business entities and to their research and analysis units, equity raisers or investment solicitors. Specific requirements to identify, monitor, mitigate, disclose and/or prevent conflicts of interest, as well as the requirement for a system of internal controls and related compliance procedures to ensure that these requirements are observed in practice are described in various detailed rules as outlined in Principle 8, including the requirement that compliance personnel review for proper treatment, mitigation, disclosure and prohibition of conflicts. The discussion also describes limits on contingent compensation to research analysts that may be related to underwriting activities. The activities related to CRAs are described under Principle 22. In general Korea follows the standards for sell-side analysts advocated by IOSCO (see also Principle 29).

### **Other Evaluators**

This Principle relates directly to the emergence of reliance on analytical services and the impact of such services on the market more generally. In this regard, the system in Korea also makes use of bond pricing agencies<sup>22</sup>. There are four of these, each of which is related to one of the four credit rating agencies. These agencies were created at the direction of the government to address the need for development of a more reliable yield curve and to assist in the pricing of illiquid products. Other rating services that are offered (as referred to by KOFIA on its website) include rating of collective investment schemes and evaluations related to mergers, acquisitions and real estate investment vehicles.

The law provides for the registration and supervision of bond pricing agencies and fund rating agencies<sup>23</sup> (FSCMA Articles 258 and 263). These evaluators are required to have certain systems and work processes more particularly spelled out by the Enforcement Decree of the FSCMA and related regulations. In this regard, the Enforcement Decree (Articles 285–288) provides criteria for the registration of bond pricing agencies and specified standards of operation including:

- Provisions for maintaining consistency and staying abreast of accepted standards;
- Prohibition on misuse of non-public information;
- Prevention of use of information developed for pricing for any other business of the company;
- Disclosure of pricing standards to the public;
- Notification and publication of changes in bond prices/yields;
- Requirement for maintenance of policies and procedures relative to conflicts of interest; and
- Supervision to ensure the policies and procedures are being followed.

Article 238 of the FSCMA provides that debt securities of a collective investment scheme should be valued at market price, but at fair market value if no market price is available on the valuation date. Market price usually means the closing market price traded or publicly announced. Article 260 of the same Act provides that in the case of debt securities, debt traded on an overseas exchange and debt for which a price has been formed for ten or more days continuously for three months immediately before

<sup>22</sup> The English translation of the FSCMA uses the term bond assessment company, but this report refers to them as bond pricing agencies as per the market practice.

<sup>23</sup> The English translation of the FSCMA uses the term fund assessment company, but this report refers to them as fund rating agencies as per the market practice.

	<p>the valuation date, may be valued on the basis of price information provided by two or more bond pricing agencies (see also Principle 27).</p> <p>Bond pricing agencies typically develop independent evaluations of prices and disseminate financial market data, especially mark-to-market data on thinly traded bonds. They also develop other financial supplementary systems such as bond, derivatives, portfolio, and market and credit risk management systems. These firms may evaluate straight bonds, structured bonds and OTC derivatives. Market participants including asset managers providing collective investment schemes and their administrators must use at least two pricing agencies when such are used for pricing purposes. The pricing methodologies are based on guidance from the KAI and proprietary models used by the providers.</p> <p>KOFIA also has substantial regulations on business conduct for financial services providers including its special members that provide valuation services to collective investment schemes. Bond pricing agencies and fund rating agencies are special members of KOFIA and subject to its regulatory regime and oversight as well as to the FSC regulations.</p>
Assessment	Fully Implemented
Comments	<p>Korea appears to be ahead of international best practice in that it has applied a similar regime to that advocated by IOSCO, and otherwise internationally, for CRAs to other pricing and rating agencies whose ratings and assessments are required as a matter of law. The authorities should keep abreast, however, of the ongoing international discussions more broadly on pricing methodologies and benchmarks, the potential for these to be abused and best practice for their oversight. They should also have clear rules related to switching among pricing models and agencies and regulatory access to relevant information relative to pricing.</p>
<b>Principles for Collective Investment Schemes</b>	
<b>Principle 24.</b>	The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.
Description	<p><b>Legal Forms Required from Collective Investment Schemes and their Operators</b></p> <p>According to Article 9(18) of the FSCMA the term collective investment scheme means any of the following forms established for making collective investment:</p> <ul style="list-style-type: none"> <li>• A trust, in which trustors that are collective investment business entities, require a trust business entity to invest and manage the property entrusted to the trust business entity in compliance with instructions provided by the collective investment business entities (investment trust);</li> <li>• A stock company under the Commercial Act (investment company);</li> <li>• A limited liability company under the Commercial Act (investment limited liability company);</li> <li>• A limited partnership company under the Commercial Act (investment limited partnership company);</li> <li>• An association under the Civil Act (investment association);</li> <li>• An undisclosed association under the Commercial Act (undisclosed investment association); and</li> <li>• A limited partnership company that invests and manages its fund in equity securities, etc. for participation in management, improvement of business structure, corporate governance, etc. by issuing equity securities only through private placement (private equity fund).</li> </ul>

In practice, all publicly offered CIS in Korea have been established in the form of investment trust or investment company. The same applies to all privately placed CIS, except one that has been established in the form of an investment limited liability company. Therefore the discussion in Principles 24–27 focuses on investment trusts and investment companies.

A privately placed fund is a collective investment scheme that issues collective investment securities only through private placement, in which the total number of investors cannot exceed a prescribed number (Article 9(19) FSCMA). The definition of a private placement in the case of collective investment schemes is similar to the one used in the case of other securities (see Principle 16).

With regards to the entities involved in operating and managing a CIS, the collective investment business entity runs the collective investment business, whereas the trust business entity keeps in custody and manages the collective investment property. A trust business entity needs to be authorized for trust business (see Principle 29); in practice banks provide these services to collective investment business entities. The investment traders and investment brokers (see Principle 29) are responsible for selling the collective investment securities. Where applicable, there is also a general administration company with which the affairs of an investment company are entrusted.

### **Authorization Requirements**

#### *Collective Investment Schemes*

According to Article 182 of the FSCMA, a collective investment scheme to be created has to be registered with the FSC. However, in cases where a collective investment business entity or an investment company files a registration application together with a registration statement, it will be deemed that the relevant CIS is duly registered at the time when the registration statement becomes effective. This means that the only CIS that have to be registered with the FSC (or the FSS under delegation from the FSC) are the privately placed funds. The process for filing the registration statement for CIS is the same as for other securities (see Principle 27).

#### *Operating/marketing a Collective Investment Scheme*

According to Article 12 of the FSCMA, an entity that wishes to obtain authorization for financial investment business (including collective investment business) is required to be a stock company under the Commercial Act. A foreign financial investment business entity may also be authorized for collective investment business in certain circumstances. A collective investment business entity has to comply with the following requirements:

- Equity capital of at least KRW 1-6 billion;
- Feasible and sound business plan;
- Human resources, an electronic computer system, and other physical facilities;
- Fit and proper executives;
- Good financial standing and social credibility; and
- System for preventing conflicts of interest between the collective investment business entity and investors, as well as between a specific investor and other investors.

Those who wish to market a CIS must obtain authorization from the FSC for investment trading business or investment brokerage business under Article 12 of the FSCMA (see Principle 29). This requirement

applies also to banks, insurance companies and other financial institutions that may distribute CIS. According to Article 16(4) of the Enforcement Decree of the FSCMA, the business plan of an applicant for authorization for financial investment business has to include information on the internal control system appropriate for risk management and prevention of financial incidents. In addition, every financial investment business entity is required to establish a risk management system to identify, assess, monitor, and control all transaction risks in a timely manner (Article 3-42 of the Regulations on Financial Investment Business). All financial investment business entities must establish and manage risk and transaction limits for each department, each transaction, and each product in order to manage risks effectively. They are required to assess and manage various types of risk, including market risk, operational risk, credit risk, and liquidity risk, and identify and monitor changes in major risks comprehensively and jointly with their subsidiaries. The Governor of the FSS may assess the adequacy of the current status of risk management of each financial investment business entity and reflect the results of such an assessment in the FSS supervision and examinations.

According to Table 2., Section 3.C. of the Regulations on Financial Investment Business (Internal control system and protection of investors) there must be supervisory and internal control systems appropriate for ensuring executives' and employees' compliance with laws and regulations, risk management, and the prevention of executives and employees from wrongdoing, based on the authorized business unit and its size. A financial investment business entity is also required to have a system for the prevention of conflicts of interest, including internal control guidelines for the detection, assessment, and management of conflicts of interest and appropriate Chinese walls (Table 2, Section 4.A of the Regulation on Financial Investment Business).

When the FSS receives an application for collective investment business, it goes through the documents and conducts an on-site visit in the applicant. It prepares a report on the application that is sent to the FSC for deciding on whether to grant the authorization or not.

#### *Soliciting investment in foreign collective investment schemes*

Foreign CIS can be sold in Korea only after the scheme has been registered with the FSC (Article 279(1) FSCMA). In principle, the same requirements apply for the registration of a foreign CIS as a domestic one.

### **Supervision and Ongoing Monitoring**

#### *On-site examinations*

The powers of the Governor of the FSS to conduct examinations and demand reports and material under Article 419 of the FSCMA apply also to collective investment business entities. Information on the general and partial examinations conducted in the collective investment business entities is provided in Principle 12. There are currently 85 collective investment business entities, 21 of which were subject to a general examination in the course of 2010-2012. Thematic examinations are conducted in a larger group of firms, but they tend to focus on inspecting the large asset management companies.

The FSS considers that there is little incentive to examine small asset management companies due to the low value of their AUM (see the table below) and the fact that 30 out of 36 small firms have entered the market after 2008 and have been rarely involved in financial incidents.

**Fund Distribution by Aggregate AUM  
(Trillion KRW), March 2013**

AUM	No. of firms	Aggregate AUM	Share (%)
Over 10	10	193.9	58.5
Over 5	7	48.1	14.6
Over 1	32	79.0	24.0
Below 1	36	8.8	2.7
Total	85	329.8	100.0

According to the information provided during the assessment mission, the FSS does not conduct examinations in the trust business entities (custodians) that would specifically focus on the custody services they provide to CIS (see Principle 25). Instead any examinations would be part of the general examinations of banks.

*Enforcement*

The enforcement measures taken against collective investment business entities and their executives and employees during the past three years are discussed in Principle 12. The statistics demonstrate that the FSS and FSC have used a range of measures to deal with the violations of the FSCMA, ranging from some minor measures taken by the FSS to a cancellation of one license in 2012 by the FSC.

*Periodic reporting*

Pursuant to Article 90 of the FSCMA a collective investment business entity is required to prepare a business report for each quarter concerning the collective investment property, and submit it to the FSC (delegated to the FSS) and KOFIA no later than two months after the end of each quarter. The FSS and KOFIA disclose the business reports to the public through their Internet homepages. KOFIA compares the performance of each CIS and discloses the results to the public through its Internet homepage.

According to the information provided by the FSS, it also monitors the asset management companies on a monthly basis using the Handy Indicators (see Principle 6) to identify any issues that deserve supervisory attention. The results of the analysis are described in a management status evaluation report of the relevant asset management company.

*Reporting of material changes*

Whenever there is any change in the matters registered, a collective investment business entity and an investment company are required to file the details of the change as a revised registration with the FSC within two weeks, except in certain cases where there is no possibility of undermining the protection of investors (Article 182 FSCMA).

**Record-keeping**

Article 187 of the FSCMA and Article 214 of the Enforcement Decree of the FSCMA include the following record-keeping requirements:

- A list of collective investment property: ten years;



- The ledger of base price of collective investment securities: ten years;
- A full statement of management of collective investment property: ten years;
- Minutes of the general meeting of collective investors and the directors' meeting: ten years; and
- Other account books and documents that any other Act or subordinate statute requires to keep and maintain: the period of time prescribed in the relevant Act or subordinate statute.

### **Conflicts of Interest**

According to Article 84 of the FSCMA, in managing the collective investment property, the collective investment business entity is not entitled to make any transactions with an interested party, unless certain exemptions apply. Such interested parties include the executives, employees and major shareholders of the collective investment business entity and their spouses (Article 84 Enforcement Decree of the FSCMA). In those cases, the collective investment business entity needs to notify without delay the details of such events to the trust business entity. In addition, in managing the collective investment property, no collective investment business entity is allowed to acquire securities issued by the collective investment business entity itself on its collective investment scheme's account. Further, no collective investment business entity is allowed to acquire securities issued by its affiliated company in excess of a limit prescribed in the Enforcement Decree of the FSCMA.

According to Article 44 of the FSCMA, a financial investment business entity is required to probe and assess the likelihood of conflicts of interest, which may arise between it and any investor, or between a specific investor and other investor in connection with its financial investment business. The purpose of this is to prevent and control such conflicts of interest in compliance with the method and procedure prescribed in the internal control guidelines issued by KOFIA. If there is a likelihood of conflicts of interest, the financial investment business entity is required to notify the relevant investors in advance, and commence trading only after reducing the likelihood of conflicts of interest to a level that will not impede the protection of investors. No financial investment business entity is allowed to commence trading, if it is difficult to reduce the likelihood of conflicts of interest.

### **Conduct of Business**

There is no specific requirement in the Korean regulatory framework in relation to the best interest of investors or best execution. However, a collective investment business entity owes investors the fiduciary duty of due care in managing collective investment property and is required to carry out the business in good faith for the purpose of protecting investors' interests (Article 79 FSCMA).

A collective investment business entity is required to give the trust business entity transaction instructions separately for each investment trust property (Article 80 FSCMA). The trust business entity must, in return, make the transaction in compliance with these instructions. If it is unavoidable for the purpose of managing the investment trust property efficiently, the collective investment business entity may acquire or dispose of any asset for investment directly in its name. When it carries out the transaction, a collective investment business entity is required to distribute the outcome in accordance with the asset distribution schedule predetermined for each investment trust property.

No collective investment business entity is allowed to manage the collective investment property in violation of the collective investment agreement or the investment prospectus, or trade the collective investment property for financial investment instruments too frequently, disregarding the collective investment scheme's management policy or strategy (Article 85 FSCMA and Article 87(4) Enforcement Decree).

A collective investment business entity must, when it intends to create an investment trust, execute a trust contract with a trust business entity in a form that contains, among others, the computation method and the time and method of payment of the fees to which the collective investment business entity and the trust business entity will be entitled (Article 188 FSCMA). There are restrictions on the maximum amount of sales commission and remuneration that an investment trader or broker selling the CIS can get (Article 76 FSCMA).

### **Delegation**

A financial investment business entity may entrust a third party with a part of its affairs (Article 42(1) FSCMA). However, it is not allowed to do so when it is likely to undermine the protection of investors or sound trade practice. The types of affairs that a collective investment business entity can entrust are stipulated in Article 45 of the Enforcement Decree of the FSCMA. Such affairs are limited to the management of foreign currency denominated assets and not more than 20 percent of the Korean won denominated assets, research and analysis related to collective investment, and valuation of the collective investment property.

Any financial investment business entity that entrusts a third party with any of its affairs is required to make an entrustment agreement that includes the scope of the affairs entrusted, restrictions on the trustee's activities, terms and conditions for maintaining records on the performance of entrusted affairs, and matters concerning termination of the entrustment contract and compensation and other conditions for entrustment. Such an agreement has to be reported to the FSC.

If any term or condition of the entrustment agreement undermines the soundness of the business management of the financial investment business entity, causes any impediment on the protection of investors, undermines the stability of the financial market, or disturbs the financial trading order, the FSC may place a restriction on the entrustment of the affair or issue an order to rectify it.

Article 756 of the Civil Act applies to the damages inflicted on investors by a person to whom any affair is entrusted in the course of carrying out the affair (Article 42(9) FSCMA). According to the Civil Act a person who employs another to carry out an undertaking is required to make compensation for damages done to a third person by the trustee in the course of the execution of the undertaking. However, this will not be the case, if the employer has exercised due care in the appointment of the trustee and the supervision of the undertaking, or if the damage would have resulted even if due care had been exercised.

Article 42(7) of the FSCMA requires that each financial investment business entity that intends to entrust its affairs to another establishes guidelines for the management of the entrusted affairs concerning the protection of investors' information and management and assessment of risks. The guidelines should include matters concerning the management and assessment of risks ensuing from the entrustment of affairs; the procedure for the determination and termination of the entrustment of affairs; the control and management of the trustee; the protection of investors' information; the countermeasures against incidents; and ways to secure means to demand written information in relation to the entrusted affairs.

In addition, the collective investment business entity can terminate the delegation and make alternative arrangements for the performance of the delegated function, where the trustee acts with negligence, since this is considered to be a violation of duty under the Civil Act.

If a person to whom any affair is entrusted violates Article 54 of the FSCMA on the prohibition on use of job-related information or the Act on Real Name Financial Transactions and Confidentiality, rejects, interferes with, or evades an examination, or fails to comply with a demand for a report by the Governor

	<p>of the FSS, the FSC may order either party to the entrustment contract or both to cancel or amend the contract (Article 43(2) FSCMA).</p> <p>Pursuant to Article 42(8) of the FSCMA, each financial investment business entity is required to state the details of the affairs entrusted in the contract documents provided to investors and in the investment prospectus, and give notice of any changes to investors, whenever there is any affair entrusted or any change made in the content of the entrustment.</p> <p>A person to whom an affair is entrusted is subject to the examinations conducted by the Governor of the FSS in connection with the entrusted affairs (Article 43(1) FSCMA).</p>
Assessment	Broadly Implemented
Comments	The on-site examination program of the FSS does not provide sufficient coverage of the small collective investment business entities. Custodians have an important role in ensuring the protection of collective investment scheme assets, and should be subject to examinations by the FSS that are targeted at addressing this role.
<b>Principle 25.</b>	The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
Description	<p><b>Legal Form</b></p> <p>The various possible legal forms of a collective investment scheme are described in Principle 24.</p> <p><b>Changes to Investor Rights</b></p> <p>In case any of the material matters included in a trust contract between the collective investment business entity and the trust business entity are to be amended, the amended contract has to be brought for resolution in advance to the general meeting of collective investors. These include an increase in the remuneration or any other fee and change in the nature of the trust business entity. The requirements for ad hoc public disclosure are in Article 89 of the FSCMA, according to which a collective investment business entity is required to disclose the following events or causes to the public without delay:</p> <ul style="list-style-type: none"> <li>• Information on any replacement of a fund manager and the fund management career of the new fund manager;</li> <li>• Decisions on deferment or resumption of redemption and the reason for it;</li> <li>• Details of non-performing assets, if any, and their depreciation rate;</li> <li>• Details of resolutions of the general meeting of collective investors; and</li> <li>• Other matters prescribed in the Enforcement Decree of the FSCMA as those necessary for the protection of investors.</li> </ul> <p>Ad hoc public disclosure is required to be made through the Internet homepage of the collective investment business entity, an investment trader or broker that sold the relevant collective investment securities, and KOFIA; by informing investors through electronic mail; and by posting a public notice at the head office, branch offices, and other sales offices of a collective investment business entity and an investment trader or investment broker that sold the relevant collective investment securities.</p>

**Investment Restrictions**

Korean CIS are subject to statutory investment restrictions, under which the collective investment business entities are prohibited from making certain investments (Articles 81 and 82 FSCMA). The following are examples of those restrictions:

*Equity securities*

- Investing the assets of each collective investment scheme in the same securities in excess of 10 percent of the total assets of each collective investment scheme;
- Investing the total assets of all collective investment schemes managed by the collective investment business entity in equity securities issued by the same corporation in excess of 20 percent of the total number of equity securities; and
- Investing the total assets of each collective investment scheme in equity securities issued by the same corporation in excess of 10 percent of the total number of equity securities.

*Over-the counter derivatives*

- Trading over-the-counter derivatives with a person that does not meet the qualification requirements prescribed in the Enforcement Decree of the FSCMA; and
- Investing assets of each collective investment scheme to over-the-counter derivatives so that the counterparty risk exceeds 10 percent of the total assets of each collective investment scheme.

*Funds of funds*

- Investing the assets of each collective investment scheme in the collective investment securities of a collective investment scheme (including foreign collective investment schemes) managed by the same collective investment business entity in excess of 50 percent of the total assets of the collective investment scheme;
- Investing the assets of each collective investment scheme in the collective investment securities of the same collective investment scheme (including foreign collective investment schemes) in excess of 20 percent of the total assets of the collective investment scheme;
- Investing assets in the collective investment securities of a collective investment scheme (including foreign collective investment schemes), which is allowed to invest in collective investment securities in excess of 40 percent of the total assets;
- Investing assets in the collective investment securities of a privately placed fund (including foreign privately placed funds corresponding to Korean privately placed funds); and
- Investing the collective investment property of each collective investment scheme in the collective investment securities of the same collective investment scheme (including foreign collective investment schemes), in excess of 20 percent of the total number of collective investment securities.

*Borrowing*

- No collective investment business entity may borrow money on its collective investment scheme's account, except when it is difficult to pay a redemption price momentarily because of rush claims

for redemption. The total amount of such loans cannot exceed 10 percent of the total value of the collective investment property at the time of borrowing (Article 83 FSCMA).

#### *Compliance with investment restrictions*

Article 85 of the FSCMA and Article 87 of the Enforcement Decree of the FSCMA prohibit, among other things, managing the collective investment property in violation of the collective investment agreement or the investment prospectus and trading the collective investment property for financial investment instruments too frequently, disregarding the collective investment scheme's management policy or strategy.

The primary responsibility for complying with the investment restrictions lies on the collective investment business entity. The trust business entity is required to examine whether the collective investment business entity violates the investment restrictions included in the laws and regulations, the collective investment agreement or the prospectus, and demand that the collective investment business entity withdraw, revise, or rectify the management instruction or operational act in case of any violation. If the collective investment business entity fails to comply with such a demand in three business days, the trust business entity must report it to the FSC. The FSS monitors compliance with the investment restrictions through periodic reporting and on-site inspections.

The FSC and FSS have the power to supervise and inspect the collective investment business entity for compliance with the above requirements.

#### **Segregation and Safekeeping of Assets**

According to Articles 246(1) and (3) of the FSCMA, a trust business entity is required to separate the collective investment property from its proprietary property, other collective investment property, and other property with which it has been entrusted by a third party for safekeeping and management. Securities and other instruments specified by Presidential Decree belonging to the collective investment property have to be deposited in the securities depository.

The trust business entities are required to execute the instructions of the collective investment business entities for the acquisition, disposition, safekeeping and management of assets separately for each collective investment scheme (Article 246(4) FSCMA).

Article 246(2) of the FSCMA prohibits a trust business entity to be an affiliated company of the investment company or the collective investment business entity. According to the information provided by the FSS, the examiners verify during their on-site examinations whether the collective investment business entity has entered into a trust agreement with an affiliate. However, the relevant section of the examination manual does not refer to Article 246, and some of the FSS staff interviewed during the mission did not seem to be aware of this prohibition. Therefore the mission has not been able to verify that compliance with this important prohibition is effectively monitored and enforced.

#### **Winding Up**

According to Article 202 of the FSCMA, an investment company has to be dissolved in certain cases. In such cases, the liquidator is required to file a report with the FSC on the reason for and date of dissolution as well as names and citizen registration numbers of the liquidator and the liquidation overseer within 30 days from the date of dissolution. When an investment company is dissolved, it must hold a liquidators' meeting composed of liquidators and liquidation overseers. If a liquidator or liquidation overseer is significantly incompetent in performing his/her duties or if there is a serious

	<p>violation of a relevant law or statute, the FSC may, ex officio or upon receiving a request from an interested person, dismiss the liquidator or liquidation overseer. In such cases, the FSC may appoint a new liquidator or liquidation overseer.</p> <p>A liquidator must inspect the status of property of the investment company immediately after his/her inauguration and prepare a property list and balance sheet within a prescribed period of time, submit them to the liquidators' meeting for approval, and submit a certified copy of them to the FSC without delay (Article 203 FSCMA). A liquidator must provide peremptory notices to creditors of the investment company within one month of his/her inauguration by providing public notice, at least twice, that creditors must file a statement on their claims within a certain period of time and that the claims on which a statement has not been filed during such period of time will be excluded from the liquidation proceedings. The time period provided for filing a statement must be at least one month. A liquidator must, upon completion of the liquidation proceedings, prepare a report of the settlement of accounts without delay for approval of the general meeting of shareholders and provide public notice of the report on the settlement of accounts and submit it to the FSC and KOFIA.</p> <p>An investment trust may be terminate only subject to prior approval of the FSC, except if there is no possibility of undermining beneficiaries' interests. In such cases, the collective investment business entity must report the termination to the FSC without delay. An investment trust has to be terminated in the following cases without delay, which termination has to be reported to the FSC immediately:</p> <ul style="list-style-type: none"> <li>• Expiration of the trust contract term stipulated by the trust contract;</li> <li>• Resolution by the general meeting of beneficiaries to terminate the investment trust;</li> <li>• Absorbed merger of the investment trust; and</li> <li>• Revocation of the registration of the investment trust.</li> </ul> <p>When terminating an investment trust, the collective investment business entity may pay the assets that belong to the investment trust property to the relevant beneficiaries in accordance with the terms and conditions of the trust contract.</p> <p>No examples were available on the potential use of these powers in the past.</p>
Assessment	Broadly Implemented
Comments	The mission has not been able to verify that compliance with the prohibition on related party custody is effectively monitored and enforced upon review of the registration statement and/or as part of on-site examinations.
<b>Principle 26.</b>	Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
Description	<p><b>Initial Disclosure Obligations</b></p> <p>According to Article 119(6) of the FSCMA and Article 127 of the Enforcement Decree of the FSCMA, each registration statement on collective investment securities must contain, among other things, the following information:</p> <p>The following matters concerning the public offering or sale:</p> <ul style="list-style-type: none"> <li>• Details of rights to collective investment securities publicly offered or sold;</li> <li>• Investment risks; and</li> </ul>

- The underwriter's opinion.
- The following matters concerning the collective investment scheme:
  - Name;
  - Purposes of, policy on, and strategy of investment;
  - Management remuneration, sales commission, sales remuneration, and other expenses;
  - Financial affairs;
  - Information on the collective investment business entity (including on promoters and supervisory directors in case of an investment company);
  - Information on professional investment managers;
  - Information on management of collective investment property;
  - Information on sale and buy-back of collective investment securities;
  - Information on valuation and public disclosure of collective investment property;
  - Information on distribution of profits and losses and taxation;
  - Information on the trust business entity and the general administration company; and
  - Matters concerning delegation of business affairs.

The FSS reviews all CIS registration statements within the 15 day time period applicable to them (see Principle 16). It also reviews all changes that are made to the registration statements after each accounting period ends. The number of registration statements (new registrations statements) filed with the FSS in the last three years is as follows:

	<b>2010</b>	<b>2011</b>	<b>2012</b>
Total number of registration statements	17,501	15,913	14,390
Number of new registration statements	671	791	548

The possibility to refuse to approve a registration statement or require a corrective registration statement described in Principle 16 applies also to CIS registration statements.

#### **Ongoing Disclosure Obligations**

According to Article 89 of the FSCMA and Article 93(3) of the Enforcement Decree of the FSCMA, a collective investment business entity must disclose, among other things, the following events to the public without delay:

- Replacement of the fund manager together with information on the fund management career of the new fund manager (name of the collective investment scheme managed, and the scale of and rate of return on the collective investment property);
- Decision on suspension or resumption of redemptions and the reason for it;
- Details of non-performing assets, if any, and their depreciation rate;
- Details of resolutions of the general meeting of collective investors;
- Other than formal or insignificant revisions made to the investment prospectus;

- Merger, division, merger after division, or transfer of business of a collective investment business entity;
- Details of a change in the base price, where the collective investment business entity or the general administration company changes the base price because it made an error in calculating the base price (subject to the exemptions described in Principle 27); and
- The fact that the collective investment scheme may be terminated due to the low value of its assets under Article 192(1) of the FSCMA.

### **Periodic Reporting**

According to Article 88 of the FSCMA and Article 92 of the Enforcement Decree of the FSCMA, a collective investment business entity must prepare a report on asset management at least once every three months and deliver the report to investors of the relevant collective investment scheme after obtaining confirmation from the trust business entity. The following matters have to be included in the report on asset management:

- Assets and liabilities of the collective investment scheme and the base price of the collective investment securities as of the relevant reference dates (either annual or quarterly);
- A summary of management progress during the time period from the immediately preceding reference date to the current reference date and the profit and loss during the management period;
- The ratio of the assessed value of each type of asset that belongs to the collective investment property to the total value of the collective investment property as of the reference date;
- The total number of stocks traded, total trading amount, and turnover rate during the pertinent management period;
- Details of investment assets that belong to the collective investment property;
- Information on the professional investment managers of the collective investment scheme;
- Investment environment and management plans of the collective investment scheme;
- Details of investment by type of business or country;
- Details of dividends of the collective investment scheme;
- Top ten investment items;
- Structure of the collective investment scheme; and
- Where the collective investment scheme trades derivatives for the purpose of avoiding exchange risk, the details of such transactions.

The asset management report has to be delivered to investors in person or by electronic mail within two months from the reference date via the KSD or the investment trader or broker that sold the collective investment securities (Article 92(4) Enforcement Decree of the FSCMA).

K-IFRS have been applied to the trust account of the collective investment business entity as of fiscal year 2011.

### **Standard Formats**

The information in the registration statements and periodic reports is required to be presented in a standardized order.



	<p><b>Advertisements</b></p> <p>According to Article 57 of the FSCMA and Article 60 of the Enforcement Decree of the FSCMA, a financial investment business entity is not permitted to include in the advertisement for investment any other statement than the name and type of the collective investment scheme, its investment purpose and operational strategy, and certain other matters prescribed by the Enforcement Decree. It must, however, include in the advertisement a recommendation that the investor reads the investment prospectus before acquiring the collective investment securities; a reference to the fact that there is a risk of loss of the invested principal; and, if the advertisement contains the past performance of the collective investment scheme, a statement that the past performance does not guarantee a future return on investment.</p> <p>Further, whenever a financial investment business entity makes an advertisement soliciting investment, it is required to refrain from showing the investment return or management results only for the period of time during which it had good performance results and from representing, without solid grounds, that a certain financial investment instrument is inferior or disadvantageous (Article 60 Enforcement Decree of the FSCMA).</p> <p>According to Article 4-12 of the Regulations on Financial Investment Business the financial investment business entities must establish and enforce compliance with internal control guidelines regulating the production and contents of advertisements. An advertisement must be confirmed by the compliance officer in advance, and a report on a plan for advertisement soliciting investment and a draft advertisement soliciting investment must be submitted to KOFIA for examination. The advertisements must state the fact that the examination by KOFIA or by the compliance officer has been completed.</p> <p><b>Enforcement of Disclosure Obligations</b></p> <p>Over the past three years, the FSS has imposed sanctions on CIS operators and their executive officers and employees in connection with CIS disclosure documents (e.g., misleading information in the prospectus, etc.) as follows:</p> <table border="1" data-bbox="529 1224 1333 1335"> <thead> <tr> <th>2010</th> <th>2011</th> <th>2012</th> <th>Total</th> </tr> </thead> <tbody> <tr> <td>22</td> <td>7</td> <td>6</td> <td>35</td> </tr> </tbody> </table> <p>The above sanctions include one severe institutional caution issued by the FSC. In addition, the FSS imposed one salary reduction, one caution against employee, 13 management recommendations for improvement, 13 action requests, and 7 on-site actions.</p>	2010	2011	2012	Total	22	7	6	35
2010	2011	2012	Total						
22	7	6	35						
Assessment	Fully Implemented								
Comments									
<b>Principle 27.</b>	Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.								
Description	<p><b>Asset Valuation</b></p> <p>According to Article 238 of the FSCMA a collective investment business entity must value a collective investment property according to market price. If there is no reliable market price available as of the valuation date, it must value it according to fair value. The method for determining the market value and fair value are prescribed in the Enforcement Decree of the FSCMA.</p>								

The market price means the closing market price at which the property was traded in the securities or derivatives exchange. However, securities of a publicly offered CIS may be valued at a different price in the following circumstances:

- The price based on price information furnished by two or more bond pricing agencies on the basis of the closing market price of debt securities on the valuation date, in case of debt securities whose market price has been formed in the securities exchange for ten or more days each month continuously during three months immediately before the month on which the valuation date falls;
- The price based on price information furnished by two or more bond pricing agencies, in case of debt securities whose market price has been formed in an overseas securities exchange; and
- The fair value means the price assessed for each type of asset that belongs to collective investment property by the committee on valuation of collective investment property (see below), considering the following matters, exercising a duty of good faith, and maintaining consistency in valuation:
  - Acquisition prices of investment assets;
  - Trading prices of investment assets;
  - Prices provided by the following persons with respect to investment assets:
    - A bond pricing agency;
    - An audit firm;
    - A credit rating agency;
    - An appraisal business entity under the Public Notice of Values and Appraisal of Real Estate Act;
    - An investment trader running an underwriting business;
    - A person similar to an above mentioned person that holds permission, authorization, registration, etc. in accordance with the relevant Act and subordinate statutes; and
    - A foreigner similar to an above mentioned person.
  - Exchange rates; and
  - Base prices of collective investment securities.

In addition, the regulatory framework permits valuing collective investment property at book value, "if investors are frequently changed or there is little possibility of undermining investors' interests". This is considered to be the case for money market funds<sup>24</sup>. If book value is used, the collective investment business entity must monitor the difference between the base price determined according to the book value and that determined according to the market or fair value, and take necessary measures as stipulated in the collective investment agreement, if the difference exceeds or is likely to exceed 50 basis points (Article 7-36 of the Regulations on Financial Investment Business).

The book price means the price determined by the following formulas:

<sup>24</sup> The weighted maturity of a money market fund's assets can be at most 90 days, which is currently planned to be reduced to 60 days.

- For debt securities: the price calculated by depreciating the difference between the acquisition cost and the face value at maturity over the repayment period by the effective interest rate method and adding or subtracting the price to or from the acquisition cost and interest income; or
- Assets other than debt securities: the price calculated by adding to the acquisition cost the interest income accrued until the valuation date.

A collective investment business entity must organize and operate a valuation committee, which is required to carry out the affairs related to the valuation of the collective investment property. It must prepare the standards and procedures for the valuation of the collective investment property to ensure that it is carried out fairly and precisely. A collective investment business entity must inform the trust business entity of the details of a valuation without delay. The trust business entity must review the valuation to confirm that it has been fairly made in accordance with the relevant Acts and subordinate statutes and the standards for valuation of the collective investment property.

A collective investment business entity and an investment company must compute the base price of collective investment securities according to the results of the valuation of the collective investment property. They must provide and post a public notice of the computed base price daily. A different period not exceeding 15 days may be stipulated by the relevant collective investment agreement, if it is difficult to provide and post a public notice of the base price daily.

A collective investment business entity and an investment company must receive an external audit for the collective investment property within two months from the end of each financial term, except where the total assets of a collective investment scheme do not exceed KRW 5 billion. In auditing the computation of the base price of collective investment securities and the accounting of the collective investment property, an external auditor must determine compliance with the standards for valuation of the collective investment property, and must inform the internal auditor (or the audit committee) of the collective investment business entity or the investment company of the results.

### **Subscription and Redemption**

A collective investment business entity and an investment company must compute the base price used in the subscription and redemption of collective investment securities by subtracting total liabilities from total assets stated on the balance sheet as at the day immediately before the publicly notified and posted date of the base price and dividing the resulting amount by the total number of collective investment securities as at the same day (Article 238(6) of the FSCMA and Article 262 of the Enforcement Decree of the FSCMA).

If a base price computed by a collective investment business entity or an investment company is false or in violation of Article 238(6), the FSC may order the collective investment business entity or investment company to entrust the work related to the calculation of base prices to a general administration company.

According to Article 235 of the FSCMA, an investor may make a claim for redemption of collective investment securities at any time. Upon receiving a request for redemption through the investment trader or broker that sold the securities, the collective investment business entity and the investment company must pay the redemption money on the day prescribed for redemption by the collective investment agreement within 15 days from the day on which the investor made the request for redemption. Certain exceptions from this requirement are provided in Article 254 of the Enforcement Decree of the FSCMA on the basis of the realizability of the investment assets of the collective investment scheme.

### **Pricing Errors**

According to Article 262 of the Enforcement Decree of the FSCMA, each collective investment business entity and investment company must, if an error in the calculation of the base price is discovered, revise it without delay and publicly notify and post the correct base price again. The requirement to publicly notify and post the correct base price excludes cases where the difference

between the base price publicly notified and posted initially and the revised base price does not exceed the following limits:

- Where the collective investment scheme invests in equity securities traded in domestic securities market: 0.2 percent;
- Where the collective investment scheme invests in equity securities traded in foreign securities market: 0.3 percent;
- Money market funds: 0.05 percent; and
- Collective investment schemes other than the above: 0.1 percent.

Each collective investment business entity and investment company must, when it intends to revise the base price, obtain the confirmation of its compliance officer and trust business entity. It also needs to report the intention to revise the base price to the FSC. On the basis of Article 7-37 of the Regulations on Financial Investment Business, the collective investment business entity and investment company must include in their report a written statement describing the changed base price, the reasons for the change, and the measures taken for protecting investors, along with documents that can prove the details of the change, such as the certificates of the compliance officer and the trust business entity. Necessary matters concerning the form and method for the preparation of the report are prescribed by the Governor of the FSS.

Article 64 of the FSCMA includes a general liability for damages that have been caused by financial investment business entities' violations of any Act or subordinate statute, term, or condition of their standardized contract form, collective investment agreement, or investment prospectus. This also applies to damages sustained by investors due to the financial investment business entities' negligence in carrying out their business. On the basis of this provision, an investor can seek compensation from a collective investment business entity in the case of pricing errors. However, there is no automatic obligation on the collective investment business entities to compensate the investors that might have subscribed or redeemed CIS securities at a wrong price.

According to the information provided by the FSS, collective investment business entities in practice examine whether a revision of the base price would cause any losses to their investors. If this were the case, they would devise a plan to compensate their investors and advise the FSC of how they have executed the plan. During the period from May 11, 2011 to June 14, 2013, the FSC was informed of a total of seven cases where collective investment business entities compensated their investors. However, given that compensating investors is not compulsory, enforcing any request to compensate investors might in practice become a challenge to the authorities in the absence of voluntary compliance.

### **Suspension of Pricing and Redemptions**

According to Article 237 of the FSCMA, in the event that a collective investment business entity or an investment company is unable to redeem collective investment securities on the day prescribed by the collective investment agreement, it may postpone the redemption in the following cases:

	<ul style="list-style-type: none"> <li>• Where it is impossible to redeem securities due to the impossibility to dispose of collective investment property as result of a significant slump in transactions or a permanent closure, temporary closure, or business suspension of the securities exchange or a foreign securities exchange, or where a natural disaster or any other similar event occurs;</li> <li>• Where equality in dealing with investors is feared to be undermined, because such a disposition is likely to lead to default on payments for checks and bills; because assets that belong to the collective investment property have no market value; or because accepting a large claim for redemption would be likely to undermine equality of investors;</li> <li>• Where it is impossible to redeem collective investment securities because of dissolution of the investment trader or broker, the collective investment business entity, the trust business entity, or the investment company from which the redemption is requested; or</li> <li>• Where any other cause similar to those above exists and where the FSC deems necessary to postpone redemption.</li> </ul> <p>A collective investment business entity must disclose to the public without delay decisions on the suspension or resumption of redemptions and the reason for it (Article 89 FSCMA). The collective investment business entity or an investment company must obtain a resolution on the matters concerning the redemption of the collective investment securities by a general meeting of collective investors held within six weeks after the postponement of redemptions.</p>
Assessment	Broadly Implemented
Comments	<p>The Korean regulatory framework includes specific regulatory requirements for the valuation of CIS assets on a regular basis. However, the assets of money market funds can be valued at book value, which contradicts the basic principle expressed in the IOSCO Methodology that requires the use of market or fair values whenever they can be determined. This principle has been further enforced in the October 2012 IOSCO Policy Recommendations on Money Market Funds, that makes the use of book values possible only subject to certain safeguards.</p> <p>The Korean regulatory requirements address the need to revise the base price in case of pricing errors, and disclose the revision of the base price above certain thresholds. However, beyond a general liability for damages, there is no automatic obligation for the collective investment business entities to compensate investors for losses occurred in the case of subscription or redemption at an erroneous base price. Even though collective investment business entities in practice tend to compensate their clients in case of errors, it would be recommendable to ensure the enforceability of the obligation by introducing a more specific, compulsory requirement.</p>
<b>Principle 28.</b>	Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.
Description	<p><b>Authorization Requirements</b></p> <p><i>Hedge fund manager</i></p> <p>Those that wish to manage hedge funds are required to be authorized as collective investment business entities. The requirements for the content of the application are the same as for regular collective investment business (see Principles 24 and 29).</p> <p><i>Hedge fund</i></p>

Korean hedge funds can only be privately placed funds for qualified investors. According to Article 249-2 of the FSCMA, when a privately placed fund for qualified investors is created or established, it must be reported to the FSC within one month.

#### **Other Regulatory Requirements**

The requirements of Article 28 of the FSCMA on internal control guidelines described under Principle 24 apply to hedge fund managers as financial investment business entities. The same applies to the requirements on risk management in Article 3-42 of the Regulations on Financial Investment Business and on conflicts of interest in Article 44 of the FSCMA that have also been described under Principle 24. Equally, the requirements for the segregation of client money and assets described under Principle 25 apply to hedge fund managers.

Pursuant to Articles 30 and 31 of the FSCMA, hedge fund managers are subject to the requirement to maintain a net operating capital ratio of 150 percent or higher (see Principle 30). In addition, they are subject to the requirements of Article 31 of the FSCMA on soundness in business management. The FSS may evaluate the actual status of business management and risks in order to secure the soundness in business management of each financial investment business entity.

#### **Disclosure to Investors**

Because hedge funds can only be privately placed, hedge fund managers are not subject to the periodic and ongoing disclosure requirements to investors set out in Articles 88–90 of the FSCMA (see Principle 26) or the requirement to disclose the base price (see Principle 27). However, they are subject to the guidelines issued by KOFIA that require hedge fund managers to provide certain information on the performance of their hedge funds to investors. The guidelines require the hedge fund managers to prepare an investment prospectus and establish a policy on the scope of other information (such as investment performance, transaction counterparties, and the arrangements for the custody and safekeeping of collective investment assets) that they will provide to investors.

The audit requirements applicable to other CIS under Article 240 of the FSCMA do not apply to hedge funds.

#### **Disclosure to the Regulator**

A collective investment business entity is required to report to the FSS the current status of the hedge funds' borrowing and sale and purchase of derivatives (Article 249-2(7) FSCMA). Article 271-2(6) of the Enforcement Decree of the FSCMA specifies that a collective investment business entity is required to file a quarterly report for each hedge fund including the following information:

- Current status on borrowing of funds and trading of derivatives;
- Current status on guarantee of liabilities or provision of collateral;
- Major fund-managing strategies and types of investment assets; and
- Matters concerning investment risk management.

#### **Supervision and Enforcement**

As financial investment business entities, the Governor of the FSS has the power to inspect the hedge fund managers and demand them to submit reports as provided in Article 419 of the FSCMA (see

	<p>Principle 10). However, given that hedge funds were first introduced in Korea only in late 2011 and that the hedge fund market is still in its early stage of development, the FSS has not yet conducted any on-site examinations of hedge fund managers.</p> <p>Similarly, the FSC has the power to take the same measures against hedge fund managers and their executives and employees as against any other regulated entities and their executives and employees on the basis of Articles 420 and 422 of the FSCMA (see Principle 11).</p> <p>The FSC's and SFC's powers to share information with and provide assistance to foreign regulators on the basis of Article 437(2) of the FSCMA are covered in Principles 13-15.</p> <p>Pursuant to Article 4-102(4) of the Regulations on Financial Investment Business, each prime broker is required to report the present conditions of credit extension and collateral to the Governor of the FSS. This includes credit extension to hedge funds.</p>
Assessment	Broadly Implemented
Comments	<p>Because Korean hedge funds can only be sold to qualified investors, the current KOFIA guideline based requirements for investor disclosure can be considered to be sufficient. However, the fact that they are not required to have their financial statements audited has the potential of undermining the quality of investor disclosures and the reliability of the reports submitted to the regulator.</p> <p>The FSS plans to start on-site examinations of hedge funds in December 2013. It is recommended to proceed with this plan, also in order to monitor developments in preparation for the likely growth of the sector.</p>
<b>Principles for Market Intermediaries</b>	
<b>Principle 29.</b>	Regulation should provide for minimum entry standards for market intermediaries.
Description	<p><b>Requirement for Authorization or Registration</b></p> <p>The financial investment businesses that require authorization or registration in Korea include (Article 6 FSCMA):</p> <ul style="list-style-type: none"> <li>• Investment trading business;</li> <li>• Investment brokerage business;</li> <li>• Collective investment business;</li> <li>• Investment advisory business;</li> <li>• Discretionary investment business; and</li> <li>• Trust business.</li> </ul> <p>All the above business falls under the IOSCO term market intermediary, with the exception of collective investment business that is covered in detail in Principles 24–27.</p> <p>No one can engage in financial investment business (except investment advisory business and discretionary investment business) without authorization (including for changes) or registration in the case of the aforesaid advisory and discretionary investment businesses (Articles 11 and 17 FSCMA). Articles 12 and 13 set out the relevant requirements. Each line of financial investment business (trading, brokerage, collective investment, trust and underwriting) must be specified as well as the range of covered products (securities, exchange-traded derivatives, over-the counter derivatives, and the type of CIS business (Article 229) or trust business (Article 103(1)). The class of investors must also be specified,</p>

and the authorization pertains specifically to the approved “authorized business units”. Banks and insurance companies have to be authorized for financial investment business, if they carry out any of the above mentioned activities (see the introduction for the number and types of approved intermediaries).

Information on authorized financial investment business entities is available on the FSC website and in the case of exchange members on the KRX website. If the firm, or its holding company, is also a public company, additional information is available in the DART system.

### **Legal Form**

The entity (except for foreign branches) authorized must be a stock company under the Commercial Act (in the case of a broker) or a type of entity otherwise specified by the Enforcement Decree (see e.g., Principles 24 et seq. regarding collective investment business). Anyone engaging in electronic brokerage (FSCMA Article 78) must also be a member of the KRX.

### **Other Criteria, Including Fitness and Propriety Criteria**

Applicants for authorization (and/or changes to the authorized business units) must have:

- Equity capital of at least KRW 500 million for each authorized business unit;
- A feasible and sound business plan;
- Proper human resources, including staff who hold the certifications of competence required for the business conducted by the entity and fit and proper executives (directors), who are not subject to statutory disqualification as set forth under Article 24 and major shareholders that are “financially sound and socially credible”;
- Appropriate physical facilities and sufficient IT system for the business authorized;
- Systems for preventing conflicts of interest and other internal controls, which include e.g., a proper internal audit function, a compliance officer with at least 10 years of work experience, outside directors; and
- Total assets of over KRW 2 trillion at the end of the preceding fiscal year (see Articles 13 and 25–28 of the Enforcement Decree of the FSCMA).

### **Banks and Insurance Companies**

In general, according to the FSC and FSS, banks and insurance companies that engage in securities business are subject to the same requirements as securities companies. Certain differences may apply to products not described as securities products and the governance requirements pertaining to banks and insurance companies are covered by their own licensing requirements, not those for financial investment business entities under the FSCMA. Additionally, there are some products, such as insurance variable annuity products indexed to securities, whose distribution is covered by insurance rather than securities conduct of business law<sup>25</sup> (see Principles 1 and 31).

Any person located in Korea, including a foreign branch or business office, must register its advisory and discretionary investment business. Such firms must have capital of KRW 100 million for each unit, fit and proper executives and major shareholders, and appropriate number of professional advisors

<sup>25</sup> The scope of what is concurrent or incidental business may also be unclear.



qualified/certified by KOFIA as advisors, analysts, etc., as specified in regulations. Registrants (i.e. investment advisors) are not permitted to directly deal (execute transactions) for clients; this must be done by authorized persons.

However, persons engaging Koreans from offshore by telecommunication for offshore transactions are not required to be authorized.

### **Authorization<sup>26</sup> Process**

The process is a two stage process with specified time limits (subject to the ability of the FSC to request additional information). It involves (as in some other jurisdictions) a period of public exposure of the application, which permits the gathering of information from the market of objections or potential disqualifications not otherwise surfaced in the vetting process. The process also involves a review of the facilities and the IT and an "on the papers" review of the business plan, strategy and other matters such as written internal control, compliance and risk management provisions. In some cases, a more complete on-site visit can be conducted rather than just a facilities verification. However, relevant staff indicated that the FSS typically did not conduct "nursery visits" early in the life of a newly authorized financial investment business entity, and often did not audit new licensees until they had had three years of operations. The authorization if granted (or denied) by the FSC and subject to judicial review, but the processing is handled by FSS.

### **Ongoing Requirements**

Requirements must be met on an ongoing basis. Any organizational change or acquisition (merger, exchange of stocks, and transfer of business) must be approved (FSCMA Article 217). Periodic financial reporting is required (see Principle 30 about compliance with capital requirements). Further, a change of an executive or of stock holdings of a large shareholder or its related persons (by at least one percent), opening or closure of a branch, addition or transfer of an authorized business unit or line, and many other specified matters must be reported immediately.

### **Denial, Suspension or Revocation**

Denials may be appealed, but the bases for reversal of a denial are limited. Once granted, in addition to the potential for suspension or revocation of the authorization or registration for violating various securities laws, rules or regulations, authorizations and registrations may also be withdrawn if a condition is breached, the application was false, or the party does not comply with an order of the FSC or fails to meet financial soundness requirements. Upon revocation, the business must be dissolved.

### **Record-keeping**

All business records must be retained on a specified schedule for at least three years FSCMA Article 60).

### **Trust Business**

Significant business is conducted through trusts that are not constructed under the rules relating to collective investment schemes (see Principles 24 to 27) or under the specific requirements for

<sup>26</sup> This process is somewhat more extensive than the registration process, which is separately articulated in the law.

	discretionary investment business. As the trusts are managed by brokers in their own names as the legal owners (in contrast to discretionary investment business where the client is the legal owner), there is the potential risk of abuse of customer funds and of a lack of appropriate arrangements to cover other risks addressed by requirements on collective investment business or discretionary investment business more generally.
Assessment	Fully Implemented
Comments	The observations on trust business have not impacted the rating on this Principle, but have been taken into account in the discussion on Principles 1, 31 and 32.
<b>Principle 30.</b>	There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
Description	<p><b>Capital Calculations and Reports</b></p> <p>In order to be authorized a financial investment business entity must meet the basic minimum capital requirement on a business unit by business unit basis. According to the FSC, this requirement also applies to banks and insurance companies that apply for authorization/registration of financial investment business. Articles 30 and 31 of the FSCMA also require the maintenance of net operating capital consistent with the financial soundness of the business enterprise on a continuous basis. Assets that constitute good capital are “discounted” in accordance with applicable guidance similar to the type of provisioning rules applied to banks, with reserves of up to 100 percent required in some cases, as described below. The granting of margin loans is limited to 100 percent of firm equity capital and up to no more than 40 percent of the value of the security margined, 30 percent in the case of on-line trading and 25 percent in the case of</p> <p>Short-term money market transactions. There is extensive guidance on assessing risk, and each of credit, liquidity and market risk are given consideration.</p> <p>Capital must be calculated daily, and reported monthly (by the end of the following month). Reports must calculate gross risks and net capital. Quarterly reports (due 45 days after quarter end) reviewed by an auditor are also required to be filed and posted on the financial investment business entity’s website. Records of these reports must be maintained for one year by brokers, and the reports themselves are contained in the electronic reporting system indefinitely. Records of investors’ trading (10 years) and proprietary trading (3 years) are maintained for different time periods (see e.g., FSCMA Article 60).</p> <p><b>Early Warning</b></p> <p>The capital requirement is based on a net capital ratio calculated as net capital divided by risk<sup>27</sup>. The early warning level is 150 percent of the minimum required amount. Early warning notices for reductions in capital or reductions of 10 percent must be filed immediately. Haircuts are not specified, but rather the financial investment business entity is to value asset quality by categories ranging from normal (0.5), precautionary (2), doubtful (75) or estimated loss (100), with the parenthetical numbers reflecting the requisite required provisioning. (KRX however applies a haircut to collateral received in connection with clearing—see Principle 37). These numbers are related to the cost of liquidating the asset and recovering its value, if need be (see FSS Handbook 2012). The Regulations on Financial Investment Business include comprehensive guidance on computing capital in Chapter II, which contains guidance on the</p>

<sup>27</sup> The handbook indicates that there are multiple measures intended to reflect specific risks related to different investment products.

measurement of market, credit, liquidity, operational, interest rate and foreign exchange risks. This guidance also permits modelling, subject to approval by the FSC.

The FSS applies RAMS to evaluate the financial soundness of financial investment business entities that engage in underwriting, brokerage and trading. This system is explained in a lengthy manual that contains additional extensive guidance on risk measurement and is provided to all financial investment business entities engaged in securities brokerage or trading (see also the discussion of Principles 6 and 12). There is no similar manual for assessing the risks of collective investment business entities, which ostensibly are exposed to different risks and have different risk profiles. The insurance and banking institutions supervised by the FSS are also reviewed against other standards. The various supervisory teams do not actively share observations about the transmission or interconnection of risks between related companies.

### **Credit Risk**

Article 4-34 of the Regulation on Financial Investment Business requires investment firms and brokers to file daily reports on credit extensions to KOFIA according to KOFIA's guidelines and KOFIA to report to the FSS credit extensions in excess of the established limit.

In addition to KOFIA's compliance monitoring, the FSS assesses the adequacy of credit extensions by investment traders and brokers during its on-site examinations and takes supervisory actions if this regulatory limit is breached.

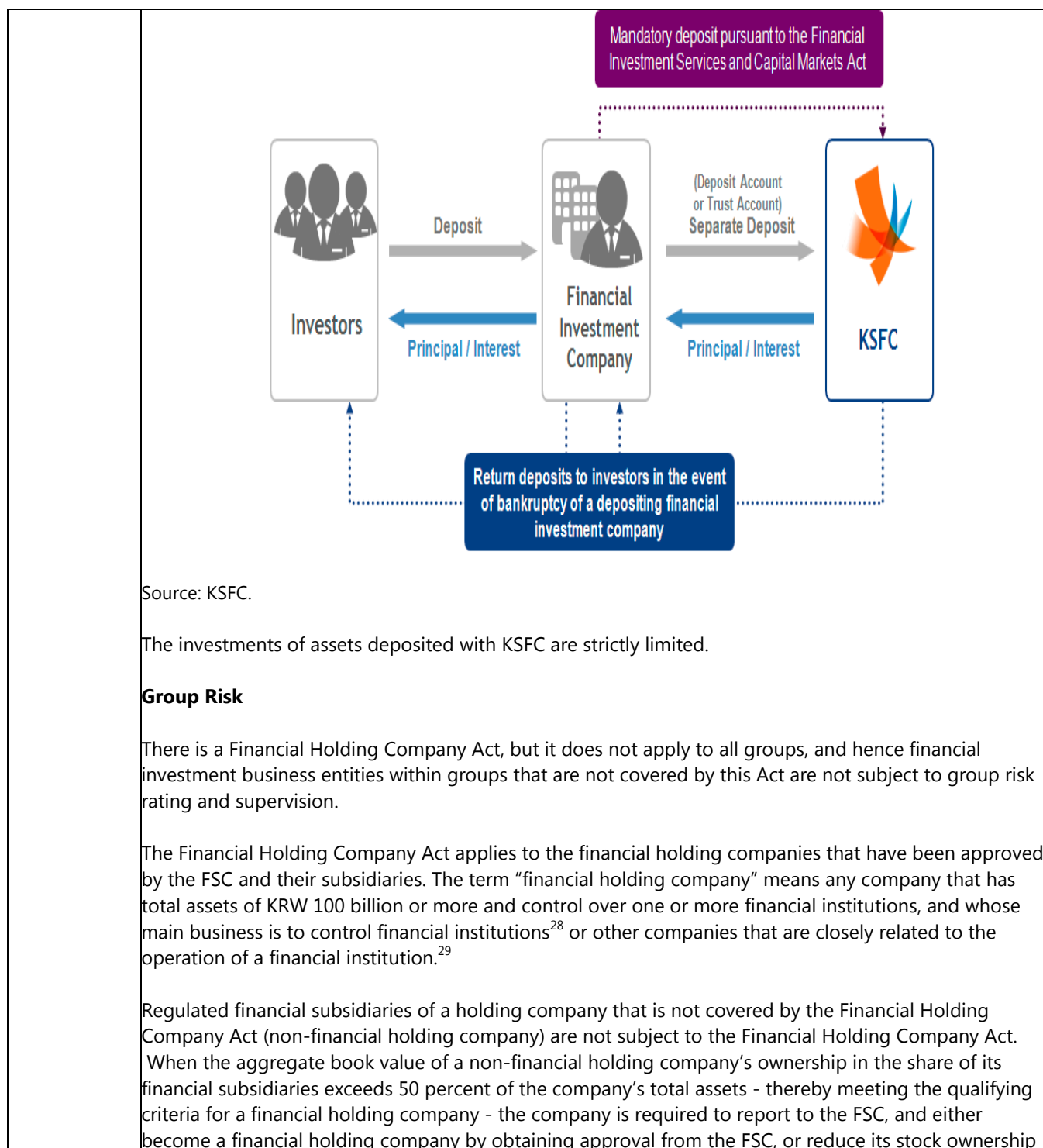
### **Corrective Actions and Timing for Rectifications**

Corrective actions for firms which fall below required capital levels range from a management improvement recommendation (such as restriction on new business, establishment of bad debt allowance, or disposal of non-performing assets) to requirements to close businesses, replace officers, or transfer business or accounts, when the capital level falls below 120 percent or the firm's qualitative control rating is 4 or lower (see discussion in Principle 31). In the case capital level falls to 100 percent, the authorities would issue an order to suspend business execution by officers or appoint an administrator. In either the case of a recommendation or an order, the firm would have two months to develop a management improvement plan.

### **Customer Funds**

These various requirements and remedial provisions do not reflect risks emanating from misuse of client assets. There is however the Act on the Structural Improvement of the Financial Industry that addresses the wind down of institutions whose ongoing operations are threatened by a scandal or financial losses (see also Principles 32 and 37).

Additionally, under Article 74 of the FCSMA, an investment trader or investment broker is required to separate an investor's fund (referring to money deposited by investors in connection with trading of financial investment instruments and other transactions) from its proprietary property and place it in a deposit or trust account with the Korea Securities Finance Company (KSFC), see the diagram below:



<sup>28</sup> Companies classified as financial or insurance companies under the Korea Standard Industry Classification under Article 22(1) of the Statistics Act.

<sup>29</sup> Companies that provide IT/information processing service to financial institutions, manage other assets held by financial institutions, or conduct survey/research on the financial industry

	<p>in financial subsidiaries to below the 50 percent threshold within one year from the day the share ownership exceeded 50 percent. Only the holding companies that are approved by the FSC to become a financial holding company are subject to the Financial Holding Company Act.</p> <p><b>Other Controls</b></p> <p>There are certain restrictions on financial investment business entities owning securities issued by a major shareholder, granting credit to major shareholders (to the lesser of KRW 100,000,000 or the one year salary) or owning stocks, bonds or notes issued by a related person in excess of 8 percent of shareholder's equity (FSS Handbook).</p>
Assessment	Fully Implemented
Comments	<p>The rating is fully implemented based on the ability of the authorities to oversee the capital regime in a timely way and the lack of failures. Nonetheless, the time frame for filing financial reports, reviewed off-site, seems too long in the case of financial investment business entities as the risks such firms undertake are primarily with respect to the trading and holding of financial instruments directly and the credit risk exposures such firms have to customers that are actively trading (see statistics on volatility and turnover above) and/or in the short term financing markets. This issue was also mentioned in the 2002 IOSCO assessment. The impact of the time frame is mitigated in that capital must be calculated daily and can be called for prior to a reporting period, monthly reports are now required and a reduction of assets of 10 percent and quantitative early warning events must be immediately reported as must other specified material events such as the departure of a compliance officer. Two months is also a lengthy time to submit a performance improvement plan in the event that a firm is actually at the minimum capital level, taking into consideration best practice and the risk of a loss of confidence or the potential risk of loss to customers (in this respect see Principle 32). The FSC does appear in practice to prevent such companies from taking on new business.</p>
<b>Principle 31.</b>	<p>Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.</p>
Assessment	Broadly Implemented
Comments	<p>The documentation, planning and execution of on-site examinations are extensive and thoughtful. The FSC and FSS should ensure that sufficient monitoring is directed to oversight of the allocation of trades and handling of orders at the brokers. In connection with the development of a more formal consumer protection regime, as discussed above, review of the fairness of the outcomes of the dispute resolution process might also be considered.</p>
<b>Principle 32.</b>	<p>There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.</p>
Description	<p><b>Contingency Plan</b></p> <p>The FSC and the FSS do not have a documented contingency plan which addresses the potential failure of a market intermediary (see also Principle 37 about the accessibility of the applicable rules). The FSC and FSS do however have substantial powers related to the management of a market failure, timely information on exposures available from the KRX, and access to more than one arrangement related to protecting customers' funds and completing pending settlements. Although the KRX performs some scenario testing of its clearing processes, it is not clear that the FSC/FSS arrangements have been tested for adequacy using various securities market scenarios since the recent crisis.</p>

The exchange has detailed rules related to posting of margin and default, as does the KSD. The sophistication of these was enhanced in 2010, when options volatility and implied volatility were added to the margin calculation. Extension of credit by brokers to customers is overseen by KOFIA. The exchange also has rules for correcting error trades and how the loss (if any) will be apportioned/borne. It can in certain cases cause cancellations and is looking into developing a so-called kill switch. There also is an explicit procedure for dealing with settlement fails in equity securities.

### **Early Warning Systems and Related Risk Mitigation Powers**

The processes for minimizing the damage and risk of loss to customers due to the failure of a market intermediary are:

- Ongoing monitoring, price limits on individual securities, and circuit breakers;
- Risk rating through off-site and on-site analysis and the application of “trigger events”-that is events (market moves, economic changes, capital reduction, early warning and other material reporting) that trigger enhanced or more intensified review of the firms;
- Measures to support the conclusion of settlement, if a firm fails or there are excessive fails to deliver; and
- A deposit insurance regime that applies to all financial investment business entity deposits (see Deposit Protection Act Article 2 (j))<sup>30</sup>. Funds deposited by securities customers thus have a certain level of protection as a matter of law (KRW 50,000,000 per investor) in the event of the insolvency of a broker.

Further, the exchange maintains both a joint compensation fund and a fidelity fund and there are exchange rules establishing a waterfall of resources for addressing troubled firms, which rules and procedures are not readily accessible to the public as stated in Principle 37, although the KRX recently posted its self-assessment under the CPSS-IOSCO Principles, which contains some of this information.

The FSS oversight program applies an early warning system trigger of 150 percent of the net capital ratio, after which more intensive monitoring and potential limitation of riskier activities occurs. The FSS, which is the prudential supervisor, also reviews firms’ periodic financial reporting using other information about risk intended to expose a firm, whose financial situation is weakening, including the measures detailed in Principle 30 above. In consequence, some firms are on a “watch list” or risk management performance improvement plan due to their risk rating. Firms are accountable to the KRX and KSD for the completion of transactions and the funding of executed trades, which become “locked in” upon matching.

In addition to providing insurance the KDIC may join on-site inspections, where it believes it has an interest and may engage in restructuring actions. The FSC, in addition to requiring a firm to take corrective actions, can act to remove management and to appoint an administrator under certain circumstances. The FSC reported, however, that no financial investment business entity has failed in the past ten years, due to which there is no practical experience from applying these measures.

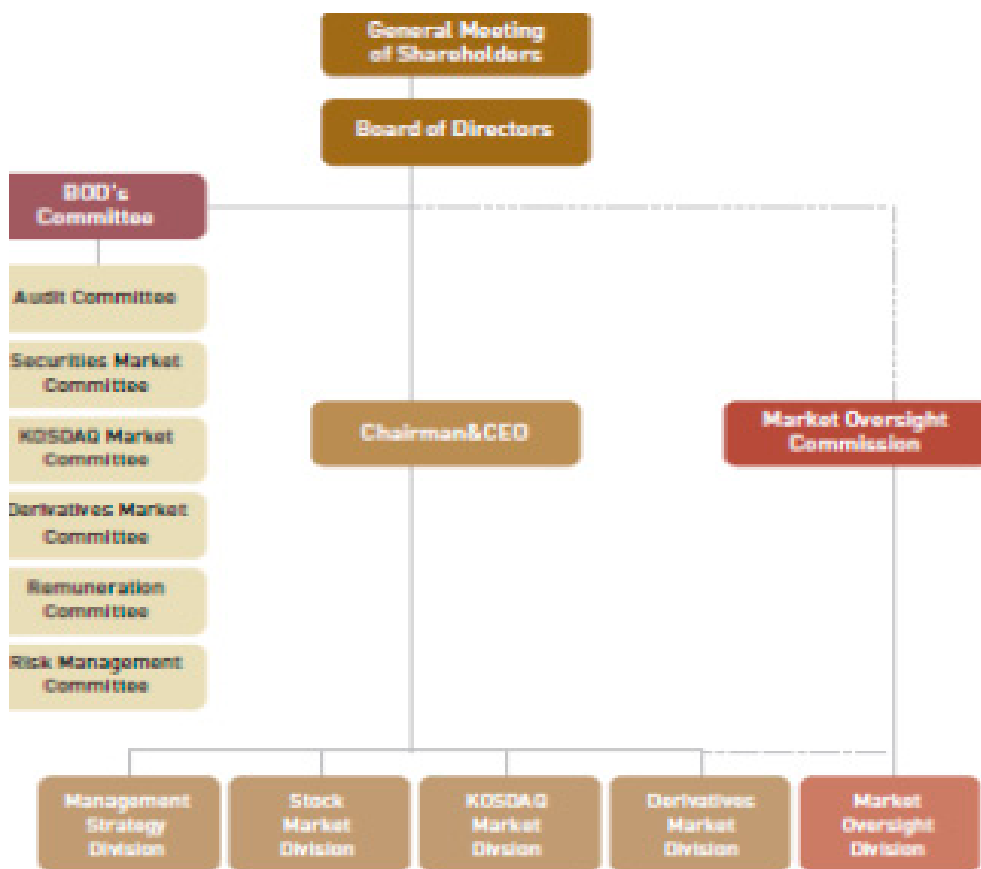
<sup>30</sup> Remaining cash balance in customer’s account, not having been used to purchase securities, etc.; Remaining cash from deposits for stock margin loans, deposits for opening a margin account and deposits for margin loans; Monetary trusts with principal guarantees; and Deposits in defined contribution retirement pension products or individual retirement accounts that are KDIC-insured.

	<p><b>Restructuring</b></p> <p>The specific provisions relative to restructuring are contained in the Act on the Structural Improvement of the Financial Industry. They require that where any financial institution's financial status falls short of required standards, the FSC must recommend, request or order the financial institution concerned or its executives to take the following measures or order it to furnish its implementation plan in order to prevent insolvency, and promote the sound management of the financial institution:</p> <ul style="list-style-type: none"> <li>• Admonition, warning, reprimand or salary reduction in relation to the financial institution concerned and its executives and employees;</li> <li>• Capital increase or capital deduction, disposal of property holdings or reduction in inventory and downsizing;</li> <li>• Ban on acquisition of high-risk assets;</li> <li>• Suspension of executives' performance of duties or appointment of management supervisors to perform executives' duties;</li> <li>• Amortization or consolidation of stocks;</li> <li>• Suspension of all or part of business;</li> <li>• Merger or third-party takeover of the financial institution concerned;</li> <li>• Transfer of business or contracts related to financial transactions, such as deposits or loans; or</li> <li>• Other measures equivalent to those listed above, which are deemed necessary to improve any financial institution's financial soundness.</li> </ul> <p>There must be compelling circumstances that there will be injury to creditors for transfer of all business or contracts to occur.</p>
Assessment	Broadly Implemented
Comments	<p>Korea is in the vanguard in that its provisions for deposit insurance and for restructuring are applied to all financial institutions, including financial investment business entities that are investment brokers or traders. Nonetheless, the FSS, FSC, and other related agencies with responsibilities for addressing default situations should consider joint crisis simulation and default remediation exercises taking into account the recent global crisis and also new Principle 6 and document their contingency plans.</p> <p>The period for returning to capital compliance of two months permitted under the law seems to be excessive in light of best practices and the volatility of the Korean market (see Principle 30).</p>
<b>Principles for the Secondary Markets</b>	
<b>Principle 33.</b>	The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.
Description	<p><b>Establishment</b></p> <p>By law, at the time of the assessment a single exchange market in the form of a stock company (Articles 373 and 386 FSCMA) was operative in Korea. KRX is for profit exchange, but it is not listed or publicly traded. As of December 2012, KRX had 94 members (see also Principle 9). The law prescribes the governance structure of the market, including the provision for a Market Supervision Committee (Article 402) and the duties and responsibilities relative to the operation of the market, as well as the role of the KRX with respect to clearing and settlement of securities and futures (see Articles 380-384, 388 FSCMA</p>

regarding governance and Articles 377 and 378 regarding duties and clearing).

The law also unifies the pre-existing markets within the KRX. Thus, the KRX contains multiple platforms (KOSPI, KOSDAQ, KOFEX and as of July 2013 KONEX), provides for clearing and non-clearing members (Articles 386–388) and has responsibilities relative to listing regulations and timely/continuing disclosure (Articles 390–392). Pursuant to these provisions, KRX trades multiple products including equities, government, corporate and market stabilization bonds, exchange-listed third party warrants (ELW)<sup>31</sup>, ETFs, stock index futures and options on multiple indexes, and interest rate futures on the Treasury bonds among others on three different platforms. Overnight trading links for KOSPI index futures and options have been developed with Eurex (since 2010) and CME (since 2009). Via these links, qualified individuals with a clearing arrangement with a KRX member can trade KOSPI 200 futures overnight using the Unified System for Global Trading (UGS) of the KRX member linked through CME Globex. The front end of the UGS is the Home Trading System.

The organization of the KRX is as follows:



**Financial Integrity of Trading and Clearing Operations**

In addition to posting the applicable margin depending upon the type of interest traded, members must contribute to both a fidelity fund to repay debt likely to be incurred in the course of undertaking

<sup>31</sup> These have been substantially reduced recently.



securities transactions, and to a joint compensation fund. Separate joint funds are maintained for the derivatives and the securities market (see Articles 394–396 FSCMA). The foregoing funds are available to satisfy debts to customers and the exchange in preference to other creditors in the event of a default as a matter of explicit provisions of the FSCMA and exchange rules. The KRX effectively acts as a CCP for exchange traded securities pre settlement and for futures. According to the legal community, the current treatment of finality and of customer funds is permitted under the relevant insolvency law. The exchange also provides that, once executed on the platform, trades are locked in and cannot be reversed.

Per the KRX Fact Book, the KRX joint compensation fund is funded at KRW 200 billion each for securities and derivatives respectively and there is a KRW 400 billion settlement reserve (fidelity fund). The KRX also maintains a line of credit of KRW 1.5 trillion. Information provided suggests that for the settlement of OTC share trading, KSD has a KRW 50 billion settlement fund and KRW 200 billion in reserve. The KRX itself also has KRW 50 billion in capital.

### **Mechanisms to Address Market Disruption and Financial Instability**

The rules of the exchange as approved by the FSC limit price fluctuation on an equity-by-equity basis to  $\pm 15$  percent from the previous day's close. The KRX also employs a circuit breaker mechanism. If the KOSPI overall declines 10 percent from the previous day's close, and the situation persists for one minute, trading will halt for 20 minutes. If the price falls 5 percent, the KRX will suspend the receipt of orders for five minutes. The KRX has the authority under the FSCMA and its own rules to suspend trading in the event of emergencies, such as natural disasters or sudden significant changes in economic conditions and for market stabilization ("overheated" trading after an IPO) and other purposes.

In addition to circuit breakers and side cars and other arrangements discussed in Principle 37, which protect the functioning of the market, the KRX has rules which permit it to suspend trading to permit more demand to develop to achieve a better equilibrium price and to prevent distortions from the possible leakage of information or other problems. These arrangements are implemented by exchange rule subject to FSC and FSS oversight.

### **Business Conduct**

Exchange rules related to business conduct as required by the FSCMA prohibit unsound business conduct, such as front running (see for example KOSPI Enforcement Rules). The exchange may request data from members to investigate market misconduct (Article 404 FSCMA). If the member fails to cooperate the exchange may suspend membership or restrict transactions (Article 404(3)). The exchange can also request that a member dismiss an employee. The FSS, FSC and SFC can also request information relative to their mandates.

### **Fairness of Order Execution Procedures and Access**

The FSC has the authority to review the trading algorithm and the trading results for fairness. In principle the exchange provides, and the law requires, equivalent access for customers. Neither the KRX nor the FSS, however, have introduced any special restrictions relative to algorithmic trading, other than checking the integrity of order routing systems and pre-trade controls. Algorithmic trading constitutes a significant amount of the volume. The rules of the exchange are public and available on the exchange website. The exchange also maintains a disclosure system that contains disclosures filed by issuers (see Principle 16). This information is available to the general public. Direct access to the exchange is limited to authorized entities, and persons whose business they guarantee. Initial responsibility for exposures is with the member (see also Principles 31 and 37).

Clients may use the APIs of brokers through whom they trade on the KRX to place orders electronically using either the Internet or a HTS. According to the KRX and KOFIA, 60 percent of all trading activity on the exchange occurs through HTS. These systems permit customers to enter their orders directly for routing via the account of the broker. There are no foreign omnibus accounts, so foreign customers must be disclosed to local brokers.

### **Oversight**

In addition to the matters discussed in Principle 9 above, the FSC approves exchange rules, including those related to products such as ETFs and to listings and delistings (Articles 409 and 412 FSCMA). The FSC also reviews the IT systems of the market, and oversees the role of the KRX in maintaining fair, efficient and transparent markets and in enforcing compliance with its business regulations. Finally, the FSC monitors the effectiveness of KRX market surveillance and operation of systems required by law such as dispute resolution. The exchange's requirements for issuer disclosures are discussed in Principle 16.

The exchange surveils market activity in real time, and the FSS reviews trading on a batch basis and also uses a KRX terminal. Audit trail records are required to be maintained for 10 years.

### **Other Markets or Trading Systems**

ATS or MTF were not permitted in Korea at the time of the on-site visit, but enabling legislation has recently been adopted. This expansion may eventually permit more extensive supervision of the current OTC market. Since 2010 two additional markets besides KRX have operated under the auspices of KOFIA, which are described as OTC markets: the OTC bond market and the Freeboard. The latter is a market in unlisted very small cap equities, where prices are quoted on the system and negotiated usually by messaging. The value of daily trading is USD 0.09 million (see also Introduction and Principle 9). Prices must be registered before settlement in the case of the OTC bond market. There are no cross listed securities among the Korean exchange markets and OTC markets, and only about 17 listed foreign issues.

There is also a provision that permits brokers to operate electronic brokerage systems. Article 78 of the FSCMA permits internal trading, that is electronic securities brokerage at the latest price on the securities exchange or a uniform price determined by a formula prescribed by Ordinance (which is a Volume Weighted Average Price calculated from certain specified transactions). These provisions also relate to block trading (or negotiated trading generally, whether during regular or after hours (see Principle 35).

### **Ownership Structure**

By law, transfer of 5 percent or more of the stocks of KRX requires FSC approval. KRX as of its 2012 Annual Report had 37 shareholders, all of which are members except the KSFC and KOFIA. Between them, the 37 shareholders held all but 924,872 treasury shares of the 20 million shares of KRX. KRX wholly owns Koscom which sells securities operations systems, and the majority of KSD. It also has an interest of 11.35 percent in the KSFC and holds a 49 percent share in the Laos exchange.

### **Market Activity**

The following details the level of activity on the KRX and compares it with other selected markets.

KRX	End 2009	End 2010	End 2011	End 2012
Number of Listed Companies	1,788	1,798	1,816	1,784
Market Cap, USD Billion	834.6	1,091.9	996.1	1,179.4
Market Cap, KRW Trillion	971.9	1,239.2	1,147.6	1,262.7
Value of Bond Trading, US Billion	438.1	515.6	716	1,285.6

Source: World Federation of Exchanges.

#### February 2013

Exchange	Number of Listed Companies	Domestic Market Capitalization (USD Billion)	Value of Bond Trading (USD Million)	Share Turnover Velocity (%)
Toronto Stock Exchange Group	3,966	2,057.2	467.3	68.5
Deutsche Börse	743	1,520.4	2,824.8	78.1
Indonesia Stock Exchange	464	480.0	no data	25.4
Korea Exchange	1,780	1,192.8	95,258.4	95.7
MICEX-RTS Exchange (Moscow)	288	827.2	37,778.6	29.2
Singapore Exchange	840	786.7	no data	52.8
Stock Exchange of Thailand	561	445.8	0.6	99.6

Source: World Federation of Exchanges.

#### Composition of the Market

The market is a heavily retail market (more than 60 percent of trading activity), and the issues traded have on average a free float of between 30 and 50 percent (and as much as 70 percent for some securities). About 20 percent of daily trading activity is that of foreign investors, and 10 percent is contributed by investment trusts. Institutional investors contribute barely 5 percent. Insurance funds hold less than 1 percent of outstanding securities and banks less than 5 percent. The largest securities contract in terms of market capitalization and trading volume is the share of Samsung Electronics. The KOSPI 200 futures and options contracts are particularly active and are also traded overnight through links with both CME and Eurex. The average number of daily contracts traded in the KOSPI 200 is 7.4 million<sup>32</sup>. Block trading is a minor part of trading activity, but the prices for blocks, which need only be of USD 50,000 on KOSPI irrespective of the security traded are not reported (see Principle 35). Only the volume is reported at the end of the day.

<sup>32</sup> This compares with only slightly more than this for a full year when the last report was done.

	<b>2010</b>	<b>2011</b>	<b>2012</b>
Stocks			
Trading Value (KRW Billion)	1,893,652.91	2,260,067.34	1,724,291.62
Trading Value (USD Billion)	1,690.76	1,950.01	1,622.10
Bonds			
Trading Value (KRW Billion)	585,205.42	824,817.00	1,376,338.25
Trading Value (USD Billion)	522.50	711.66	1,294.77
Structured Products			
ETFs (KRW Billion)	27,660.20	121,420.80	134,961.60
ETFs (USD Billion)	24.70	104.76	126.96
ELWs (KRW Billion)	410,987.40	318,853.60	59,916.80
ELWs (USD Billion)	366.95	275.11	56.37
Derivatives			
Futures (KRW Billion)	13,843,385.51	16,005,746.90	13,230,164.96
Futures (USD Billion)	12,360.17	13,809.96	12,446.06
Options (KRW Billion)	318,061.02	436,326.35	304,684.69
Options (USD Billion)	283.98	376.47	286.63
KRW/USD Exchange Rate*1	1,120.00	1,159.00	1,063.00
Source : FSC Data Questionnaire Responses.			
*1. Korea Exchange Bank			
<p>The Freeboard equity market has 40 members, as of end 2012 traded 52 equities and had a market capitalization of USD 554 million, of which the 10 largest companies constituted about 80 percent. The number, amount of trading and capitalization has decreased significantly in the last three years. 99 percent of all trading on this market is by retail participants.</p> <p>In the OTC bond market, although the system permits for all quotations to be entered on the system, transactions may be negotiated by messaging outside the system and reporting them to KOFIA prior to settlement. The rules require reporting within 15 minutes of the trade.</p>			
Assessment	Fully Implemented		
Comments	The clearing and settlement arrangements including the “waterfall” should be prominently displayed on both the KRX and the KSD websites and linked through the FSC website as well (see Principles 32 and 37).		
<b>Principle 34.</b>	There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.		
Description	<p><b>Ongoing Compliance</b></p> <p>Both the KRX and the FSS monitor the ongoing compliance of market participants and issuers with the requirements of the FSCMA and the KRX rules and procedures. Effectively, the KRX is the front line overseer of the market, and also accountable for compliance with its own trading, listing and ongoing disclosure requirements as approved by the FSC.</p> <p>The governance of the KRX oversight function is that the Market Oversight Division (i.e. staff of the exchange) reports to the Market Supervision Committee, a structure required as a matter of law to</p>		

ensure that the regulatory function of the exchange is insulated from the commercial function. KOFIA has a similarly insulated self-regulatory function.

### **Trade Monitoring**

The exchange monitors trading in both real time and by batch using proprietary parameters and exception reporting. The KRX system is known as the Intermarket Surveillance Information System (ISIS). The FSC, SFC and FSS all have access to records of the exchange as necessary to oversee compliance with applicable law and appropriate maintenance of an audit trail. Trading records are maintained for 10 years.

### **Supervision by the Financial Services Commission/Financial Supervisory Service**

As do other regulated entities, the KRX files multiple reports with the FSC/FSS. In addition the FSC, through delegation to the FSS, can request additional reports from the exchange and can conduct an inspection of the exchange (see FSCMA Articles 410 and 419)

The FSS conducts biennial inspections of the exchange (see Principle 9 above). It or the FSC also can take action against the exchange and exchange officials (Article 416 FSCMA), including:

- In the case of executives or officials:
  - Suspension from office;
  - Request for dismissal; and
  - Disciplinary or cautionary warning.
- In the case of the exchange itself:
  - Suspend all or part of business for up to six months;
  - Order transfer of a contract;
  - Order correction or suspension of a violation;
  - Order publication of measures taken to correct a violation; and
  - Issue an institutional warning or caution or other measure permitted by the Enforcement Decree of the FSCMA.

Officers of the SFC, FSS and KRX may also convene a council of agencies to investigate and examine unfair trading practices, coordinate investigative policies and organize procedures for the deterrence, detection and investigation of unfair trading practices on a continuous basis (Regulation on Investigation of Capital Markets Section 41).

### **Practice**

A review of files of on-site inspections conducted by the FSS indicated that the FSS examines the KRX's operations and regulatory program in detail to determine that it is properly fulfilling its self-regulatory function and maintaining a fair and equitable market. In this regard, the FSC, as recommended by the FSS examiners and the Governor of the FSS, may provide significant recommendations related to the integrity of those functions, investor protection and the adequacy of exchange management and supervision. The FSC requests the opening of the examination of the exchange, which is a unique type of examination with different procedural requirements than the on-site inspection of a financial investment business

	<p>entity. The planning for the examination for which files were reviewed took into consideration monthly and other business reports, complaints, market information, and unofficial sources.</p> <p>The documentation for the examination conducted in 2010 consumes eight volumes. The focus of the examination included: adequacy of personnel, rules for trading and listing, operation of the market surveillance system, governance, and specific issues including listing of Chinese companies. Transcripts of certain of the interviews conducted are maintained. The overall examination took 24 people over 15 business days. The post examination report goes to the Senior Deputy Governor in charge of the subject matter. Ultimately the Enforcement Review Committee and the Secretariat of the FSC review the evidence of the matters for which recommendations are proposed. The final recommendations are decided by the FSC, although some limited matters can be decided by the Governor of the FSS (see also Principles 9, 33 and 37). In this respect, recommendations for certain improvements and follow-up were made.</p> <p><b>Information Technology Systems</b></p> <p>The FSS conducts reviews of KRX IT connections. To ensure the safety and soundness of the financial system, the FSS has a Management Evaluation System for financial institutions, and examinations under the system include an examination of IT operations. KRX indicates that it strives to provide equal response times to the extent possible, and that it discloses latency in links and other arrangements (see also the Electronic Financial Transactions Act relative to the security of IT facilities servicing electronic financial transactions more broadly).</p> <p><b>Transparency</b></p> <p>The KRX has an informative website that contains a variety of information about the markets it operates, the membership of the KRX, its rules and requirements, statistics and other data, and publications. It also runs KOSCOM that produces additional information. Fact books, information on contract terms and conditions and other information are available on the website. The KRX has a comprehensive set of operating, regulatory, and dispute resolution requirements available through its web site, for each of its markets (see also Principle 35). It however does not routinely make statistics on its member actions public (see Principle 36)</p>
Assessment	Fully Implemented
Comments	<p>More in house capacity at the FSS to monitor exchange trading and related IT support would ensure the continuing ability of the FSS to properly oversee the trading systems operating in Korea. This will become increasingly important, if more trading systems are permitted and as new, complex, and possibly more risky products such as inverse and synthetic ETFs are traded.</p> <p>The process for conducting the examination, while very professional, is subject to an internal review procedure that is difficult to parse. The structure of the different examinations and resulting exception and sanctioning process should be made substantially more transparent (see also Principles 2, 4 and 12).</p>
<b>Principle 35.</b>	Regulation should promote transparency of trading.
Description	<p>The KRX system displays an array of bids and offers in real time to participants.</p> <p>KRX also provides prices on a deferred basis electronically. In addition it publishes daily trading volume, daily settlement prices, and the highest, lowest and closing prices of securities and of exchange traded derivatives and other information as may be specified by the FSS or by Article 364(2) of the Enforcement Decree of the FSCMA.</p>

	<p>More specifically, the exchange rules (§101) require that the KRX makes public the market prices, etc., which correspond to the following items:</p> <ul style="list-style-type: none"> <li>• Current price, opening price, highest price, lowest price, and closing price;</li> <li>• Trading volume and trading value<sup>33</sup>;</li> <li>• Closing prices of the previous day or base prices;</li> <li>• Ex-dividend, ex-rights, ex-distribution or ex-interest; and</li> <li>• The quotation information and other data that are stipulated in the Enforcement Rules of the FSCMA, including the expected matching price during the quotation receiving hours for single price auction (e.g. open), expected best bid and offer prices, and the expected best bid and offer prices during the quotation receiving hours for multiple price auction.</li> </ul> <p>The KRX also has specific rules for block trades in the equity markets, which are placed using a block trading facility during the regular trading hours and thereafter. These rules require that the price is within the price band (which is 30 points). In the case of certain periods (at the open, after hours), the price must be established by the volume weighted average price (VWAP) of prices produced within a certain time period. Blocks are reported at the end of the trading day, but only the volume not the price of the block is reported. Block sizes are relatively low: USD 50,000 for the KOSPI and USD 20,000 for the KOSDAQ. According to the information received from the KRX, block volume is very low—less than one per cent of overall trading value. Even with a pricing formula, this reporting model does not meet international best practices with respect to transparency, because the price of the transactions is not reported. Further the block size is very small and uniform for all shares independent of their liquidity, which raises further questions as to the overall purpose of this trading vehicle (see also Article 78 of the FSCMA).</p> <p><b>Over-the-Counter Transactions</b></p> <p>In addition to the bonds traded on the KRX platform, the bond trade reporting service offered through KOFIA provides for a platform where all bids and offers could be displayed. Anecdotal evidence suggests however that prices are reported post trade at the time trades are settled in/reported to the KSD. The pricing of bonds more generally is aided by the use of four bond pricing agencies, which value illiquid securities as more specifically described under Principle 23. The bond market also makes use of some primary dealers. The overwhelming amount of bond trading is in government bonds. IOSCO however does not have comprehensive guidance on such pricing.</p>
Assessment	Fully Implemented
Comments	<p>Despite the deficiencies of the block trading regime, this Principle was assessed as Fully Implemented due to the low volume of block trading. However, further work should be undertaken to address the deficiencies of the current block trading regime.</p> <p>More effort could also be expended to address timely reporting of OTC bond trades, though the experience in Korea is similar to that of other platforms, where dealers are reluctant to take on risk pending conclusion of a trade.</p>

<sup>33</sup> How this is interpreted with respect to block trades has not been confirmed.

<b>Principle 36.</b>	Regulation should be designed to detect and deter manipulation and other unfair trading practices.
Description	<p>The FSCMA prohibits insider trading and misappropriation of information and requires the return of short swing profits (FSCMA Article 172) and reporting of significant shareholdings by executives and shareholders (Article 173); prohibits misuse of material non-public information (Articles 174 and 175) and manipulation and other unfair trading activity, such as the use of a scheme or device to defraud, and the introduction of false information into the market (Articles 176 and 178). See also the related Enforcement Decree (Article 355).</p> <p>See Principle 12 for the assessment of the effectiveness of the enforcement of the above requirements by the FSS, SFC, FSC and the public prosecutor's office.</p> <p><b>Exchange Enforcement Rules</b></p> <p>However, KRX also has its own rules for members and a real time trade surveillance and disclosure system that can support the detection of such violations, as well as comprehensive investigative powers. Under its rules the KRX can take action and request its members also to take action against offending employees.</p> <p>Subject to review by the FSC, the exchange Enforcement Rules (see VIII § 3 and 4) prohibit a number of practices that the market has determined to be inconsistent with customer protection or the fairness, equity and credibility of the market. These include for example:</p> <ul style="list-style-type: none"> <li>• Front running;</li> <li>• Wash trading;</li> <li>• Banging the close;</li> <li>• Guarantees against loss;</li> <li>• Recommendations for customers directly contrary to proprietary positions taken fairly contemporaneously;</li> <li>• Submitting quotations in a manner that gives a false appearance of a price;</li> <li>• Excessive quotations (and related cancellations);</li> <li>• Using a third party to improperly obtain a gain or a loss for one's own account against a customer; and</li> <li>• Providing false information to the market.<sup>34</sup></li> </ul> <p>The KRX is required to report violations of exchange rules that are also violations of the FSCMA, but according to the KRX rules, such a report would not preclude the KRX from bringing its own actions. The exchange can take disciplinary action for specific violations, for failure to comply with actions taken by the disciplinary committee pursuant to the law, for obstruction or non-cooperation with an investigation or inspection or refusal to provide information.</p>

<sup>34</sup> Effectively, the specification of these types of offenses (with more particularity in the actual rules) are intended to give more content as to what is a practice not tolerated by the market and considered by it to be detrimental to customer protection and equitable principles of trade.



Sanctions by the exchange can include:

- Expulsion from membership;
- Suspension of membership privileges or trading privileges in whole or in part;
- Imposition of a fine amounting a minimum of KRW 10 million and a maximum of KRW 1 billion; and
- A warning notice or a caution.

In 2010–2012, the exchange conducted 565 investigations in its members to ensure that they comply with its rules. In 112 cases, disciplinary action was taken as a result of the investigation. Four cases were referred to the FSS, and 453 cases were closed without action.

#### **Insider Trading and Manipulation Case Referrals**

In case of suspected insider trading or market manipulation, the KRX does not take disciplinary action itself, but refers the cases to the FSS due to the penal nature of violations that can involve non-exchange participants as well as exchange members. In 2010–2012, the number and types of cases referred were:

<b>Type of Violation</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Price manipulation	136	126	92
Insider trading	79	78	73
Other things	42	45	117
Total	257	249	282

#### **Complaints**

The exchange also has a complaints and dispute resolution process.

#### **KRX's Classification of Complaints and Disputes**

	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013 (Jan-Jul)</b>
Discretionary trading	17	7	11	7
Unauthorized trading	8	8	16	7
Undue recommendation	14	17	17	14
Errors in dealing with orders	12	25	16	9
Computerized trading operational errors	30	33	29	10
Others*	8	17	18	9
Total	89	107	107	56

\* Others: Liquidation, breach of fiduciary duty, regulation violation, etc.

These, and their disposition, can be reviewed by the FSS as part of its oversight process.

	<p><b>Cross-Border and Cross-Market Arrangements</b></p> <p>The FSC and FSS jointly are signatories of the IOSCO MMoU and 20 bilateral MoUs (see Principle 14) and the KRX itself has executed MoUs with other markets, for example, the Boca Declaration and arrangements with NYSE-Euronext. It also has surveillance arrangements pursuant to its links with the CME and Eurex to monitor position limits among other things and its Market Surveillance Committee has within its mandate overseeing relationships between the cash and derivatives markets.</p> <p>The KRX operates both the Korean derivatives and equity markets. In consequence there is coordination among other things of circuit breakers and other trading halts and information sharing on related risks.</p>
Assessment	Fully Implemented
Comments	<p>The deficiencies of the criminal enforcement process have been addressed under Principle 12 and have impacted the rating of that Principle.</p> <p>KRX could expand its powers over employee traders of members by requiring them to have some type of membership or other contractual obligation to follow the rules of the exchange.</p>
<b>Principle 37.</b>	Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
Description	<p><b>Exchange-based Programs for Monitoring Exposures and Short Positions</b></p> <p>The exchange has multiple arrangements to monitor for, and to address, material exposures:</p> <ul style="list-style-type: none"> <li>• Real time trade monitoring;</li> <li>• Reports on short interest, in particular net short positions in excess of 0.01 percent of total issuance (within three days of acquisition);</li> <li>• Up-tick rules;</li> <li>• Position limit requirements for derivatives;</li> <li>• Symmetric (up and down) individual security price limits;</li> <li>• Market wide circuit breakers;</li> <li>• Ability to call a trading halt;</li> <li>• Process of novation (which results in the exchange becoming the central counterparty);</li> <li>• Back-up systems of financial/liquidity support to address fails to deliver securities or to meet obligations, such as margin, to the market;</li> <li>• Pre-funding of accounts and automatic liquidation for insufficient margin;</li> <li>• The ability to close out positions if a market participant refuses information to the exchange; and</li> <li>• Limitation of margin lending by brokers.</li> </ul> <p>The means for aggregating exposures is not however documented.</p> <p><b>Short-selling</b></p> <p>Beyond required notifications of net short interest, the law restricts naked short sales (FSCMA Article 180). There is also an uptick rule. Short sales notifications are monitored and follow up procedures can limit a broker's taking of short positions. There are exceptions for arbitrage activities and market making.</p>

Rules 17 and 18 of the KRX business regulations provide more detail, particularly with respect to what is deemed "covered," for which the stock must be subject to an "agreement to borrow."

### Default Procedures and Resources for Redress of Defaults

Exchange rules and the FSCMA contain the requirements as to the composition and valuation of member contributions to the compensation and fidelity funds (see Principle 32), the inability to encumber deposits (to create a security interest prior to that of the broker and the exchange) and the waterfall of resources and the order of their application in the event of default. However, this information is not readily accessible by reviewing the websites of the exchange, the KSD or the regulatory authorities and the definition of what constitutes a default is implied rather than stated. In this connection, the FSCMA and related KRX rules do provide that a clearing member is accountable to the KRX for its customer's default, and that the KRX members as a whole may be accountable under a common bond arrangement (the agreement to contribute to make up the short-fall in a specified percentage related to trading volume and size of the participant) to support the conclusion of settlement where an individual member is unable to do so.

One issue that was raised by market participants was the risk management arrangement whereby KRX limits its risk to margined transactions (which can be undertaken with 30 percent deposit of the value of the security) via a process in which purchased securities are automatically sold if the margin is not timely paid. In their view, under certain adverse circumstances such sales could precipitate a price cascade that even with price limits and circuit breakers could be destabilizing. The Exchange and the FSS though believe that there would be means to take action in a crisis to stage such a sale if necessary.

### Clearing and Settlement

	KOSPI			KOSDAQ	Derivatives Market	OTC		
	Stocks	Government bonds	Corporate bonds	Stocks	Options, Futures	Institutional Stocks	Bonds	Free Board Stocks
CCP	KRX	KRX	KRX	KRX	KRX	KSD	-	-
Securities settlement	KSD	KSD	KSD	KSD	-	KSD	KSD	KSD
Cash settlement	BOK-Wire+	BOK-Wire+	BOK-Wire+ (except retail bonds)	BOK-Wire+	Commercial banks	BOK-Wire+	BOK-Wire+	BOK-Wire+
DVP model	DVP3	DVP3	DVP3	DVP3	-	DVP2	DVP1	DVP3
Settlement day	T+2	T+1 (T for repos)	T	T+2	T+1 (T+3 for physical settlement)	T+2	T+1	T+2
Number of members	61	85	85	61	63	N/A	N/A	N/A

The following summarizes the distribution of clearing and settlement functions by product:

Proprietary and customer denominated accounts. The underlying ownership of customer securities is only determinable from the books of the Investor Account Book managed by the broker. Similarly

	<p>pledges of clients and participants are marked on the books of the participant for purposes of the KSD. If such obligations are not properly recorded by the participant clearing member, this could raise issues as to the ultimate ownership of securities, including pledged securities, and also potentially permit misuse. The prohibition or risk management of intra-cycle trading is not expressly treated in the rules though the new procedures for continuous net settlement (CNS) referred to below may mitigate some of these risks. Not all shares and longer tenured bonds are in a dematerialized form, and though securities are required to be accounted for in the true name of the broker and the underlying customer, anecdotally there have been some issues related to the use of "extra-legal" nominees. This factor can also affect the ability to completely identify exposures.</p> <p>In 2012, the KSD introduced a CNS system, which has been subject to testing over a three month launch period. This system is still in the initial implementation phases. Fails are permitted for delivery of shares, but not for derivatives. Transactions in foreign securities must pass through a Foreign Member Information System<sup>35</sup> to permit the authorities to evaluate the extent of exposure to foreign currency. Foreign securities must be held through accounts at the KSD opened by a local custodian of certain approved international depositories, such as Euroclear and Clearstream.</p> <p><b>Legal Powers</b></p> <p>Legal practitioners indicate that the relatively new Act on Rehabilitation and Bankruptcy of 2007 provides support for settlement finality and reinforces exchange protections. Further the Deposit Protection Act provides USD 50,000 of protection for each account held in a separate capacity for any financial institution which maintains accounts, including investment brokers and traders.</p> <p>Under Article 416 of the FSCMA, the FSC can issue orders relative to the management of proprietary property and the handling of the custody of customers' funds. If it finds that "transactions cannot be normally made" because of a natural disaster, warfare, disturbance, sudden and significant change in economic conditions or other incidents, it can order the suspension of transactions, temporary closing of securities markets, alteration of hours or other necessary measures (Article 413).</p> <p>There is also an Act on the Structural Improvement of the Financial Industry that permits the authorities to take corrective actions. In some cases, there is provision for up to six months or more to return to compliance with applicable financial soundness regulations pursuant to a financial performance improvement program (in this regard, see also the discussion under Principle 32).</p> <p><b>Practice</b></p> <p>The FSS also reviews off-site reports and material event reports on those exchange members that are authorized financial institutions, as well as receives early warning notices and results of financial inspections. The process for two-way sharing between the FSS, KRX and KSD with respect to managing early warning information and financial fall-out related to excessive exposures or financial deterioration at a member firm is not documented.</p> <p>There is also no specific program to identify concentrated open exposures or to integrate market and financial information.</p>
Assessment	Broadly Implemented

<sup>35</sup> This is information relative to transactions involving foreigners, and potentially foreign currency.

Comments	<p>Although KRX rules and regulations provide the legal basis for the management of a default, some key aspects could be articulated in a more extensive way, such as (a) the actions that an FMI can take when a default is declared; (b) the extent to which such actions are automatic or discretionary; (c) potential changes to the normal settlement practices, should these changes be necessary in extreme circumstances, to ensure timely settlement; (d) the management of transactions at different stages of processing; (e) the expected treatment of proprietary and customer transactions and accounts; (f) the probable sequencing of actions; (g) the roles, obligations, and responsibilities of the various parties, including non-defaulting participants; and (h) the existence of other mechanisms that may be activated to contain the impact of a default (see also Principle 32).</p> <p>The sufficiency of these measures should be kept under continuous review. In particular, the FSC and FSS should closely monitor the operation of the newly implemented CNS and intra-cycle trading, particularly to test various stress assumptions and to determine the extent to which failed trades or other failures could result in market disruption or exhaust pre-deposited resources and lending facilities requiring a draw on the common bond. The proper allocation of securities to customer accounts and the operation and security of pledging of securities should also be kept under review (see Principle 31). Any recommendations developed pursuant to the assessment of implementation of the Principles for Financial Market Infrastructures (PFMIs) conducted separately at the KRX should also be taken into account. The securities settlement system should also be assessed for compliance with the CPSS-IOSCO PFMIs.</p> <p>The FSS and FSC should consider how to integrate information received off-site and on-site with respect to the financial condition of firms doing business in the capital markets with information on market volatility and changes in overall system liquidity developed as part of KRX market surveillance measures and any protocol for the analysis of systemic risk and related information sharing among sectors. More clarity of, and greater accessibility to, the description of events of default and compensation and redress of resource arrangements would assure the public and the direct clearing members are properly informed.</p> <p>Acceleration of plans to dematerialize all securities should be pursued.</p> <p>The time frame for resolving deteriorating financial institutions involves a period of forbearance that appears excessive for financial investment business entities that operate in the securities and futures markets, where continuing and immediate capacity to perform obligations to the market is critical (see also Principles 30 and 32).</p>
<b>Principles Relating to Clearing and Settlement</b>	
<b>Principle 38.</b>	Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.
Description	
Assessment	Not Assessed.
Comments	