

MEASURES TO STRENGTHEN INVESTOR PROTECTION WITH HIGH-RISK INVESTMENT PRODUCTS

The Financial Services Commission and the Financial Supervisory Service unveiled measures to strengthen investor protection with high-risk financial investment products in light of the recent derivatives-linked funds (DLFs) mis-selling cases. The reform measures are aimed at enhancing consumer protection and maintaining stability in the financial system, without jeopardizing private equity funds' critical function of supplying venture capital.

BACKGROUND

The recent DLFs mis-selling controversy was caused by financial institutions' attempt to sell high-risk funds to retail investors in private offering to avoid stringent regulation on public offering; loopholes in investor protection measures; and insufficient internal controls by financial institutions.

The DLFs structured to track the yield of Germany's 10-year government bonds or the performance of constant maturity swap (CMS) rates of the U.S. or the U.K. were sold to retail investors¹ by two local commercial banks with sales balance of KRW795 billion as of August 7 this year.

The losses were mostly accrued in September and October with an average loss of 52.7 percent with KRW99.1 billion reaching maturity and KRW97.8 billion redeemed. By November 8, the sales balance of the derivatives remained at KRW587 billion.

Due to a rise in the value of underlying assets, such as the German 10-year government bonds, the expected loss of the derivatives with future maturity dates will be lower.

(in billion KRW, %)

	Total sales (A)	DLFs matured or redeemed (loss)			DLFs with future maturity (current yield rates applied)			Total loss (B+C)	Total loss rate (B+C)/A
		Amount	Loss(B)	Loss rate	Amount	Loss(C)	Loss rate		
German 10-year bonds	125.5	85.0	-53.1	-62.5	40.5	-1.0	-2.5	-54.1	-43.2
US/UK CMS	669.5	122.9	-56.4	-45.9	546.5	-77.2	-14.1	-133.6	-20.0
Total	795.0	208.0	-109.5	-52.7	587.0	-78.2	-13.3	-187.7	-23.6

¹ Mostly elderly people who could make an investment of more than KRW100 million.

REFORM MEASURES

I. STRENGTHEN CONSUMER PROTECTION

- ▶ Tightening standards for deciding a public offering fund

The standards for determining features of a public offering fund will be tightened to prevent funds that should have been a public offering fund from being sold in the form of a private fund to avoid stricter regulations, which apply to public offering funds. *If a fund's profit and loss structure is equivalent to that of its underlying asset, the fund shall be sold as a public offering fund.*

- ▶ Strengthening regulatory regime for 'highly complex' investment products

Financial investment products whose (i) valuation methods are difficult for investors to understand, and (ii) possibility of losing principal is higher than 20~30 percent, will be categorized as 'highly complex' products,² subject to stricter investor protection measures.³

- ▶ Prohibiting banks from selling 'highly complex' private funds

Banks will be banned from selling 'highly complex' private funds.

	<i>Private offering or trust funds</i>	<i>Public offering funds</i>
'Highly complex' Products	banned	<i>stricter investor protection</i>
Other products	allowed	allowed

- ▶ Raising threshold for minimum investment in hedge funds by retail investors

The threshold for minimum investment in hedge funds by retail investors will be raised from KRW100 million to KRW300 million to ensure that those with sufficient risk-absorbing ability can make investments, bearing responsibilities on their own for possible loss.

- ▶ Strengthening requirements of recording and cooling-off period

Financial institutions who sell 'highly complex' funds, both private and public offering funds, to retail investors will be required to record their sales practice and provide investors with a cooling-off period.

² e.g. structured products, credit-linked securities, equity-linked products, products whose profit and loss structure linked to market variables, other derivatives products (CDS, etc.). Products listed on the exchange are excluded from the category of 'highly complex products'

³ 'Highly complex products' will be subject to: (i) obligations of recording and providing a cooling-off period if such products are sold to retail investors; (ii) obligations of financial institutions to provide written explanations detailing investment-related risks; (iii) prohibition from a simple registration; (iv) requirement that limits sales persons to those qualified for recommending and selling derivatives investment products.

The age criterion for defining 'elderly investors' will be strengthened from those aged more than 70 to those aged 65 or over.

The cooling-off period will be more strictly applied to elderly and disqualified investors. Financial institutions are required to notify that the subscription to an investment contract is automatically withdrawn unless investors give a separate consent of approval during a cooling-off period.

► Tightening supervision over sales process and practice

The government will strengthen supervision over the process and practice of selling high-risk products to ensure investor protection measures work properly.

Financial institutions will be required to keep relevant documents and data for ten years and immediately submit such documents upon investors' request. Classification of investors by risk appetite will be renewed at a regular basis within one to three years and stored in a database.

Writing a subscription on behalf of investors, or manipulating the classification of investors by risk appetite will be punished as unfair practices.

► Improving protection for professional investors

The standards for professional investors will be newly established:

- (loss-absorbing capability) *annual income of more than KRW100 million, or net assets of more than KRW500 million*
- (investment experience) *maintaining an account for more than one year with a remaining balance of KRW50 million or more*

II. ENHANCE ACCOUNTABILITY AND SUPERVISION OF FINANCIAL COMPANIES

► Clarifying management accountability of financial companies and strengthening internal control rules⁴

► Establishing guidelines on sales of highly complex financial products

The newly established rules specify what asset management companies and financial companies will have to abide by at every stage of the brokerage process.

► Tightening regulation standards for financial companies selling OEM funds⁵

Under the Capital Markets Act, the current regulation only targets asset management companies, while the new regulation will establish a ground to regulate sellers of OEM funds as well.

⁴ A revision to the Act on Corporate Governance of Financial Companies is currently pending at the National Assembly.

⁵ Funds established and operated by asset management companies upon "order, direction, request" of sellers.

► Toughening punishment for mis-selling of financial products

The government will strengthen punishment for mis-selling of financial products – e.g. punitive fines (up to 50% of unfair gains); fines of up to KRW30 million for violations of principles of suitability and appropriateness in sales practice; shift of burden of proof; protection of consumers' right to withdraw, etc.⁶

► Increasing monitoring and supervision by regulatory authorities

The regulators will hold meetings on a regular basis to monitor and review investor risks associated with high-risk financial products.

III. SUPPLEMENTARY MEASURES PRIOR TO LEGISLATIVE CHANGE

Prior to any legislative change, the government will provide supplementary protective measures for investors through administrative guidelines.

The government will enhance its supervision, guidance and inspection of the sales of high-risk financial instruments by banks.

With regard to the recent DLFs mis-selling cases, the government will ensure prompt and fair proceedings of dispute resolutions from the perspective of consumer protection.

⁶ A bill on financial consumer protection is currently pending at the National Assembly.

IMPLEMENTATION SCHEDULE

The comprehensive plan will be finalized after receiving feedback from stakeholders for the following two weeks.

Tasks	Measure needed	Schedule
I. Strengthen Investor Protection		
✓ Tighten standards for deciding a public offering fund	Proactive interpretation of relevant regulation Revision to the Enforcement Decree of the FSCMA ⁷	immediately Q1 of 2020
✓ Strengthen regulatory regime for 'highly complex' investment products	Revision to the Enforcement Decree of the FSCMA	Q1 of 2020
✓ Prohibit banks from selling 'highly complex' private funds	Revision to the Banking Act and the Insurance Business Act	Q1 of 2020
✓ Raise minimum investment threshold for hedge funds by retail investors	Revision to the Enforcement Decree of the FSCMA	Q1 of 2020
✓ Strengthen obligations of recording and operating a cooling-off period	Revision to the Enforcement Decree of the FSCMA	Q1 of 2020
✓ Tighten supervision over sales process and practice	Revision to the Enforcement Decree of the FSCMA	Q1 of 2020
✓ Establish new standards for professional investors	Implementation with investor protection measures	Nov. 21, 2019
II. Enhance Accountability and Supervision of Financial Institutions		
✓ Clarify accountability of the management and strengthen internal control	Revision to the Act on the Corporate Governance in Financial Institutions pending in the National Assembly	-
✓ Establish guidelines on sales of 'highly complex' financial products	Establishment by Korea Financial Investment Association (KoFIA)	Q1 of 2020
✓ Tighten regulations on OEM fund sellers and application standards	Revision to the Enforcement Decree of the FSCMA	Q1 of 2020
✓ Toughen punishment for mis-selling	Financial Consumer Protection Bill pending in the National Assembly	-
✓ Strengthen monitoring and supervision by regulatory authorities	on a regular basis	Q4 of 2019~
III. Supplementary Measures Prior to Legislative Change		
✓ Improve investor protection through administrative guidelines		Q4 of 2019~
✓ Ensure prompt and fair proceedings of DLF-related dispute resolutions		

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For any inquiry, please contact Foreign Press & Relations Team at fsc_media@korea.kr.

⁷ Financial Investment Service and Capital Market Act