

MEASURES TO IMPROVE REGULATORY FRAMEWORK ON HEDGE FUNDS

The Financial Services Commission and the Financial Supervisory Service unveiled on February 14, 2020 an evaluation of hedge fund market and the measures to improve its regulatory framework. The measures are intended to ensure the autonomy of private fund management while addressing regulatory inadequacy and vulnerabilities found in the assessment by introducing a minimum necessary level of regulations.

BACKGROUND

Hedge funds play an important role in providing venture capital in startup investment ecosystem from business setup to scale-up to exit. However, the recent misselling, inadequate liquidity management and unlawful and/or unfair activities in the market have shown the necessity to improve the regulatory framework.

Against this backdrop, the government unveiled on November 14 last year the [Measures to Strengthen Investor Protection with High-risk Investment Products](#), which a) prevented sales of public offering funds in the form of private funds, b) placed stronger investor protection for 'highly complex investment products,' c) raised entry requirements for retail investors from KRW100 million to KRW300 million, and d) tightened regulation standards for financial companies selling OEM funds.

From November 2019 to January 2020, the government conducted a review on the hedge fund market to assess potential risks and vulnerabilities. The assessment was made on 52 asset management companies and 1,786 private funds worth KRW 22.7 trillion. Most hedge funds did not show risky operation methods or investment structures unlike the large scale suspension of redemption cases surfaced recently.

Based on this market review, the government has prepared the following measures in order to strengthen investor protection and ensure credibility in the market.

KEY MEASURES

I. ENHANCE RISK MANAGEMENT BASED ON MARKET DISCIPLINES

The government will work to establish a foundation in which different market participants and players can provide a supervisory role and "checks and balances" against one another.

Market participants	Measures for improvement
Fund management companies	<ul style="list-style-type: none"> ▪ Strengthen internal control for identifying and managing risks ▪ Prevent transmission of risks between funds by prohibiting fund managers from appraising asset values at his or her own discretion when cross-trading ▪ Increase damage compensation capacity in the case of financial accidents
Fund sellers	<ul style="list-style-type: none"> ▪ Impose responsibility to follow up after sales of funds to check whether funds are being properly managed
Depository & Prime Brokerage Service (PBS) providers	<ul style="list-style-type: none"> ▪ Grant supervisory function on fund management companies' unlawful and/or unfair activities (Depository & PBS providers) ▪ Strengthen management responsibility for prime brokers given their service of provision of leverage
Investors	<ul style="list-style-type: none"> ▪ Strengthen rules to provide more information so that investors can make investments at his or her own risk. - Sellers shall provide key investment information to investors at the time of sales - Fund managers shall provide retail investors with asset management report on a regular basis

II. ADDITIONAL MEASURES FOR INVESTOR PROTECTION

The FSC will address vulnerabilities in the structure of funds with a minimum necessary level of regulatory measures to better protect investors.

Vulnerabilities in fund structures	Measures for improvement
Maturity mismatch	<ul style="list-style-type: none"> ▪ Introduce regulations on the operation of open-type funds <ul style="list-style-type: none"> - e.g. ban on setting up an open-type fund if the fund makes 50% or more investments in illiquid assets; and stress tests on a regular basis ▪ Provide investors with information on funds' liquidity risks and strengthen supervisory monitoring
Complexity of investment structure	<ul style="list-style-type: none"> ▪ Prohibit cross-investment between a PE company's multiple funds ▪ Provide investors with information on a multi-layered structure of umbrella and sub-funds; and strengthen supervisory monitoring ▪ Introduce liquidity regulations to address maturity mismatch arising from the multi-layered structure of funds
Leverage through TRS agreements	<ul style="list-style-type: none"> ▪ Limit counterparties to TRS agreements for the purpose of leverage to prime brokers ▪ Include the amount of leverage via TRS agreements in a fund's maximum leverage ratio (400% of a fund's assets) ▪ Establish investor protection measures for possible losses in case of unilateral termination of TRS agreements by brokerage firms ▪ Strengthen investor protection in the operation of leveraged funds

III. STRENGTHEN SUPERVISION AND INSPECTION BY FINANCIAL REGULATORS

The financial regulators will bolster the supervision and inspection of hedge fund market.

- ▶ Enhance monitoring and strengthen reporting requirements so that the government is able to respond properly at appropriate times and take precautionary steps.
- ▶ Introduce a fast-track revocation of registration with fund management companies that fail to meet regulatory requirements in capital and human resources.
- ▶ Strengthen self-regulatory functions of the Korea Financial Investment Association.

LIME ASSET MANAGEMENT'S REDEMPTION SUSPENSION

With regard to Lime Asset Management which recently suspended redemption of its funds, the government will work on the following.

- ▶ Continue to closely monitor the process and ensure that redemptions take place in an orderly and fair way.
- ▶ Promptly conduct an investigation on dispute resolution cases¹ related to misselling and work on providing remedies for investor losses.
- ▶ Impose strict penalties for unlawful activities and cooperate with the prosecutor's office (if the misselling charges are confirmed, the government will also look into the fund sellers for any violations)

The government will bolster market monitoring of hedge funds and take necessary measures promptly when similar cases arise in the future.

FURTHER PLANS

The government plans to finalize and announce specific measures for improving the regulatory framework on hedge fund market in March this year, after gathering opinions from stakeholders and experts.

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¹ 214 cases in total as of February 7, 2020