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Press Release

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REGULATORY FOLLOW-UP MEASURES FOR NOV. 11 STOCK MARKET PLUNGE

Background

The Financial Services Commission (FSC) and Financial Supervisory Service (FSS) have developed measures to improve derivatives-related trading system jointly with the Korea Exchange (KRX) and the Korea Financial Investment Association (KOFIA) based on the investigation of risk management status of financial investment companies and a public hearing held on December 20, 2010 after the stock market plunged on an option expiry day, November 11, 2010.

The latest regulatory measures are designed to prevent the recurrence of a similar event on expiry dates of futures and options contracts and mitigate risks arising from derivatives investment by institutional investors, seeking to keep capital markets sounder and more efficient.

Regulators are thoroughly investigating and inspecting alleged acts of unfair trading and violations of asset management-related laws that caused a market plunge on the option expiry day and will take appropriate actions against any violation of laws.

Investigation updates

1. Investigation of alleged acts of unfair trading

The FSS conducted an on-site investigation in Hong Kong in December 2010 and is currently working to determine if any act of violating the Capital Market and Financial Investment Business Act, including market manipulation, was involved.

Any violation of laws will be punished according to laws, if found.

2. Examination of Wise Asset Management

Right after the option shock incident, examiners conducted a probe into Wise Asset Management from November 12 to December 3, 2010 to identify the cause of the incident and check the adequacy of derivatives fund operation and internal control system.

Regulators will complete the analysis of the inspection results as soon as possible and proceed to impose sanctions against any violation, if found.

3. Risk management in the financial investment industry

The FSS examined financial investment companies to check their risk management status and whether they were in compliance with the margin rule from the end of November to the beginning of December 2010.

As a whole, they were found to have maintained good risk management although there were some breaches of margin rules and daily trading limits.

The findings will be reflected in the latest regulatory reform.

Regulatory reform

1. Reducing settlement risk

1) Revising margin rules

Currently, KRX members designate qualified institutional investors* who will be allowed to make margin payments after trades, as opposed to before trades, by considering their financial soundness and creditworthiness. However, most of qualified institutional investors are now allowed to put up deposit margins after trades.   .

* Banks, insurers, financial investment companies, credit-specialized financial companies, collective investment schemes, pension funds, etc.

The new rules will require pre-trade margin deposits for qualified institutional investors with less than KRW 500 billion in total assets or financial investment managers with less than KRW1 trillion in collective investment assets.

Still, post-trade margin payment will be allowed in case the risk management department of a relevant KRX member acknowledges that there is no settlement risk from after-trade margin deposits.   .

*As of end-September 2010, 19 P&C insurance companies, 62 mutual savings banks, 30 credit-specialized financial companies, 17 asset management companies are expected to be required to deposit margins before trades.

2) Setting a daily order limit

Under the current rule, KRX members have the right to set their qualified institutional clients' order limits.

Under the new guidelines which will be developed by the KOFIA, KRX members will set a daily order limit for each of their qualified institutional clients by considering its total assets, size of assets under management, credit worthiness, financial conditions and others. KRX members will be required to set up their own internal rules related to daily order limits under the KOFIA-developed guidelines.

Those that are allowed to put up post-trade margin deposits will be limited to trading as much 10 times the value of their deposits even they are within their daily order limit.

2. Alleviating market shocks

1) Revising random end rules

Currently, if the gap between the expected matching price for the last five minutes from 14:55 to 15:00 and the tentative closing price is 5% or more, the deadline for submitting quotations is extended by up to 5 minutes.

Under the new rules, if the gap between the immediately preceding price at 14:50 and the tentative closing price is 3% or more, the deadline for submitting quotations will be extended by up to 5 minutes.

The random end rule applied at the opening of the market is maintained the same.

2) Additional program trading

Currently, new program trading quotation is prohibited after the deadline for prior reporting at 14:45 on the expiry date.

But the regulator will allow additional quotations* if they are made to address a certain level of imbalance** between selling and buying amount in program trading reported until the deadline at 14:45.

*Post-trade reporting is allowed in an exception.
**When the proportion of program buying to program selling or vice versa is more than 75% and the gap in amount is KRW500 billion or more

However, quotation for buying will be limited below the immediately preceding price and quotation for selling should be above the immediately preceding price so that the market index is not converted into the other way around due to additional program trading.

3. Improving financial soundness

1) Cap on positions (unsettled commitments)

Currently, a cap on investors' positions only apply to speculative futures contracts, with institutional investors being limited to 7,500 contracts per day and retail investors 5,000 contracts after the end of the trading day.

Under the new rules, speculative positions in options and futures for institutional investors will be limited to a maximum of 10,000 contracts per day while hedging and arbitrage positions in options and futures has no limits.

On option expiry dates, positions in KOSPI 200 options and futures for an institutional investor will be limited to 10,000 contracts, regardless of the nature of such positions (speculative, hedging and arbitrage trading). This is the equivalent of about 1.3 trillion won in spot-market trade.

Foreign investors of Deutsche Bank AG's South Korean securities unit held about 43,000 contracts and Wise Asset Management about 35,000 contracts on November 11, 2010.

The limit on retail investors' positions will be maintained the same as 5,000 contracts.

The combination of hedging, arbitrage as well as speculative options and futures trading activities on option expiry dates tends to dramatically increase the trading volume, , bringing a shock to spot and futures markets. Therefore, positions in speculative, hedging and arbitrage trading will be all limited on option expiry dates.

2) Reporting large holdings

Currently, investors are required to report on large holdings and change only in holdings of commodity futures (based on gold and pork) above a certain volume in accordance with Article 173-2 of Capital Market Act.

*Large holdings: Gold 30 contracts, mini gold 300 contracts, pork 300 contracts
*Change in holdings: Gold 6 contracts, mini gold 60 contracts, pork 60 contracts

Regulators will require a reporting duty for large holdings and change in holdings of KOSPI 200 futures and options as well.

Ex) Large holdings: 5000 contracts of futures and options combined
Change in holdings: 1000 contracts of futures and options combined

Anticipated effects

The new regulations are expected to bring the following effects.

First, settlement risk in the market is expected to decrease. Tightening risk management rules by reforming post-trade margin requirements and limiting a daily order limit will reduce exposure to derivatives by asset management companies or institutional investors and thereby alleviating corresponding risk to the market on the whole.

Second, new regulations will ensure an opportunity of counter trades for institutional and retail investors to alleviate market shocks coming from massive transactions by a few investors in the short term.

Lastly, tightening derivatives rules such as a cap on positions and a reporting duty for large holdings to catch up with global standards is expected to lessen market volatility from excessive arbitrage and speculative trading and significantly enhance transparency in trading.

Future plans

New regulations will be enforced by revising KRX regulations in January, except for a reporting duty for large holdings, which will require the revision of Capital Market and Financial Investment Business Act.

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