

## FSC FINALIZES MEASURES TO IMPROVE REGULATORY FRAMEWORK ON PRIVATE EQUITY FUNDS

The FSC and the FSS announced the finalized measures to improve the regulatory framework on private equity funds on April 24. The final measures are based on the previously introduced plans on February 14, and take into account opinions from experts and stakeholders. While ensuring the autonomy of private equity funds, the measures aim to establish market disciplines and introduce a minimum necessary level of regulations to protect investors and prevent system risks.

### **BACKGROUND**

The private equity fund market has grown significantly backed by the government's policy promoting its development. However, concerns over investor protection became an issue due to problems of misselling, liquidity management and other unfair and/or unlawful sales practices. Against this backdrop, the government introduced on November 14, 2019 its plans to strengthen investor protection with high-risk investment products<sup>1</sup> to prevent excessive consumer damages to retail investors. Between November 2019 and January 2020, the government conducted a study on the private equity fund market to check potential risks and vulnerabilities, and announced a set of improvement measures on February 14.<sup>2</sup> Based on the previous announcements and after taking into account various expert opinions, the government prepared the below finalized measures to improve the regulatory framework on private equity funds.

### **KEY MEASURES**

The basic principles of the improvements are largely in line with the previously announced changes with further details added thereafter.

#### **I. STRENGTHENING 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.

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<sup>1</sup> Please click [here](#) to see press release.

<sup>2</sup> Please click [here](#) to see press release.

Market participants	Measures for improvement
Fund management companies	<ul style="list-style-type: none"> <li>Strengthen internal control for identifying and managing risks <ul style="list-style-type: none"> <li>Require reporting of 'checklist' and compliance result to FSS</li> </ul> </li> <li>Set up safeguards to ensure fairness in assessing fund assets <ul style="list-style-type: none"> <li>Establish assessment standards for nonmarketable assets (e.g. non-listed stocks &amp; investments, convertible bonds, bonds with warrant, etc.)</li> <li>Require an assessment from an independent agency when cross-trading, and place a cap on the monthly amount of cross-trading within 20 percent of the average depository in the preceding March</li> <li>An external audit will be mandatory for private equity funds in excess of KRW50 billion or between KRW30 billion and KRW50 billion with additional fund issuance within the last six months</li> </ul> </li> <li>Increase damage compensation capacity of professional fund managers to prepare for financial accidents (from the current requirement of only the minimum capital requirement of KRW700 million to the minimum capital requirement plus additional reserves proportional (0.03 percent) to the size of the depository)</li> </ul>
Fund sellers	<ul style="list-style-type: none"> <li>Impose responsibility to follow up after sales of funds to check whether funds are being properly managed <ul style="list-style-type: none"> <li>Require sellers to verify the appropriateness of investment information and continue to check whether investment strategies and asset managements are carried out as indicated in the investment information</li> </ul> </li> </ul>
Depository & Prime Brokerage Service (PBS) providers	<ul style="list-style-type: none"> <li>Grant supervisory and management function on fund management companies' unlawful and/or unfair activities (Depository &amp; PBS providers) <ul style="list-style-type: none"> <li>PBS providers shall evaluate leverages (including total return swaps) on private equity funds and manage risk levels</li> </ul> </li> </ul>
Investors	<ul style="list-style-type: none"> <li>Strengthen rules to provide more information so that investors can make investments at his or her own risk <ul style="list-style-type: none"> <li>Sellers shall provide key investment information to investors at the time of sales, and failure to keep up with investment information shall be sanctioned for unfair sales practice</li> <li>Fund managers shall provide investors with asset management report on a regular basis</li> </ul> </li> </ul>

## II. IMPROVING INVESTOR PROTECTION

The FSC will address vulnerabilities in the structure of funds with a minimum necessary level of regulatory measures to improve investor protection.

Vulnerabilities in fund structures	Measures for improvement
Maturity mismatch	<ul style="list-style-type: none"> <li>Introduce regulations on the operation of open-type funds <ul style="list-style-type: none"> <li>Require stress tests at least once a year and the drawing up of an emergency plan for liquidity risks</li> <li>Impose a ban on setting up an open-type fund if the fund makes 50 percent or more investments in illiquid assets</li> </ul> </li> <li>Provide investors with information on funds' liquidity risks and strengthen supervisory monitoring</li> </ul>
Complexity in investment structure	<ul style="list-style-type: none"> <li>Provide investors with information on a multi-layered structure of umbrella and sub-funds and strengthen supervisory monitoring</li> <li>Introduce liquidity regulations to address maturity mismatch arising from the multi-layered structure of funds</li> <li>Prohibit cross-investment between a PE company's multiple funds</li> </ul>
Leverage through TRS agreements	<ul style="list-style-type: none"> <li>Strengthen investor protection in the operation of leveraged funds, such as TRS</li> <li>Include the amount of leverage via TRS agreements in a fund's maximum leverage ratio (400 percent of a fund's assets)</li> <li>Limit counterparties to TRS agreements for the purpose of leverage to prime brokers and require prime brokers to carry out function of leverage risk management on private equity funds</li> <li>Establish a requirement for reaching an agreement between stakeholders three days prior to the early termination of TRS agreements by brokerage firms</li> </ul>

### **III. STRENGTHEN SUPERVISION AND INSPECTION**

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

- ▶ Enhance monitoring for unfair sales practices and strengthen reporting requirements<sup>3</sup> in order to respond properly at appropriate times and take precautionary steps
- ▶ Introduce a fast-track revocation of registration system for fund management companies that fail to comply with regulations in terms of their capital and other operational requirements
- ▶ Strengthen self-regulatory functions of the Korea Financial Investment Association (KOFIA), which will provide a tailored checklist on fund management companies' internal control and risk management requirements and carry out regular assessments

### **FURTHER PLANS**

The government will swiftly implement the measures requiring no amendments to the existing laws, such as establishing assessment standards for nonmarketable assets, carrying out inspections on private fund management companies that are considered to be substandard, promoting self-regulatory functions of the KOFIA, etc. For the measures that require amendments to the laws, the government will make use of administrative guidance prior to the amendments becoming effective. The amendments will be announced for public opinion within the second quarter of this year.

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For any inquiry, please contact Foreign Press & Relations Team at [fsc\\_media@korea.kr](mailto:fsc_media@korea.kr).

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<sup>3</sup> Regular reporting period changed from semi-annual to quarterly with additional reporting criteria.