The Revisions to Korea's *Financial Investment Services and Capital Markets Act* and Korean Securities Companies' Efforts to Diversify Their Earnings

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I. Revisions to *Financial Investment Services and Capital Markets Act*

On 26 July 2011 Korea's Financial Services Commission (FSC) published a bill revising Korea's *Financial Investment Services and Capital Markets Act* (FSCMA), which is modeled on Japan's *Financial Instruments and Exchange Law*.

At a press conference the FSC's standing commissioner, Dr Hong Young-Man, explained that the revisions to the FSCMA were a response to the changes in financial market conditions brought about by the global financial crisis of 2008 and were intended to strengthen Korea's capital markets. The FSC plans to present the FSCMA revision bill to the ordinary session of Korea's National Assembly in November 2011 after it has been the subject of public comment and scrutinized by Korea's Regulatory Reform Committee.

II. Outline of the FSCMA revision bill

The FSCMA revision bill mainly covers the following five areas: (1) regulations intended to promote the development of major Korean investment banks, (2) deregulation of Korea's fund management industry to meet the challenges presented by the country's declining birth rate and aging population, (3) reform of Korea's capital market infrastructure , (4) diversification of direct financing channels, and (5) stricter regulation of unfair trading practices. In the rest of this section we take a closer look at each of these in turn.

1. Regulations intended to promote the development of major Korean investment banks

The bill permits "securities companies" (hitherto a discrete category) that satisfy certain criteria (e.g., shareholders' equity of KRW3 trillion (roughly ¥210 billion)) to act as "investment banks" (a new category denoting comprehensive financial investment service providers) [1]. As of end-March 2011, the average shareholders' equity of Korea's five major securities companies (Daewoo Securities, Samsung Securities, Hyundai Securities, Woori Investment & Securities, and Korea Investment & Securities) was KRW2.7 trillion (roughly ¥189 billion). Therefore, if they are to act as investment banks soon after the bill becomes law, some will, in our view, need to merge or be taken over.

Once recognized as investment banks, they will find it easier to offer comprehensive corporate financial services as they will be allowed, for example, to extend new lines of credit to corporate clients, internalize order execution, and engage in prime broking. At the same time, the FSC has made it clear that it will take action to discourage excessive risk taking (e.g., by limiting how much an investment bank may lend to one corporate client, monitoring lending to corporate clients, and regulating the risks that investment banks may take). The following are some specific examples:

(1) The FSC will regulate lending to corporate clients and the internalization of orders to buy or sell shares in unlisted companies to make it easier for investment banks to offer corporate clients a comprehensive financing service.

(2) Investment banks offering prime broking services to hedge funds will be allowed to provide credit to the hedge funds to enable them to invest in products other than equities (e.g., derivatives and commodities).

(3) To reflect the risks associated with investment banking, investment banks will be subject to the Basel capital adequacy requirements as well as the net capital ratio requirements securities companies are expected to comply with.

2. Deregulation of Korea's fund management industry to meet the challenges presented by the country's declining birth rate and aging population

In order to enable fund management companies to meet the investment needs of a client base that is becoming increasingly diverse as Korea's birth rate declines and its population ages and to offer their clients customized investment products that will be profitable and generate a steady return, the bill's second pillar has three main aims: (1) to make a clear distinction between collective investments and discretionary accounts; (2) to amend the rules governing the trust business; and (3) to make Korean fund management companies more independent and innovative. The following are some more specific examples:

- To clarify the customized investment approach to be adopted for discretionary fund management accounts.

[1] According to an FSC press release of 26 July 2011 ("Revision Bill of the Financial Investment Services and Capital Markets Act"), investment banks may be required to increase their shareholders' equity once the revision bill becomes law. However, this will depend on how their businesses develop.

- To establish a body to determine what constitutes trust property in order to extend the current legal definition from seven types of assets to a more flexible definition covering other types in order to reflect changing financial market conditions and increasingly diverse investor needs.
- To reform trust law to enable banks and insurance companies to offer comprehensive trust services.
- To define a "trust type of investment" currently missing from the rules governing financial investment products.

The bill also contains a provision requiring fund management companies to exercise voting rights in the interests of their investors and in their capacity as holders of shares in their funds as well as a provision intended to simplify mergers, so long as shareholder interests are not affected, in order to encourage smaller funds to merge.

3. Reform of Korea's capital market infrastructure

Korea Exchange (KRX) is not just the only securities exchange operator in Korea: no alternative trading systems (ATSs), operated mainly by securities companies and bypassing securities exchanges, are permitted, either.

The revision bill introduces a licensing system that will permit the establishment of other securities exchanges and alternative trading systems. This will enable securities companies and other financial investment service providers that have the minimum required capital of KRW50 billion (roughly ¥3.5 billion) and are approved by the FSC to operate an alternative trading system[2]. Furthermore, if the transaction volume on an alternative trading system is more than a certain amount, the operator will be able to apply to become a securities exchange. In such cases, the securities exchange is additionally required to carry out self-regulatory functions in listing and market supervision. In this connection it is perhaps worth mentioning that some market participants think that the FSC might permit Korea Exchange to own an alternative trading system through a subsidiary.

The proposed revision creates a new category of "clearing business for financial investment transactions." By introducing a licensing system for a clearing business provider, it aims to provide clearing services for a variety of products (e.g., OTC derivatives and securities lending). The revision also lays the legal foundation for establishing a central counterparty (CCP).

Regulations on the credit rating business, currently governed by the Credit Information Act, will be governed by the FSCMA, given that the credit rating business plays an important role in bond markets. This will expand the business scope

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2 An individual may own up to 15% of the shares in an alternative trading system, while a financial institution may own up to 30%, provided the FSC agrees.

of credit rating companies, while strengthening their responsibility for investor protection and public disclosure requirements.

4. Diversification of direct financing channels

The bill's fourth pillar is to diversify the direct financing opportunities available to listed companies. Under the bill, listed companies will be allowed to issue contingent securities and warrants in addition to "securities," issuance of which is currently allowed under the Commercial Act[3]. However, in order to support sound market practices, the purpose of issuing warrants and the issue price will be limited, and the issuance of detachable warrants will be restricted.

In addition, the rules governing the exercise of voting rights at the general shareholder meetings of listed companies will be relaxed. For example, reducing the grace period for distributing letters of proxy from five to two days will extend the period during which proxy holders are actually entitled to exercise their voting rights. The “shadow voting” system, under which Korea Securities Depository (KSD) exercises proxy voting rights on behalf of absent shareholders by counting the proportion of votes cast by shareholders attending general shareholder meetings of listed companies, will be abolished in 2015. The reason for the proposed change is that, although shadow voting has enabled some listed companies to achieve a quorum for voting on a proposal, a 29 May 2010 amendment to the Commercial Act allowing voting rights to be exercised via the Internet means that listed companies no longer depend on shadow voting.

5. Stricter regulation of unfair trading practices

The bill's fifth pillar is to strengthen the regulations governing unfair market practices such as price manipulation to prevent overseas investment banks or hedge funds from exploiting regulatory arbitrage. In particular, price manipulation using unlisted securities (e.g. equity-linked securities) or OTC derivatives will be punished with criminal charges if the underlying assets of such products are listed securities. Similarly, acts of market abuse such as scalping, where traders seek to exercise an undue influence on quotes by executing a series of rapid trades, will be subject to administrative sanctions.

III. Background to FSCMA revision bill: likely emergence of major Korean investment banks

We can attribute the drafting and publication of the FSCMA revision bill to an attempt by the Korean government, which wants to make Korea an international

3 At present, they can only be issued in the form of stock options, convertible bonds or warrant bonds.

financial hub, to bring Korean capital markets closer into line with global standards. For example, the FSC sees the introduction of alternative trading systems, part of the revision bill's third pillar ("Reform of Korea's capital market infrastructure"), as an inevitable global trend and points out that, at a time when there are already some 120 alternative trading systems in operation worldwide, 42% of equity trading in the US is executed on alternative trading systems. The bill's fourth and fifth pillars ("Diversification of direct financing channels" and "Stricter regulation of unfair trading practices") can probably also be seen as intended to bring Korea's capital markets closer into line with global standards.

However, the revision bill's main aim is probably to foster the development of major Korean investment banks able to compete with international rivals. This was also the aim of the original FSCMA. However, our impression is that its apparent lack of success in achieving that aim has led the Korean authorities to propose further measures to speed up the development of investment banks in Korea. We take a closer look at this in the rest of this section.

1. Outline of the FSCMA

Like Japan's *Financial Instruments and Exchange Law*, the FSCMA, which was enacted on 4 February 2009, shifted the application of financial regulation from types of business (i.e., company-specific regulation) to functions to make it easier to offer a comprehensive range of financial services. The original FSCMA comprehensively reformed Korean financial regulation by combining the six laws governing different types of financial business ((1) the Securities and Exchange Act, (2) the Futures Trading Act, (3) the Korea Stock and Futures Exchange Act, (4) the Indirect Investment Asset Management Business Act, (5) the Trust Business Act, and (6) the Merchant Banking Act), and dividing the "financial investment business" into six types: investment trading, investment brokerage, collective investment, trust business, investment advisory services, and discretionary investment (Figure 1).

As a result, a single financial investment company (FIC) may now engage in businesses that were previously separated by type of company (e.g., the securities business, fund management, and futures). This means that securities companies, for example, may now engage in a wide range of activities, including futures and fund management, and will therefore find it easier to diversify their activities and earnings. The Korean authorities hope that this will lead to the successful development of major Korean investment banks.

2. Current state of Korean securities companies

However, two-and-a-half years since the FSCMA became law, we see no clear signs that it has produced the results desired as the investment banking business in Korea continues to be dominated by foreign investment banks. According to the investment banking league table for 2010, the top five places in the three areas of initial public offerings, M&A and overseas bond issues were all taken by foreign

Figure 1: Types of financial investment business covered by the FSCMA and outline of FSCMA

	Types of business	Concepts	Type of company	Entry regulations	Governing law prior to FSCMA
1	Investment trading	Regardless of account name, to trade financial investment products on one's own account, to issue and underwrite securities, to advise clients to apply for such securities, to apply for them, and to approve such applications.	Securities companies Futures companies	Licensing system	Securities and Exchange Act, Futures Trading Act
2	Investment brokerage	Regardless of account name, to trade financial investment products on a third party account, to advise clients to apply for securities, to apply for them, to approve such applications or to advise clients to apply for securities that are being issued or underwritten, and to apply for or approve such applications.	Securities companies Futures companies	Licensing system	Securities and Exchange Act, Futures Trading Act
3	Collective investments	To acquire, dispose of or manage assets and distribute the resulting profits to investors, using money solicited from two or more clients and unconstrained by any instructions from those clients.	Asset management companies	Licensing system	Indirect Investment Asset Management Business Act
4	Trust business	To carry on trusts based on the Trust Act.	Trust companies Securities companies Asset management companies	Licensing system	Trust Business Act
5	Investment advisory services	To provide advice on the value of financial investment instruments or related judgments.	Investment advisory companies Securities companies Asset management companies	Registration system	Indirect Investment Asset Management Business Act
6	Discretionary investment	To acquire, dispose of or invest financial investment products after being given complete or partial discretion to do so by a client.	Discretionary investment companies Securities companies Asset management companies	Registration system	Indirect Investment Asset Management Business Act

Source: Nomura Institute of Capital Markets Research, based on various written materials related to FSCMA

Figure 2: Korean investment banking league table (2010)

Rank	IPOs	M&A	Overseas bond issuance
1	Korea Investment & Securities	Bank of America Merrill Lynch (US)	Deutsche Bank (Germany)
2	Goldman Sachs (US)	Morgan Stanley (US)	Bank of America Merrill Lynch (US)
3	Shinhan Financial Investment	Goldman Sachs (US)	BNP Paribas (France)
4	Morgan Stanley (US)	Macquarie (Australia)	Citigroup (US)
5	Merrill Lynch (US)	HSBC (UK)	RBS (UK)

Source: Bo-song Shin, Korea Capital Market Institute, "How to Revitalize Investment Banking in Korea," 28 June 2011

investment banks, the only exceptions being in IPOs (Figure 2). Only two Korean companies were represented among the top five in IPOs: Korea Investment & Securities (in first place) and Shinhan Financial Investment (in third place).

Similarly, although Korean securities companies' share of investment banking earnings rose from 4.1% in 2003 to 7.3% in 2009, they can hardly be said to have

Figure 3: Breakdown of Korean securities companies' earnings by type of business

	Net operating income	Brokerage commission		Investment banking		Fund sales and management		Dealing	
		Amount	%	Amount	%	Amount	%	Amount	%
2003	6,697	3,620	54.1%	275	4.1%	1162	17.4%	1,263	18.9%
2004	5,199	3,205	61.6%	326	6.3%	333	6.4%	884	17.0%
2005	8,314	5,076	61.1%	376	4.5%	797	9.6%	1,293	15.6%
2006	7,846	4,407	56.2%	442	5.6%	995	12.7%	1,181	15.1%
2007	11,616	7,187	61.9%	649	5.6%	1280	11.0%	1,520	13.1%
2008	8,848	5,281	59.7%	615	7.0%	738	8.3%	2,086	23.6%
2009	11,091	5,578	50.3%	809	7.3%	930	8.4%	3,346	30.2%

Note: Amounts are in KRW billion.
Source: Nomura Institute of Capital Markets Research, based on KOFIA data

Figure 4: Daewoo Securities' operating income

	Amount (KRW billion)				Share(%)			
	2006	2007	2008	2009	2006	2007	2008	2009
Net operating income	820.2	1012.5	702.8	1048.8	100%	100%	100%	100%
Brokerage commission	372.2	608.1	393.8	530.1	45.4%	60.1%	56.0%	50.5%
Investment banking commission	40.3	67.2	42.8	83.5	4.9%	6.6%	6.1%	8.0%
(Equity) underwriting	5.2	8.9	4.5	20.5	0.6%	0.9%	0.6%	2.0%
(Bond) underwriting	16.9	18.4	21.9	23.3	2.1%	1.8%	3.1%	2.2%
Project finance and financial advisory services	10.1	39.8	16.3	39.6	1.2%	3.9%	2.3%	3.8%
Wealth management fee	68.6	116.1	104.5	115	8.4%	11.5%	14.9%	11.0%
Collective investment securities	13.6	25.8	20	18.1	1.7%	2.5%	2.8%	1.7%
Wrap accounts	7.5	11.2	10.1	16	0.9%	1.1%	1.4%	1.5%
Trusts	1	2.1	3.9	13	0.1%	0.2%	0.6%	1.2%
Structured securities	46.4	77	70.5	67.9	5.7%	7.6%	10.0%	6.5%
Profit/loss on proprietary account	102.9	77.7	-46.5	49.4	12.5%	7.7%	-6.6%	4.7%
Net interest income	280.1	215.4	263.2	335.6	34.2%	21.3%	37.5%	32.0%
(–) Commission paid, etc.	43.9	71.8	54.9	64.7	5.4%	7.1%	7.8%	6.2%

Note: Data are on a fiscal year basis (e.g., FY09 = April 2009–March 2010).
Source: Nomura Institute of Capital Markets Research, based on Daewoo Securities' annual reports

diversified their earnings since more than 50% still comes from low-margin brokerage commission, which is sensitive to market conditions (Figure 3).

It is perhaps worth mentioning in this context that brokerage commission is still the main source of earnings for Korea's top three securities companies in terms of market capitalization (Samsung Securities, Daewoo Securities and Woori Investment & Securities). However, all three have clearly been making considerable efforts to diversify their activities and reduce their dependence on brokerage commission.

For example, Daewoo Securities' commission from investment banking more than doubled from KRW40.3 billion in FY06 (April 2006–March 2007, similarly below) to KRW83.5 billion in FY09, and its share of operating income rose to 8.0% (Figure 4). A breakdown (into commission from equity and bond underwriting as well as financial advisory services) for FY06 and FY09 shows that earnings from equity underwriting, project finance and financial advisory services each roughly quadrupled during this period, an indication that the company's investment banking business has become more diversified and less dependent on bond underwriting. Daewoo

Figure 5: Woori Investment & Securities' operating income

	Amount (KRW billion)				Share (%)			
	2007	2008	2009	2010	2007	2008	2009	2010
Net operating income	793.5	724	650.4	799.4	100.0%	100.0%	100.0%	100.0%
Brokerage commission	377.9	263.5	336.5	377.9	47.6%	36.4%	51.7%	47.5%
Investment banking income	37.3	61.7	71.8	54.7	4.7%	8.5%	11.0%	6.8%
Dealing income	205.4	283.7	235.2	268.6	25.9%	39.2%	36.2%	33.6%
Interest income	108.6	92.6	69.1	77.3	13.7%	12.8%	10.6%	9.7%
Financial product sales income	76.5	64.6	49.3	73.5	9.6%	8.9%	7.6%	9.2%
Other income	-12.2	-42.1	-111.4	-18.2	-1.5%	-5.8%	-17.1%	-2.3%

Note: Data are on a calendar year basis.
Source: Nomura Institute of Capital Markets Research, based on Woori Financial Group data

Securities has been a subsidiary of Korea Development Bank (KDB) since May 2000[4] and is engaged in a range of activities that seek to produce synergy effects from that relationship. Examples of this collaboration are the cash management account "One Kdb CMA" jointly developed by Daewoo Securities and KDB, and a range of investment banking services, including M&A and financial advice. KDB was ranked fourth in terms of financial advisory services for global PFI/PPP project finance loans in 2010, a reflection of its ability to use its position as a government-backed financial institution[5].

Finally, the Korean government, which owns 57% of the shares in Woori Financial Group, the parent of Woori Investment & Securities, whose earnings from investment banking are not very different from those of Daewoo Securities, has indicated on a number of occasions its intention to sell its holding. In particular, there was considerable interest in April 2011 in the sale of Woori Financial Group to KDB as the merger of Woori Investment & Securities and KDB subsidiary Daewoo Securities might have created a major Korean investment bank[6]. However, the deal fell through. KDB is due to be privatized as a commercial bank under the Banking Act by 2014. However, there were probably strong objections to creating a global investment bank that is a wholly owned subsidiary of a government-backed financial institution.

Similarly, Samsung Securities, which has shown no clear increase in its commission from investment banking, has shown an increase in its earnings from managing wrap accounts. These have increased from KRW6.6 billion (1.0% of total earnings) in FY06 to KRW96.9 billion in FY10 (9.3% of total earnings), a fifteen-fold increase (Figure 6).

4 With the formation of a holding company, KDB Financial Group (KDB FG), on 28 October 2009, Daewoo Securities became a group subsidiary. Initially, Daewoo Securities' parent, KDB, also became a group subsidiary (on 24 November 2009). In this connection it is perhaps worth mentioning that KDB currently owns 39.1% of the shares in Daewoo Securities.

5 In June 2008 the Korean government announced a plan to privatize KDB, and in April 2009 it revised the KDB Act. Under the revised KDB Act, KDB must sell at least one of its shares by May 2014.

6 The FSC's chairman, Kim Seok-dong, attracted attention when, in an interview he gave on 4 April 2011, he said (with regard to a merger between Daewoo Securities and Woori Investment & Securities) that such a merger would be one way of strengthening Korean securities companies.

Figure 6: Samsung Securities' operating income

	Amount (KRW billion)					Share (%)				
	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010
Net operating income	657.6	980	777.1	895.8	1046.5	100%	100%	100%	100%	100%
Brokerage commission	298.7	483.6	321.6	410.3	427.5	45.4%	49.3%	41.4%	45.8%	40.9%
Wrap account management commission	6.6	8.9	5.9	15.3	96.9	1.0%	0.9%	0.8%	1.7%	9.3%
Fund sales commission	90.4	127.4	80.3	76.3	71.8	13.7%	13.0%	10.3%	8.5%	6.9%
OTC derivative sales commission	39	51.2	0	25.9	47.7	5.9%	5.2%	0.0%	2.9%	4.6%
Investment banking commission	18.0	27.4	29.0	42.1	34.2	2.7%	2.8%	3.7%	4.7%	3.3%
Underwriting	-	-	-	32	25	-	-	-	3.6%	2.4%
M&A	-	-	-	10	9	-	-	-	1.1%	0.9%
Dealing income	31.3	49.4	76.1	109.7	105.2	4.8%	5.0%	9.8%	12.2%	10.1%
Interest income	165.6	223.2	245.1	222.8	227.5	25.2%	22.8%	31.5%	24.9%	21.7%
Other income	8.1	8.8	19	-6.7	35.7	1.2%	0.9%	2.4%	-0.7%	3.4%

Note: Data are for fiscal years (e.g., FY09 = April 2009–March 2010).
Source: Nomura Institute of Capital Markets Research, based on Samsung Securities' annual reports

Korean securities companies have also made steady progress in diversifying their earnings by expanding their overseas operations. Examples of such moves include plans by Daewoo Securities to more than triple the number of its staff in the rest of Asia from 35 to 120 and to expand its investment banking, trading and research activities. Similarly, Mirae Asset Securities, which was the first Korean securities company to open an office in Brazil, plans to increase its staff in South America by some 30%.

IV. Conclusion

As we have seen, Korea's FSCMA revision bill has been making progress through the National Assembly, and we expect it to be enacted by the end of 2011. While the bill is important in that it aims to bring Korea's capital markets closer into line with global standards, more important, in our view, is whether it will help major Korean securities companies (or, as some of them will be recategorized, "investment banks") to expand their business.

However, we wonder how much point there is in distinguishing between "investment banks" and normal "securities companies" mainly on the basis of their shareholders' equity. This is because we cannot help feeling that the move goes against the trend initiated by the enactment of the FSCMA in February 2009: namely, to make it easier for Korean securities companies to engage in a wider range of activities by removing the distinction between, for example, securities companies, futures companies and fund management companies and replacing it with one category, "financial investment services provider." In other words, there is no guarantee that the demarcation between "investment banks" and "(normal) securities companies" will lead to the formation of investment banks as the Korean authorities hope.