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New OTC derivative product approval

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Under the Financial Investment Services and Capital Market Act (the FSCMA), the financial investment products are broadly classified into two categories, securities and derivatives, depending upon the nature of risk involved. The term securities is defined to mean all investment products that carry a risk of loss up to the invested amount. The term derivatives is defined to mean all investment products that carry a risk of loss over and above the invested amount. Derivatives are further categorised into exchange-traded derivatives and over-the-counter derivatives (OTC derivatives) depending on the trading channel.

As a result of the amendments to the FSCMA, which became effective on June 13 2010, all dealers and brokers licensed under the FSCMA (including licensed securities companies and banks) are required to submit new OTC derivative products for review by the Korea Financial Investment Association (Kofia) before offering such OTC derivative products to investors.

The new OTC derivative products subject to review by Kofia include:

(i) OTC derivative products where the underlying assets consist of credit risk, or OTC derivative products where the underlying assets consist of risk related to a natural, environmental or economic phenomenon, which can be computed or assessed by price, interest rate, index or unit in a reasonable and appropriate way, to be newly offered by a dealer or broker to professional investors such as the financial institutions and other institutional investors; and

(ii) any OTC derivative products to be newly offered by a dealer or broker to any

investor other than professional investors (the general investors).

Therefore, the offering of any OTC derivative products, the underlying assets of which consist of a financial investment product, currency or commodity, only to professional investors will not be subject to the above-mentioned review by Kofia.

Notwithstanding the foregoing, certain OTC derivative products will be exempt from such review by Kofia to the extent that:

(i) the price information on the underlying assets of the products is publicly disclosed through certain derivatives exchanges or other markets designated by the Financial Services Commission (the FSC); or

(ii) the products which satisfy the criteria set forth by Kofia have the same or similar structure as those reviewed by Kofia in the past.

Kofia established a committee (the New Product Review Committee), which consists of nine commissioners for the purpose of reviewing new OTC products. The New Product Review Committee's general meetings will be convened twice a month and its extra-ordinary general meetings will be convened at the request of either the chairman of such committee or at least four commissioners.

With respect to the review of new OTC derivative products to be offered only to professional investors, the New Product Review Committee will consider the following:

(i) whether the price information on the underlying assets of the products can be provided on a regular and continuous basis for a sufficient period of time;

(ii) in the case where the price information is provided by an external source:

a. whether the price information is provided based on a quotation from multiple market participants; and

b. whether the entity that provides the price information is objective and independent from the parties to the products;

(iii) whether the price information can be readily obtained by the parties to the products;

a. in case where the price information is provided by a dealer or broker which is a party to the products, whether the price information is calculated based on an objective and reasonable method;

b. whether the price information is calculated in accordance with the internal control policy of the relevant dealer or broker;

c. if the calculation of the price information is outsourced to a third party, whether the price information is calculated by such third party based on a quotation from multiple market participants and whether such third party is objective and independent from the parties to the products; and

d. whether the price information can be readily obtained by the parties to the products;

(iv) in the case of credit derivative products, whether the information regarding the credit rating etc. of the reference entity or reference obligation can be provided on a continuous basis for a sufficient period of time.

With respect to the review of new OTC derivative products to be offered to the general investors, the New Product Review Committee will consider the following: (a) the appropriateness of the structure for risk hedging; (b) the completeness of the product explanatory material and (c) the appropriateness of the marketing plan. Kofia announced it would commence its review of the new OTC derivative products within ten business days upon receipt of the application for review.

The requirement for the review of new OTC derivative products under the FSCMA is scheduled to be abolished on December 31 2012, unless the FSCMA is otherwise amend-

ed to extend the application of such require
ment beyond December 31 2012.