



FSS Poised to Enhance Investigation of Short-Selling by Global Investment Banks

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On November 5, 2023, the Financial Supervisory Service (“FSS”) declared its decision to re-impose a ban on short-selling shares at least until June 2024. The regulator was expected to take a hard look at short-selling, in particular by foreign financial institutions. The Governor of the FSS proposed the possibility of criminal sanctions against employees of the global investment banks which are alleged to have engaged in years’ of illegal short sales while he was responding to the National Assembly on October 27, 2023, during the 2023 annual audit of government agencies. Shortly after the Governor’s comment, the FSS announced launching a special investigation unit to conduct exhaustive investigation of short-selling and other trades linked to short sales by local and international financial institutions.

1. New Investigation Team and FSS’ Position on Short-Selling

The amendments to the Financial Services and Capital Markets Act (“Capital Markets Act”) adopted on April 6, 2021 allow criminal and administrative sanctions¹ against illegal short-selling. And in 2022, Korea Exchange found a special inspection department and the FSS mobilized a new taskforce to intensify supervision of short-selling trades. On March 8, 2023, the FSS imposed an administrative fine on a short sale transaction which was made in breach of the short-selling regulations, an unprecedented action by the agency, and in October 2023, the FSS discovered two potential breaches of short-selling regulations by global investment banks’ Hong Kong offices: a KRW 40 billion short-selling internally made between a bank’s different departments without recordation of the underlying stock lending and a KRW 16 billion unlevered short-selling without a basis of a finalized stock lending trade. To support its heightened regulatory efforts, the FSS is promoting the taskforce’s status to be a special unit and expanding the unit’s manpower to at least 20 investigators. The FSS’ new special investigation unit is set to perform rigorous examination of global investment banks’ short-selling transactions.

2. Exhaustive Investigation

In response to the plunge of stock prices and hike in short sale transactions following the COVID-19 outbreak, the FSS temporarily suspended short-selling on March 13, 2020, and partially reinstated short-selling on May 3, 2021. The FSS' new special investigation unit is planning on performing exhaustive investigation over trades made since May 2021.

The FSS is also targeting local brokers (securities companies) which take orders from global investment banks in relation to their processing of short sale orders and knowledge of illegality of any such orders. Further, the FSS will probe into end-investors' potential abuse of short-selling trades.

3. Criminal Sanctions against Non-Korean Persons

Global institutions and non-Korean persons who are not resident in Korea cannot rule out the possibility of criminal actions taken by the Korean government against them, in particular where a serious violation of Korean short-selling regulations has been found. The FSS uses multilateral collaborative investigation and enforcement arrangements with foreign regulatory agencies, including the Securities and Future Commission of Hong Kong and the Monetary Authority of Singapore. There is a precedent of the Korean Prosecutors Office's arrest of a non-Korean individual accused of a Capital Markets Act violation, supported by the Interpol and the FSS' on-site examination in Hong Kong in collaboration with the Securities and Future Commission and the Hong Kong Monetary Authority.

4. Response Strategies for FSS Investigation

Illegal stock short-selling cases found by the FSS' include:

- (a) a short sale in excess of shares in deposit resulting from erroneous stock deposit management such as mismatch of deposit dates and share numbers;
- (b) a short sale in excess of shares in deposit resulting from a trader's negligence, including insertion of incorrect stock codes and trading party information;
- (c) a short sale made without underlying stock deposit resulting from deficiencies in internal control procedures and policies; and
- (d) an unlevered short sale order placed for the purpose of covering losses, followed by a after-hours block purchase of the short-sold stock.

Prior to the April 6, 2021 amendments, the regulatory authorities were unable to take criminal measures against intentional violations of short-selling regulations due to the absence of a criminal sanction provision in the Capital Markets Act. After the amendments however, criminal actions are considered depending on intentionality, market impacts and relations to other illegal activities. Further, on May 8, 2023 the FSS adopted a new rule which poses enhanced administrative remedies, including an administrative fine on illegal short-selling resulting from negligence in deposit management.

The FSS will offer a leniency program in tandem with its investigation of illegal short-selling. Financial institutions which voluntarily disclose potentially illegal short sales during the grate period are likely to be subject to reduced

administrative fines and other leniency measures. Accordingly, it is advisable for global financial institutions to perform internal compliance audits to diagnose the possibility of facing the FSS' penalties and improve internal control systems and policies to mitigate potential regulatory damages.

Shin & Kim's financial market regulatory enforcement team consists of experts in the field, including former officers of regulatory agencies and Korea Exchange, and we are available at your convenience to discuss the matters addressed in this newsletter, including assisting you with reviews of your compliance policies and procedures, as well as ways to respond to the FSS' investigation and other regulatory actions which may affect your business and employees.

¹ Under the amended Capital Markets Act, individuals and entities responsible for illegal short sales may be subject to imprisonment for up to one year, a criminal fine in the amount between 300% and 500% of the unjust enrichment taken from the transactions, and an administrative fine up to the transaction amount.

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