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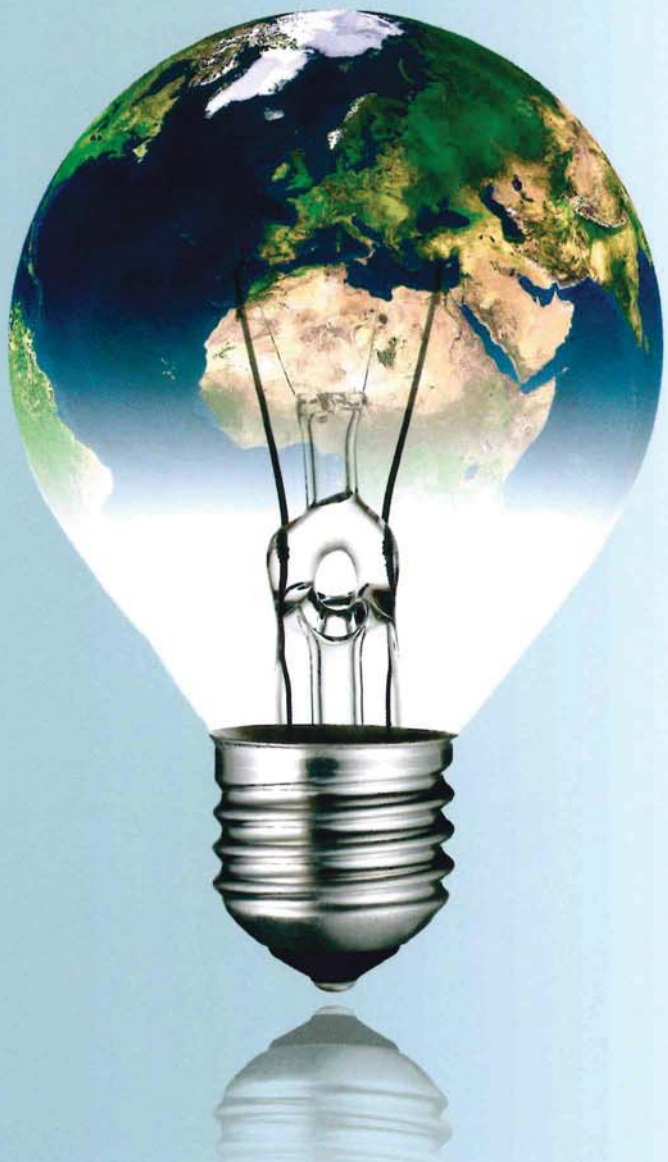
INTERNATIONAL FINANCIAL LAW REVIEW

PRIVATE EQUITY AND VENTURE CAPITAL REPORT 2014



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South Korea private equity funds: 10 years on

Haeng-Gyu Lee and **Hee-Suk Chai** of **Jipyong** examine proposed amendments to legislation, which herald the second phase of the Korean government's plan for PEFs

It has been 10 years since the introduction of private equity funds (PEFs) in Korea. During this period, the private equity (PE) market has rapidly expanded, both in size and importance. As of the end of 2013, registered domestic PEFs numbered 237 and the total capital commitments reached W44 trillion ($43 billion). Further, in today's depressed M&A market, where large corporations are reluctant to engage in deals due to risk concerns, PEFs have become integral players in driving deal volume, and their importance is underscored by their being party to virtually all the big M&A deals in recent times. In this and in other ways, the tenth anniversary of the introduction of PEFs in Korea represents an important marker in their evolution. It is only now that the liquidation of the first wave of Korean PEFs, which generally have a 10-year term, is taking place and offering a means of exit for investors. Equally significant, and a sure sign of the PE market's maturation in Korea, is that as a result of the liquidation of the first Korean PEFs established in 2004, the PE firms that have served as general partners (GPs) are now being assessed according to their performance in the market.

A sure sign of the PE market's maturation is that as a result of the liquidation of the first Korean PEFs, firms that have served as GPs are now being assessed according to their performance in the market

When the PEF scheme was introduced in Korea in 2004, the Korean government laid out a plan to develop Korean PEFs in three phases. They were to be tailored to the circumstances in Korea and distinguished from their global counterparts. The first phase would separate PEFs from general private funds in a two-track system and regulate PEFs with the government's right to intervention. The second phase would relax the regulations on PEFs while maintaining the two-track system. The third and final phase would do away with the two-track system and regulate PEFs and general private funds in the same manner, removing any special regulations. In 2013, the Korean government proposed amendments to the Financial Investment Services and Capital Markets Act (FSCMA), which included changes to the existing PEF scheme. Although the proposed amendments to the FSCMA mainly relate to the revitalisation of the M&A market in response to the economic recession after the global financial crisis in 2008, the proposed changes to the PEF scheme can be seen as heralding the second phase of the Korean government's developmental plan for Korean PEFs.The proposed amendments to the FSCMA relating to PEFs can be separated into three major categories. The first is the replacement of the existing registration requirements with a mere reporting requirement. This is a major change that facilitates the process of establishing PEFs, and should the proposed amendments be approved by the National Assembly, it is anticipated that the government regulation of PEFs would ease significantly. The second relates to the increased regulation of PE firms acting as GPs, due to the need for sup

If they are approved by the National Assembly, supplemental legislation will be amended accordingly. Then, Korean PEFs will have clearly entered the second phase of development

plemental regulatory measures to address potential issues resulting from simplifying establishment procedures for PEFs. The third involves asset management restrictions; the two-track system of regulation is maintained, with the proposed amendments greatly relaxing the restrictions for general private funds while maintaining asset management restrictions for PEFs.

Simplifying establishment procedures for Korean PEF

The existing FSCMA requires PEFs to be registered with the Financial Services Commission (FSC), a financial regulatory body in Korea, before commencing their business. Accordingly, GPs are required to register the PEF with the FSC after the PEF's incorporation, and they are prohibited from managing its assets or proceeding with investing activities before proper registration. The registration procedures generally take one month, during which time the FSC examines in detail compliance with proper establishment procedures and satisfaction of all requirements for PEFs.

The proposed amendments to the FSCMA abolish the existing registration requirement for PEFs and stipulate a subsequent reporting requirement instead. By virtue of such amendments, PEFs are permitted to begin conducting their business, including asset management and other investment activities, immediately after their incorporation, which will be of great convenience to GPs. Of course, the relevant governmental authority may examine PEFs after the fact and demand corrective measures if subsequent examinations find that they are in violation of applicable laws.

The complicated procedures for establishing PEFs are often cited as a major factor in discouraging their use as investment vehicles. Therefore, if implemented, such amendments are expected to have a positive effect in enhancing the viability of PEFs for use in M&A and other investment transactions.

Strengthening registration requirements for GPs

The proposed amendments to the FSCMA make establishment procedures less burdensome for PEFs, while simultaneously strengthening registration requirements for GPs. This difference stems from the need to protect investors from the prospect of unqualified GPs participating in the PE market due to the relaxation of PEF establishment procedures.

Registration requirements for GPs in the proposed amendments to the FSCMA require that GPs be registered with the relevant governmental authority before establishing the PEFs and managing their assets. The following conditions must be met in order for GPs to be so registered: (i) GPs must have equity capital of more than W100 million; (ii) GPs' executives must not have a criminal record for the preceding five-year period; (iii) GPs must satisfy certain requirements as asset managers; and, (iv) GPs must possess internal control systems for the prevention of conflict of interest. Additionally, the proposed amendments to the FSCMA stipulate good financial standing and social credibility for GPs as further conditions for registration. Details of these conditions are to be included in the proposed amendments to the Enforcement Decree of the FSCMA and supplemental legislation, which are scheduled to be issued at the end of 2014. Considering examples from other similar legislation, the good financial standing requirement may deal with issues of capital adequacy ratio, liquidity ratio, asset quality, social credibility, criminal records of executives, and relationship with insolvent financial institutions.

Regulation of asset management by PEF

The proposed amendments to the FSCMA do not include significant changes to the regulation of asset management by PEFs. Accordingly, asset management by a PEF is basically limited to buy-out investments such as: (i) investment in 10% or more of the total number of outstanding voting stocks; or (ii) investment in less than 10% of the total number of outstanding voting stocks that enables the PEF to exercise de facto control over the major business of a target company, including the appointment and dismissal of executives. A PEF may also use 50% or more of its assets for buy-out investments within two years of the partners' contribution (the two-year rule). In addition to the two-year rule, other regulations on asset management by PEFs, such as the restriction on mezzanine investment, the six-month rule and the restriction on the investment with options, are maintained.

Restriction on the mezzanine investment

While PEFs are permitted to use their assets for mezzanine investments, such as investments in convertible bonds (CBs) or bonds with warrants (BWs), such investments do not fall under the category of buy-out investments. Accordingly, to satisfy the two-year rule, PEFs may convert CBs or exercise the warrants of BWs within two years of the partners' contribution.

Six-month rule

PEFs must satisfy the buy-out investment requirements within six months of acquiring shares in a certain company. If the PEF fails to satisfy the requirements, it must sell the shares they have acquired. Further, PEFs must continue to own the shares for more than six months after satisfying the buy-out investment requirements.

Restriction on investment in options

PEFs are prohibited from managing their assets by lending money, and accordingly the investment in options as lending is prohibited. For example, PEFs are not permitted to acquire put options which have similar qualities as a loan, with the put options becoming exercisable after a certain time and the exercise price amounting to principal and certain additional profits.

The complicated procedures for establishing PEFs are often cited as a major factor in discouraging their use as investment vehicles

However, there are some minor changes with respect to the management of a PEF's remaining assets after the buy-out investments. Most significantly, the limitation in securities investment for the purpose of maintaining an investment portfolio is enhanced from 5% to 30% of the total assets of the PEF. Further, investment in derivatives for hedging foreign exchange risk is also permitted by the proposed amendments to the FSCMA.

Meanwhile, the regulations on conflict of interest between PEFs and GPs have been elaborated in the proposed amendments to the FSCMA. Under the existing FSCMA, transactions between PEFs and GPs are permitted with the consent of all the PEF partners, and beyond such rule, the conflict of interest is regulated by the fiduciary duty of GPs. However, in accordance with the proposed amendments to the FSCMA: (i) any transaction between a PEF and GPs (or specially related persons to GPs) is prohibited in principle, except when such transaction takes place on a stock exchange, or when such transaction is clearly favourable to the PEF; (ii) PEFs are prohibited from acquiring securities issued by GPs; and, (iii) the acquisition of securities issued by specially related persons to GPs is permitted only up to a certain limit. Additionally, proposed amendments to the FSCMA stipulate regulations on the participation of specially related persons to GPs as limited partners in a PEF.

Regulation on the use of SPC

As explained earlier, various restrictions are applied with respect to asset management by a PEF. However, PEFs may get around such restrictions by using a special purpose company (SPC). For example, the PEF may invest their entire assets in an SPC, which may in turn use the assets in a manner prohibited for PEFs, such as lending money. As the investment of PEFs in SPCs falls under the category of buy-out investments, the SPC can be misused by the PEF to avoid restrictions on asset management. As a result, the FSCMA stipulates certain requirements for an SPC when used by a PEF, and restrictions on asset management are also applied to the SPC. Further, to ensure the effectiveness of such regulations, PEFs are not permitted to invest in a newly established company, since it is hard to distinguish a newly established company from an SPC.

Regulations on the use of an SPC are maintained under the proposed amendments to the FSCMA, although there have been strong requests from market players to abolish such restrictions. The proposed amendments, however, do relax some restrictions on SPCs. The PEF may: (i) make use of two-level SPCs; and (ii) invest in a newly established company other than the SPC permitted by the FSCMA in order to acquire a business. If approved, the proposed amendments to the FSCMA will have the effect of further stimulating PEFs' M&A activities.

Next steps for the FSCMA amendments

The process of gathering opinions and feedback from industry professionals and the public on the proposed amendments to the FSCMA has been completed, and they will shortly be sent to the National Assembly for a vote. If they are approved by the National Assembly, supplemental legislation, including the Enforcement Decree of the FSCMA and the Regulations on Financial Investment Business, will be amended accordingly. Then, Korean PEFs will have clearly entered the second phase of development, as planned by the government 10 years ago when it implemented the PEF scheme. The opportunities that the PE market maturation in Korea will bring to investors are keenly awaited.

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