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"Hedge Funds" in Korea?

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The concept of the "hub" is one of the catchphrases of Korean public policy. The Government seems always partial to any proposal that capitalises on Korea's supposed geographical hub status between Japan and China, and substantial funding (and public relations activity) has been dedicated to realising that. The idea that Korea could become a "financial hub" has also been a kind of holy grail, although it has not had much traction with foreign observers, or with the market. The fact that Korean financial institutions handily weathered the financial storms of recent years has not changed that perception. The problem is the heavy hand of government supervision and regulation that continues to weigh on the industry.

Article 249-2 of the *Financial Investment Services and Capital Markets Act (FISCMA)*, which became effective in February 2009, was intended to enhance the integration of the Korean capital markets and financial investment products industry. It introduced a measure of flexibility into the regulatory framework, greatly expanding the kinds of financial business that may be carried out by a single entity. Among its goals was to begin to foster the development of what are popularly styled "hedge funds", ie. lightly regulated private funds that accept high risks in a quest for high returns.

Article 249-2 introduced a new type of private fund, known as a Private Fund for Qualified Investors (PFQI), which was interpreted by legal scholars and industry watchers in Korea as the first step to introducing the concept of "hedge funds" (or, more properly, alternative funds) in Korea. Some had high hopes for this new vehicle. As one observer said, "Through the introduction of Private Funds for Qualified Investors, collective investment businesses in Korea may develop and apply innovative investment techniques and offer investors a wider range of financial investment products. We believe that Private Funds for Qualified Investors will contribute to the advancement of the Korean financial industry and serve as a foundation for a sweeping introduction of hedge funds in Korea."

A PFQI may obtain funds by issuing "collective investment securities" through private placements (ie. offerings to fewer than 50 investors) to "qualified investors". Qualified investors (as defined by a Presidential Decree) include a broad range of government corporations, public and private financial institutions, as well as foreign financial institutions.

So what is the regulatory advantage of a PFQI? Basically, a PFQI is granted a freer hand in leveraging itself than other kinds of funds. A PFQI may borrow up to 300 percent of the fund's property, whereas the ceiling is set at only 10 percent for privately placed funds. Similarly, a PFQI may offer up to 50 percent of the fund's property to secure any loans, compared to 10 percent of the fund's property for privately placed funds.

These are substantial advantages, but they come at a substantial cost: As noted above, they must be marketed only to qualified investors. And at least 50 percent of the fund's property must be invested in a company that is subject to corporate restructuring. This greatly reduces the scope of potential investment for a PFQI and constitutes a huge disincentive to using the vehicle. In effect, the PFQI is forced to be a special purpose restructuring fund, rather than a flexible all-purpose vehicle.

Given the expectations that this kind of entity would lead to the growth of a general alternative fund industry in Korea, these limitations seem self-defeating, to say the least. It remains to be seen whether this vehicle will prove to be sufficiently attractive (given the potential targets in restructuring) to live up to the expectations that accompanied its enactment.

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