

# Legal Frameworks for Consumer Protection in Financial Services: Korea

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- I. Background
- II. Reform Efforts
- III. Consumer Protection Regime
- IV. Financial Products
- V. Wholesale & Retail Customers
- VI. Ex-post Consumer Protection
- VII. Conclusion

# I. Background

# I. Background

## A. Introduction

- Proposition: Financial regulation should reflect financial markets.
- Changes in financial markets
- Need to reform financial regulation to address these changes

# I. Background

## B. Changes in the Financial Markets

- Mega-regulator

Financial Supervisory Commission/Financial Supervisory Service covering all financial sectors including banking, insurance and securities

# I. Background

- Changing Needs of the End-Users
  - Aging population and the growth of disposable income
  - Growing demand for diverse types of financial products

# I. Background

- Advances in Computer and Telecommunication Technologies
  - New market structures (e.g., ATS) and new financial products with advanced information technology
  - Question on the meaning (and relevance) of a well-established legal term (e.g., stock exchange)

# I. Background

- Blurring of Sectoral Distinctions
  - Financial products: use of derivatives
  - Financial services providers
    - financial conglomerates: financial holding company
    - Cross-selling of financial products

# I. Background

## C. Limits of Current Financial Laws

- Institution-based or product-based approach
  - Banking Act 1950(“Bank”)
  - Securities Transaction Act 1961(“Securities”)
  - Insurance Business Act 1962(“Insurance Contracts”)

# I. Background

- Limits of Current Financial Laws
  - Insufficient and inflexible regulatory definitions
  - Regulatory inequality among sectors
  - Vertical and horizontal dispersion of regulatory rules

# I. Background

- Insufficient and Inflexible Regulatory Definitions
  - Strict (and limited) listing approach in defining securities
    - preventing financial services providers from developing new financial products
    - lack of consumer protection for new financial products

# I. Background

- Regulatory Inequality
  - Regulatory inequality among financial sectors
  - Regulatory Treatment of OTC derivatives in banks and securities firms
    - Equity-linked deposits vs Equity-linked securities

# I. Background

- Unsystematic Organization of Regulation
  - Rules of the same dimension on various levels of law
  - For market participants, difficulty of compliance with the rules
  - For regulators, difficulty of systematic and consistent reform of the regulatory system

# I. Background

- Evaluation of the current regulatory system
  - Not adequate protection of the consumers' interest (consumers)
  - Lack of a level playing field (financial services provider)
  - Unduly complicated structure & difficulty of systematic reform(regulator)

## II. Reform Efforts

## II. Reform Efforts

- Several Alternatives
  - to revise diverse financial laws one by one to achieve a level playing field
  - to aim for a partial integration, unified COB regulation
  - to consolidate all different financial statutes into a single code

## II. Reform Efforts

- Consolidated Financial Law Project
  - MOFE project to consolidate existing financial services laws into a single statute(March '03)
  - Response to consolidated financial markets
  - Effort to change an “interventionist” approach towards a more “market-friendly” one

## II. Reform Efforts

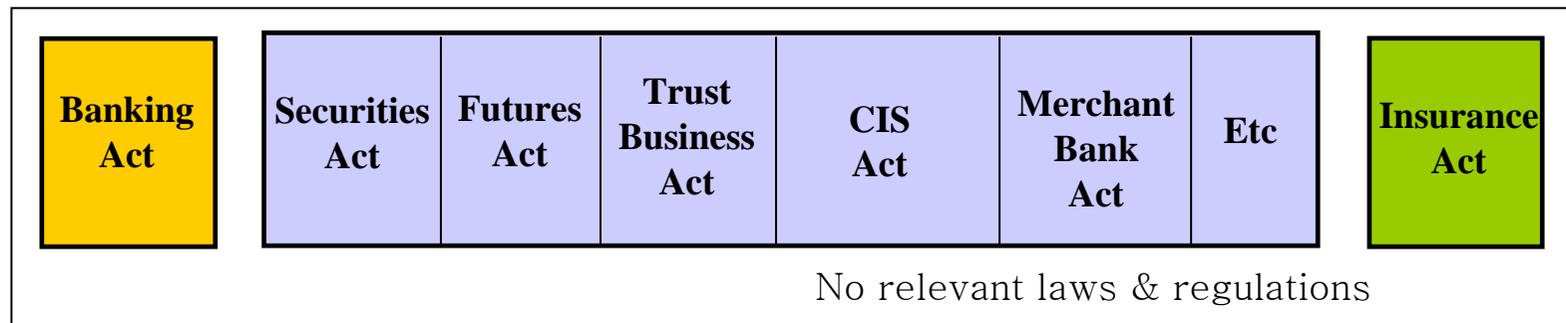
- Consolidated Capital Markets Law
  - MOFE announced to consolidate existing laws on capital markets into a single statute(Feb '06)
    - Securities Trading Act/Futures Trading Act
    - Trust Business Act etc
  - Effort to make a Korean “Goldman Sachs”

# '03 Consolidated Financial Law Project

- Single statute, but no fundamental changes to the substance
- Modeled after the *Financial Services and Market Act 2000* (UK) in form, but its substance to reflect Korea's market and legal environments

# '03 Consolidated Financial Law Project

< Before Consolidation >



< After Consolidation >



# '06 Consolidated Capital Markets Law

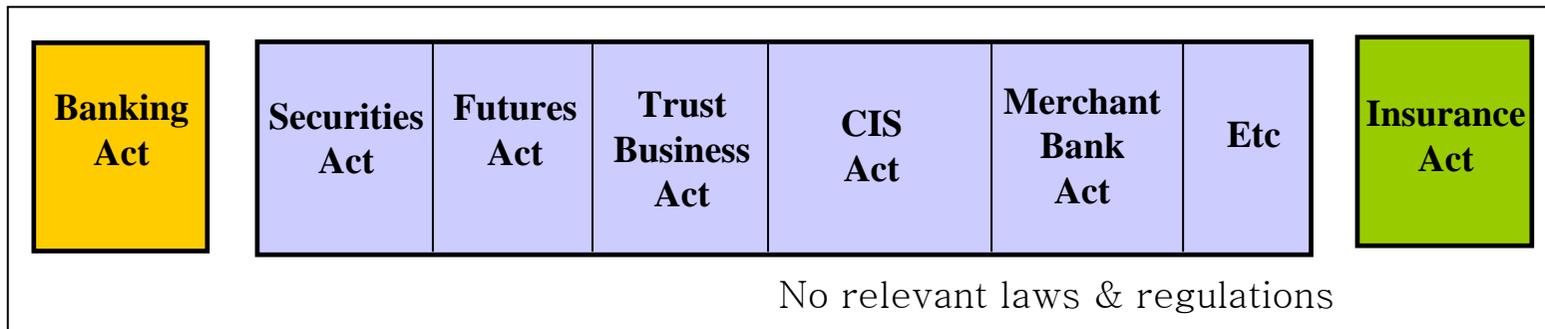
- Single statute, but excluding Banking Act & Insurance Business Act
- Modeled after the *Financial Services Reform Act 2001* (Cth) in form, but its substance to reflect Korea's market and legal environments

# '06 Consolidated Capital Markets Law

- *Principles*
  - Function regulatory approach
  - Negative system for the definition of permissible financial products
  - Expanding business scope of investment bank
  - Upgrading consumer protection system

# '06 Consolidated Capital Markets Law

< Before Consolidation >



< After Consolidation >



# III. Consumer Protection Regime

# III. Consumer Protection Regime

## *A. Introduction*

- Consumer protection in financial services

# III. Consumer Protection Regime

## B. *Currently*

- No comprehensive laws for consumer protection in financial services
  - between banks and consumers
  - between insurance companies and consumers

# III. Consumer Protection Regime

## B. *Currently*

- Conduct of business regulation by FSC /FSS
  - between stock companies and consumers

# III. Consumer Protection Regime

## B. *Currently*

- Lending Business Registration and Financial Customer Protection Act 2002
  - Lending Business: doing a lending of money or its brokerage by way of business (§2)
  - Subject to the regulation of mayor or governor of province (§12)

# III. Consumer Protection Regime

- Registration requirement (§3(1))
- Duty to provide and keep contract document (§6)
- Prohibition of excessive lending (§7)
- Restricting rates
  - Interest rates 66% pa (§8)
  - Default interest rate 66% pa (§15)
- Prohibition of illegal promotion (§9-2)
- Prohibition of illegal collection (§10)

# III. Consumer Protection Regime

## *C.'06 Consolidated Capital Markets Law*

- Duty of good faith
- Know your customer
- Suitability
- Prohibition of unsolicited call
- Financial promotion regulation

## IV. Financial Products

# IV. Financial Products

## *A. Introduction*

- Insufficient and inflexible regulatory definitions
  - preventing financial services providers from developing new financial products
  - lack of consumer protection for new financial products

## IV. Financial Products

- Market needs of broad and flexible approach in financial products' definition
- Core concept for determining the coverage of the Consolidated Law

## IV. Financial Products

- In defining the term “financial products”, two issues are being considered:
  - comprehensive definition of financial products
  - consumer protection by minimizing the regulatory gap

## IV. Financial Products

### B. *Currently*

- Securities
  - *Strict (and limited) listing approach* in defining securities
  - 21 types including stocks, bonds etc

# IV. Financial Products

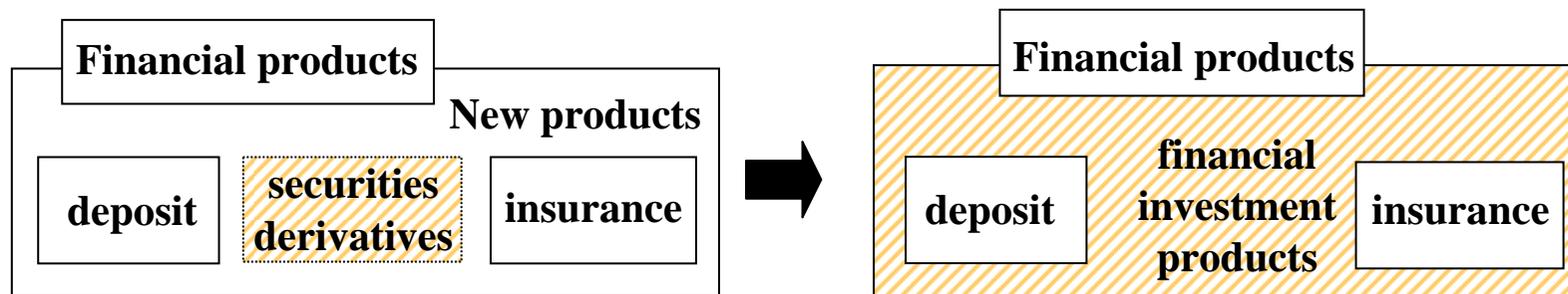
## B. *Currently*

- Derivatives
  - *Restricting the kinds of underlying assets*
    - securities
    - currency
    - commodity
    - credit risk

# IV. Financial Products

## C. '06 Consolidated Capital Markets Law

- securities → financial investment products



## IV. Financial Products

### C. '06 Consolidated Capital Markets Law

- *financial investment products*
  - *securities*
  - *on-exchange derivatives*
  - *off-exchange (OTC) derivatives*

# IV. Financial Products

- financial investment products
  - Right: contractual right(s)
  - Purpose: to get profits, to avoid losses or to manage risks
  - Investment factor: with potential loss of principal or potential liability of additional payment(contingent liability)
    - cf. differentiating deposit and insurance products
  - Money: involving movement of money

# IV. Financial Products

- securities

Name		Definition	Example
Traditional Securities	Debt securities	Debt	Treasury bond, CP etc
	Share securities	Investment share	Stock etc
	Beneficial securities	Beneficial right	Investment trust etc
	Securities depository securities	Depository receipt	KDR, GDR, ADR etc
Investment Contract		Howey case	Non-typical CIS etc
Securitized Derivatives		Securities derivatives	CLS, ELS, ELW, ILS etc

# IV. Financial Products

- derivatives

OTC derivatives

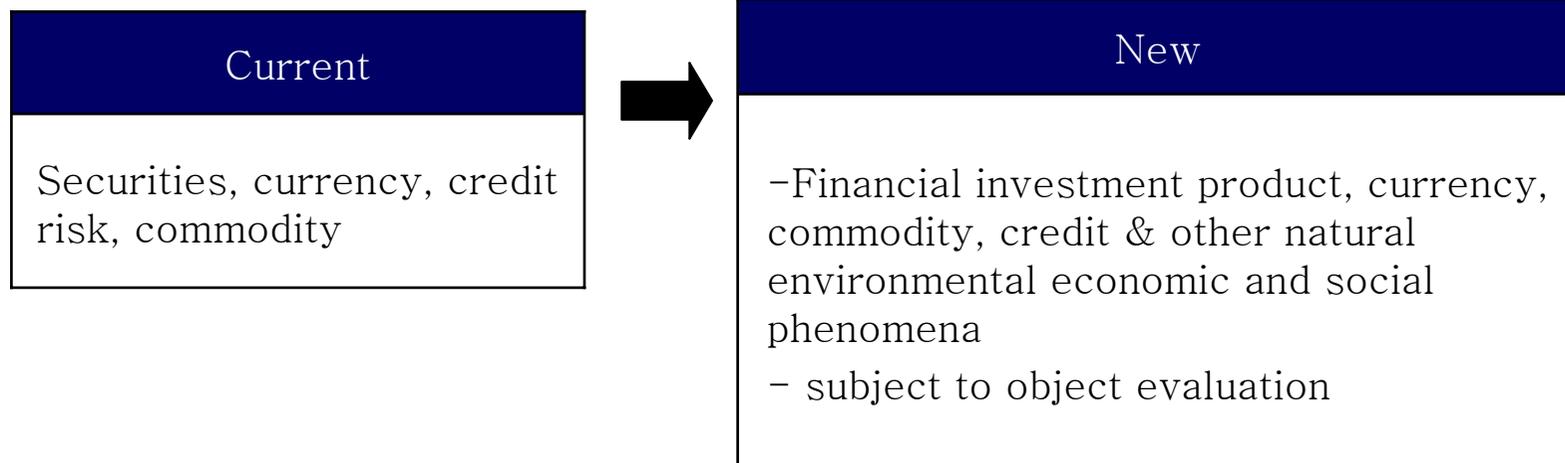
**Forwards, options, swaps**

On-exchange  
derivatives

**Derivatives traded on organized exchanges**

# IV. Financial Products

- Derivatives: underlying assets



# V. Wholesale & Retail Customers

# V. Wholesale & Retail Customers

## *A. Introduction*

- Wholesale and retail clients
  - By concentrating regulatory resources on the retail, non-professional clients
  - To promote efficient use of scarce regulatory resources and to lower the overall level of regulation in financial markets

# V. Wholesale & Retail Customers

## B. *Currently*

- *No* such approach
- But, *Presidential Decree for the Securities Trading Act §84-28(2)*
  - Limiting the capacity of counterparties for OTC derivatives transactions of securities companies

# V. Wholesale & Retail Customers

## C. '06 Consolidated Capital Markets Law

- Classifying customers into two categories, *professional investors* and *ordinary investors*
  - according to the investment experiences, knowledge, size of the relevant transactions etc of the investors

# V. Wholesale & Retail Customers

## C. '06 Consolidated Capital Markets Law

- Prohibiting sales of OTC derivatives to *ordinary investors*
  - *ordinary investors* may go to the exchanges for derivatives trading

# VI. Ex-post Consumer Protection

# VI. Ex-post Consumer Protection

## *A. Introduction*

- Ex-post protections of consumers for losses brought by market fluctuations blamed on financial institutions
- Need of simple, flexible and uncostly dispute resolution system
- Gains by illegal activities in the financial transaction between financial institutions and consumers to be redeemed to consumers

# VI. Ex-post Consumer Protection

## *B. Currently*

- Ex-post protections of consumers for losses brought by market fluctuations blamed on financial institutions
  - Ruled by general private law principles in court

# VI. Ex-post Consumer Protection

## *B. Currently*

- Dispute resolution between the financial institutions and consumers
  - Financial dispute resolution committee in the FSS
  - Consumer Protection Board

# VI. Ex-post Consumer Protection

## *B. Currently*

- Gains by illegal activities in the financial transaction between financial institutions and consumers to be redeemed to consumers
  - No special rules

# VI. Ex-post Consumer Protection

## *C. '06 Consolidated Capital Markets Law*

- Ex-post protections of consumers for losses brought by market fluctuations blamed on financial institutions
  - If there is a breach of the duty to explain, financial institutions should pay for the damages
  - loss of principal assumed to be the damages

# VI. Ex-post Consumer Protection

## *C. '06 Consolidated Capital Markets Law*

- Dispute resolution between the financial institutions and consumers
  - No changes

# VI. Ex-post Consumer Protection

## *C. '06 Consolidated Capital Markets Law*

- Gains by illegal activities in the financial transaction between financial institutions and consumers to be redeemed to consumers
  - No changes

# VII. Conclusion

# VII. Conclusion

- Benefits of the Consolidated Capital Markets Law (if enacted)
  - First, to enhance the consumer protection regime in financial services
  - Second, to address the insufficient regulatory definition of financial products with a comprehensive definition
  - Third, to eliminate room for regulatory inequality based on no reasonable ground

# VII. Conclusion

- Market Responses to the Consolidated Capital Markets Law
  - Responses of market participants differ depending on their core sectors and competitive edge
  - First, the banking sector is relatively negative
  - Second, the securities sector is affirmative
  - Third, the insurance sector is relatively negative