



FINANCIAL SERVICES COMMISSION

124, Sejong-daero, Jung-gu,  
Seoul, 100-745, Republic of Korea

August 12, 2015

Mr. Christopher J. Kirkpatrick  
Secretary  
U.S. Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, NW  
Washington, DC 20581

Dear Mr. Kirkpatrick,

As the regulatory authority over the Korean capital market, I would like to firstly deliver my sincere appreciation for the efforts of your esteemed institution to safeguard the financial market. I believe that close cooperation between the regulatory authorities is more important than ever in our global financial markets.

Korea Exchange, Inc. (“**KRX**”) is subject to extensive and comprehensive regulation in Korea. The Financial Services Commission (“**FSC**”) supervises KRX in accordance with the Financial Investment Services and Capital Market Act, and oversees the business of KRX to protect investors and reinforce the stability of financial markets. All of the rules of KRX must be reviewed and ultimately approved by the FSC.

In this regard, I confirm, on behalf of the FSC, that in developing the regulatory regime to which KRX is subject, Korean authorities sought to incorporate the relevant standards articulated in the Principles for Financial Market Infrastructures (the “**PFMIs**”) developed by the Committee on Payment and Settlement Systems of the Bank for International Settlements and the Technical Committee of the International Organization of Securities Commissions — and apply such standards to KRX, on an ongoing basis — through a combination of: provisions in Republic of Korea’s Financial Investment Services and Capital Markets Act, enforcement decrees, FSC regulations, and by a requirement that KRX incorporate certain provisions directly into their rulebooks. I strongly believe that this approach to the regulation of KRX is consistent with the PFMI standards. For further details on the mechanism of the regulatory framework of Korea and its observance of the PFMIs, please refer to the explanatory memorandum attached herewith, which the FSC confirms the accuracy.

Sincerely,

Lee, Hyoung Ju  
Director  
Capital Market Bureau  
Financial Services Commission



---

Busan International Finance Center, 40 Munhyeongeumyung-ro, Nam-gu, Busan, Republic of Korea, 608-828  
Telephone: +82-51-662-2000, www.krx.co.kr

**To: U.S. Commodity Futures Trading Commission**  
**From: Korea Exchange, Inc.**  
**Re: PFMI Observance of the Korean Regulatory Framework**  
**Date: August 12, 2015**

This memorandum is intended to provide the U.S. Commodity Futures Trading Commission with information concerning how Korean authorities incorporated into the Korean regulatory regime the relevant standards articulated in the Principles for Financial Market Infrastructures (the “PFMIs”)<sup>1</sup> and apply such standards to Korea Exchange, Inc. (“KRX”). Korean authorities have achieved this goal through a combination of: (1) provisions in the Financial Investment Business and Capital Market Act (the “Act”); (2) an Enforcement Decree established under the Financial Investment Business and Capital Markets Act (the “Enforcement Decree”); (3) the Regulations on Financial Investment Business (the “FSC Regulations”); and (4) the Business Guideline for Financial Market Infrastructures (the “FSC Guideline”),<sup>2</sup> which include the requirement that central counterparties (“CCPs”) in Korea incorporate certain provisions directly into their own rulebooks.

## Background

As set out in the Act on the Establishment, etc. of the Financial Services Commission, the Financial Services Commission (the “FSC”) has overall responsibility for financial policy and financial supervision of the financial market and financial institutions in Korea. The responsibility of the FSC includes, among others: determination of financial policies and systems; conducting supervision and sanctions against the financial institutions; management, supervision and surveillance of capital markets; and establishment, amendment and abrogation of Acts and subordinate statutes concerning the above matters. The Financial Supervisory Service (the “FSS”) is responsible for conducting inspections on the affairs and the financial status of the financial institutions, including KRX, under the guidance and supervision of the FSC<sup>3</sup>, and provides business support to the FSC and the institutions under its jurisdiction. The FSS is not itself a governmental body. It is a “non-capital special corporation” that operates under the supervision of the FSC. The FSC shall guide and supervise the affairs, operation, and administration of the FSS, and shall deliberate and resolve the matters regarding approval for the articles of incorporation, budget and final accounts of the FSS, and other matters necessary for the FSC guidance and supervision. For example, when the FSS provides inspection and supervisory services on financial institutions under the guidance and supervision of the FSC, the FSS must report the results of the inspection to the FSC, and the FSC makes the resolution with regard to inspection, sanctions, authorization of business administration of the financial institutions, etc. The FSC is the sole Korean governmental regulatory authority over CCPs, and it has the final say when it speaks in regards to a CCP’s regulatory standing in Korea.

The FSC has the authorization rights (i.e., the right to issue or revoke the license) for central counterparty clearing business<sup>4</sup>. It supervises the clearing operations of CCPs, and has the approval rights to the CCP regulations and charter upon their establishment and their amendments<sup>5</sup>, meaning

---

<sup>1</sup> The term “PFMIs” refers to the Principles for financial market infrastructures published by the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions in April 2012.

<sup>2</sup> Despite the use of the word “Guideline”, the FSC Guidelines are mandatory, binding requirements—not merely suggested guidelines or best practices.

<sup>3</sup> The Regulations on Examination and Sanctions against Financial Institutions is a FSC regulation that prescribes the procedure, method and necessary requirements of the FSS inspection.

<sup>4</sup> Article 323-3(1) of the Act

<sup>5</sup> Article 323-11(2) of the Act

that CCPs must obtain approval of the FSC in establishing and amending its regulations and charter. The FSS has the inspection rights on the operation and the financial conditions of CCPs, including whether CCPs are maintaining their authorization requirements<sup>6</sup>. The inspections conducted by the FSS constitute the preliminary findings for the FSC to determine whether to authorize the CCPs' clearing operations or revoke such authorization.

In regards to the central clearing of OTC derivatives, the amended Act and the Enforcement Decree, each of which is final and currently binding, were enacted on May 5, 2013 and came into force on July 6, 2013. The FSC published the FSC Regulations subsequent to and delegated by the Act and the Enforcement Decree on the same day. On March 20, 2015, the FSC released the FSC Guideline which came into effect on that same day, in order to clearly state the principles that financial market infrastructures (the "FMIs")<sup>7</sup> in Korea including CCPs for both OTC derivatives and exchange listed products must adhere to and reflect in their rulebooks in line with the PFMI.

The Act establishes the high-level requirements for the authorization and operation of CCPs in Korea, which are not meant to be amended as often as the subordinate regulations. Certain provisions in the Act are therefore intended to provide the legal basis for the subordinate regulations to prescribe the binding standards applicable to CCPs in appropriate detail. The Enforcement Decree, the FSC Regulation and the FSC Guideline, which are delegated provisions and subordinate regulations to the Act (collectively the "**Subordinate Regulations**"), prescribe the detailed regulatory standards applicable to CCPs that were not addressed in the Act. The combination of the Act and its Subordinate Regulations constitute the CCP regulatory framework of Korea.

### **Incorporation of the PFMI in the Korean Regulatory Framework**

As noted, Korean authorities have incorporated the regulatory standards articulated in the PFMI and apply such standards to KRX on an ongoing basis through a combination of: the Act; the Enforcement Decree; the FSC Regulations; and the FSC Guideline, which include the requirement that CCPs in Korea incorporate certain provisions directly into their own rulebooks.

#### ***A. Relevant Provisions of the Act and the Enforcement Decree***

Articles 323-2 through 323-20 of the Act stipulate the requirements applicable to CCPs, which observe certain key aspects of the PFMI such as: legal basis, governance, credit risk, collateral and margin, liquidity risk, participant default rules and procedures, general business risk, access and participation requirements, efficiency and effectiveness, market data and the requirement that CCPs establish certain provisions directly in its rulebooks.

Article 323-3(2)5. of the Act states that a CCP shall obtain authorization from the FSC and that a CCP's articles of incorporation and rules on clearing business shall comply with the Acts and subordinate substitutes and be adequate for the performance of CCP clearing business, stipulating that CCPs must be established with a sound legal basis.

To ensure governance arrangements of CCPs that support the stability of the financial system, Article 323-3(2)3. of the Act states that the CCP business plan shall be feasible and sound, and its subordinate provision Article 318-3(2) of the Enforcement Decree states that such business plan shall fulfill the following: (1) stable operation of CCP clearing business shall be ensured; (2) internal control system adequate for risk management and the prevention of financial accident, etc. shall be installed; (3) methods of conducting business adequate for protecting investors shall be prepared; (4) it shall not

---

<sup>6</sup> Article 323-19 of the Act

<sup>7</sup> The FSC Guideline categorizes the financial market infrastructures in Korea into clearing organizations, settlement organizations and central securities depositories

be in contravention of any Acts and subordinate statutes, and have no risk of undermining sound financial transaction order.

In order to prevent conflicts of interest, Article 323-3(2)9. of the Act and Article 318-3(6) of the Enforcement Decree states that a CCP shall have a system for preventing conflicts of interest; a system under which the possibility of occurrence of conflicts of interest between a CCP and a clearing member in connection with the operation of CCP business is probed, evaluated, and appropriately managed in accordance with the methods and procedures specified by an internal control guidelines of a CCP. For qualification of executives, Article 323-3(2)6. of the Act states that the executives of the CCP need to satisfy the qualifications stated in the Article 24 of the Act<sup>8</sup>.

In regards to collateral, Article 323-13 of the Act stipulates that a clearing member shall deposit margin for clearing in a CCP with money or similar as prescribed by its rules on clearing business in order to guarantee the repayment of obligations to the CCP: provided, that the same shall not apply to trades subject to clearing acknowledged by the CCP; where a clearing member fails to repay obligations to a CCP incurred from a transaction subject to clearing, the CCP may appropriate the margin of such member for the repayment of the obligations.

In order to address the liquidity risk of CCPs, Article 323-14 of the Act states that: (1) a clearing member shall set aside a joint compensation fund in a CCP with money or similar in order to compensate for damages resulting from default arising from a transaction subject to clearing: provided that the same shall not apply clearing members prescribed by the rules on clearing business; (2) a CCP shall set aside joint compensation funds under paragraph (1) separately for each type of trade subject to clearing; (3) a clearing member (excluding clearing members specified in the proviso to paragraph (1)) shall take a joint responsibility for damages resulting from default arising from a transaction subject to clearing within the limit of the joint compensation funds prescribed in paragraphs (1) and (2); (4) where a CCP compensates for damages pursuant to paragraph (1) from the joint compensation fund, it shall be entitled to the right of indemnity for the compensated amount and all the expenses incurred therefrom against the clearing member that has caused such damage; (5) a CCP shall appropriate the amount of money collected in accordance with paragraph (4) for the joint compensation fund; (6) the amount of the total reserve of the joint compensation fund under paragraph (1), method of the reserve, usage, operation and repayment thereof, exercise of the right of indemnity under paragraph (4), and other necessary matters shall be prescribed by Presidential Decree.

---

<sup>8</sup> Article 24 (Qualification of Executives) (1) No person who falls under any of the following subparagraphs shall become an executive of a financial investment business entity (including a person falling under Article 401-2 (1) 3 of the Commercial Act who is prescribed by Presidential Decree; hereafter the same shall apply in this Article), and an executive shall lose his/her office if he/she falls hereunder after taking the office:

1. A minor, an incompetent, or a quasi-incompetent;
  2. A person declared bankrupt, not yet reinstated;
  3. A person for whom five years have not elapsed since the completion (or deemed completion) of, or exemption from, a sentence of imprisonment without prison labor or heavier punishment, pronounced against him/her, or payment of a fine for negligence or greater, imposed upon him/her pursuant to this Act, other finance-related Acts and subordinate statutes specified by Presidential Decree (hereafter referred to as "finance-related Acts and subordinate statutes" in this Article) or finance-related Acts and subordinate statutes of a foreign country (referring to Acts and subordinate statutes of a foreign country, similar to this Act or any finance-related Acts and subordinate statutes; hereafter the same shall apply in this Article);
  4. A person against whom a sentence of suspension of imprisonment without labor, or greater punishment, was pronounced and who is still under a period of suspension;
  5. A person who was once an executive or employee of a corporation or company whose business permission, authorization or registration was revoked pursuant to this Act, other finance-related Acts and subordinate statutes, or finance-related Acts and subordinate statutes of a foreign country (limited to a person who is directly or substantially liable for the occurrence of the cause or event that gave rise to such revocation as specified by Presidential Decree) and for whom five years have not elapsed since such revocation;
  6. A person for whom five years have not elapsed since he/she was removed or dismissed pursuant to this Act, other finance-related Acts and subordinate statutes, or finance-related Acts and subordinate statutes of a foreign country;
  7. A person against whom a notice was given that he/she should, as a retired executive or employee, have been subjected to a disposition of demand for removal or dismissal pursuant to this Act or other finance-related Acts and subordinate statutes if he/she was in service or in employment at the time of such notice, and for whom five years have not elapsed since such notice was delivered (or seven years since the date of his/her retirement or resignation, in cases where the period of five years after the date of such notice exceeds the period of seven years after such retirement or resignation);
  8. A person prescribed by Presidential Decree as likely to undermine the protection of investors or sound trade order.
- (2) Executives of a financial investment business entity shall be persons experienced and learned in finance and unlikely to undermine the public interest, sound management and order of credit.
- (3) Detailed matters concerning the qualifications for executives under paragraph (2) shall be prescribed by Presidential Decree.

Accordingly, Article 318-8 of the Enforcement Decree states that: (1) the scale of total accumulation, accumulation ratio and method by clearing member, etc. of the joint compensation fund for damages under Article 323-14(1) of the Act (hereinafter referred to as "joint compensation fund") shall be prescribed by rules on clearing business (referring to the rules on clearing business under Article 323-11 of the Act; hereinafter the same shall apply) taking into consideration payment risk by trade subject to clearing, payment risk by clearing member, and any other circumstances; (2) where a CCP is compensated for damages with the joint compensation fund under Article 323-14(1) of the Act, the joint compensation fund set aside by the defaulted clearing member shall be used preferentially, and the deficiency shall be filled as prescribed by the rules on clearing business; (3) where a CCP has collected the damages from a clearing member by exercising the right of indemnity under Article 323-14(4) of the Act, it shall make up for the used part of the joint compensation fund set aside by other clearing members as prescribed by the rules on clearing business, and further make up for the used part of the joint compensation fund set aside by the clearing member which has caused the damage, if any balance remains; (4) Articles 362(3) through (8) and 363(1)<sup>9</sup> shall apply mutatis mutandis to the administration, refund, management of the joint compensation fund and the exercise of the right of indemnity.

Article 323-3(2)2. of the Act and Article 318-3(1) of the Enforcement Decree states that a CCP shall have its own equity capital equivalent to or more than 100 billion won to address the general business risk of CCPs.

To ensure fair and open access, Article 323-12 of the Act states that no CCP shall discriminatorily treat any specific clearing member without justifiable grounds.

To promote efficiency and effectiveness, Article 380(5) of the Act states that the Exchange shall appoint outside directors at the general meeting of shareholders after the recommendation of the nomination committee; Article 381(1) of the Act states that a majority of the board of directors shall be outside directors; Article 414 of the Act states that the FSC shall establish a market efficiency committee in order to review matters regarding the reduction of transaction costs on the securities market and the derivatives market; where any organization established by the Act or any other organization prescribed by Presidential Decree intends to change its commissions or invest more than the amount prescribed by Presidential Decree in data-processing facility, the organization shall proceed through the deliberation of the market efficiency committee. Accordingly, Article 368(3) of

---

<sup>9</sup> Article 362 (3) The Exchange shall earmark the joint fund for each member who has contributed to it so that it can be separately managed, and shall keep it separate from other property for separate accounting.

(4) The Exchange shall refund from the joint fund to an opting-out member as stipulated in the membership management regulations.

(5) The Exchange shall manage the joint fund in any of the following ways:

1. Purchasing the State bonds, local government bonds, or the monetary stabilization bonds of the Bank of Korea under Article 69 of the Bank of Korea Act;
2. Purchasing guaranteed corporate bonds;
3. Lending to or depositing in a securities finance company or purchasing bonds issued by a securities finance company;
4. Depositing in a bank. (6) The Exchange shall add yields generated by managing the joint fund in accordance with paragraph (5) into the principal of the joint fund as stipulated in the membership management regulations.

(7) Necessary matters concerning accumulation, management, investment, etc. of the joint fund shall be stipulated by the membership management regulations, in addition to the matters provided for in paragraphs (1) through (6).

(8) "Guaranteed corporate bonds" in paragraph (5) 2 means corporate bonds for which any of the following financial institutions, etc. guarantees the payment of principal and interest:

1. A bank;
2. The Korea Development Bank under the Korea Development Bank Act;
3. The Industrial Bank of Korea under the Industrial Bank of Korea Act;
4. An insurance company;
5. An investment trading business entity;
6. A securities finance company;
7. A merchant bank;
8. The Korea Credit Guarantee Fund under the Credit Guarantee Fund Act (guaranteed corporate bonds for which the Korea Credit Guarantee Fund guarantees payment, include those guaranteed on account of the industrial infrastructure credit guarantee fund pursuant to Act on Private Participation in Infrastructure);
9. The Korea Technology Credit Guarantee Fund under the Technology Credit Guarantee Fund Act.

Article 363 (Exercise of Rights to Claim Reimbursement of Indemnity) (1) The Exchange shall, when it compensates someone for losses pursuant to Article 339 (1) of the Act, report it to the Financial Services Commission, and shall exercise the rights to reimbursement of indemnity against a breaching member in a way that replenishes the joint fund promptly.

the Enforcement Decree states that the market efficiency promotion committee under Article 414(1) of the Act shall be comprised of seven or less members commissioned by the chairperson of the FSC among non-governmental experts specializing in finance, law, accounting, and electronic computation.

In regards to market data, Article 323-16 of the Act states that (1) a CCP shall keep and manage information on transactions subject to clearing under Article 166-3 and other transaction information prescribed by Presidential Decree; (2) a CCP shall report transaction information that it keeps and manages under paragraph (1) to the Financial Services Commission and other persons prescribed by Presidential Decree. Accordingly Article 318-9 of the Enforcement Decree states that a CCP shall keep and manage information on transactions referred to in Article 323-16(1) of the Act for 10 years; a CCP shall report the following matters to the FSC on a monthly basis in accordance with the forms and procedures prescribed and publicly notified by the FSC: 1. matters concerning trades subject to clearing referred to in Article 9(25) of the Act and financial investment instruments which become the subjects thereof; 2. matters concerning the fulfillment, etc. of obligation of clearing members; 3. current state of administration and management of margin for clearing and the joint compensation fund; 4. other matters prescribed by Ordinance of the Prime Minister taking internationally acknowledged standards for supervision, etc. into consideration; where a CCP is compensated for any damage from the joint compensation fund or where any matter prescribed by Ordinance of the Prime Minister with regards to the payment risk of clearing members occurs, it shall report thereon to the FSC without delay under Article 323-16(3) of the Act, notwithstanding [the above].

Article 323-11 of the Act stipulates the provisions which the CCPs must incorporate directly in its rulebooks and obtain approval from the FSC, details of which the FSC may separately prescribe. Such matters include: matters regarding transactions subject to clearing and financial investment instruments subject to such transactions; matters regarding the requirements for business entities subject to clearing; matters regarding the bearing of obligations through assumption of the obligations, novation, or through an analogous legally binding arrangement, which is conducted as the central counterparty clearing business, and the performance thereof; matters regarding the securing of repayment of debts by business entities subject to clearing; matters regarding the guarantee money for clearing and the joint compensation fund for damages; where a person who is not a business entity subject to clearing causes the CCP to bear obligations incurred from transactions subject to clearing through a business entity subject to clearing, matters regarding the brokerage, arrangement or acting as an agent for the clearing of such financial investment instruments transactions; matters regarding cooperation with foreign central counterparties (referring to persons who engage in business corresponding to the central counterparty clearing business in foreign countries under the foreign Acts and subordinate statutes); and other matters prescribed and publicly notified by the FSC as necessary for conducting central counterparty clearing business.

In addition, Article 323-6 of the Act requires CCPs to not only satisfy the requirements stipulated in the Act and in turn, the Subordinate Regulations for the initial authorization for their business, but also to sustain such requirements in their clearing operations. In this regard, the FSC has the constant supervision right including the rulebook approval rights and the FSS may conduct inspections on the CCPs to verify the compliance, upon direction of the FSC.

### ***B. Relevant FSC Regulations and Guideline***

The FSC Regulations further set forth additional regulatory standards that CCPs in Korea must satisfy in Articles 8-3-2 through 8-3-8 and the provisions in Annex 19-3, which also observe certain aspects of the PFMI, including but not limited to: legal basis, governance, comprehensive risk management, business risk, operational risk, and the requirement that CCPs establish certain provisions directly in its rulebooks, as delegated by the Act and the Enforcement Decree. In particular, Article 8-3-5(1) Annex 19-3 1.A. of the FSC Regulations states as the primary requirement for an applicant for the clearing business authorization to reflect the PFMI in its charter and the rules on clearing business.

The FSC Guideline confers upon CCPs a requirement to reflect the relevant standards of the PFMI directly in its rulebooks in further technical detail than the Enforcement Decree and the FSC Regulations. It reorganized the 24 principles of the PFMI into 14 principles in accordance with the Korean regulatory framework and provides detailed standards for their implementation. It comprises common standards applicable to the FMIs in Korea, standards for CCPs and standards for Central Securities Depositories. Common standards for FMIs prescribe the principles in: legal basis, governance, overall risk management, credit risk, liquidity risk, collateral, settlement, participant default rules and procedures, general business risk, custody and investment risk, operational risk, participation, efficiency and effectiveness, information disclosure and communication. The standards specific to CCPs are: credit risk, margin, liquidity risk, protection of clients. As stated in Article 1, the FSC Guideline is the business standard which the financial market infrastructures must observe in conducting its business, and not merely meant to be suggestions or best practice recommendations<sup>10</sup>. Article 3 of the FSC Guideline clearly states that CCPs must reflect the prescribed standards to obtain approval for establishing or amending its rulebooks. The FSC Guideline is the standard with which the FSC shall determine whether to approve the CCP's rules, as well as the criteria with which the FSC shall conduct its inspection on CCPs.

Thus, CCPs in Korea (including KRX) must reflect the PFMI in its rulebooks in accordance with the FSC Regulation and Guideline to obtain the authorization from the FSC to conduct their clearing businesses, and as Article 323-6 of the Act requires, must also maintain such standard.

KRX has complied with all of the above requirements and regulatory standards in being authorized as a CCP in Korea by the FSC on September 11, 2013, and is continuing to do so under the constant supervision of the FSC.

### ***C. FSC Supervision***

Authorized CCPs in Korea are subject to constant and comprehensive supervision of the FSC under the Act. The FSC has the responsibility to supervise the CCPs with the regulatory standards in line with the PFMI as prescribed in the Act and the Subordinate Regulations, and to mandate the CCPs to maintain the requirement to incorporate the PFMI in its rulebooks directly as the FSC Guideline requires and as the FSC Regulations stipulates as delegated by the Act and the Enforcement Decree.

### **Publication of the June 2015 CPMI IOSCO Assessment Report**

In June 2015, the Implementation Monitoring Standing Group (the “**IMSG**”) of the CPMI-IOSCO Steering Group published the second update to the Level 1 assessments<sup>11</sup> (the “**Assessment Report**”), which reflects the progress of jurisdictions’ implementation of the PFMI. That report assigned a rating of 2 to Korea in respect to Korea’s implementation of the Principles for CCPs. Despite the fact that the report was dated June 2015, the 2 rating of Korea’s implementation of the Principles for CCPs was based on an assessment of the Korean regulatory regime *as of January 9, 2015*. The FSC Guideline was published on March 2015, and therefore was not taken into account for purposes of the June 2015 report.

As noted, Korean authorities have incorporated the regulatory standards articulated in the PFMI and apply such standards to KRX on an ongoing basis.

---

<sup>10</sup> Although the press release accompanying the release of the FSC Guideline uses the language such as “should” or “guideline”, Article 1 of the FSC Guideline clearly states that it is intended to “provide the business standards that the financial market infrastructures under [FSC’s] supervision must observe in conducting business”. The Korean legal language does not differentiate between “should” and “must”, they have the same legal connotation and binding effect. In fact, it is customary for the English versions of the Korean statutes to use the language “shall” rather than “must”.

<sup>11</sup> Level 1 is to assess whether jurisdictions have completed the process of adopting the legislation, regulations and other policies that will enable them to implement the 24 principles and 5 responsibilities included in the PFMI.

\* \* \*

If you have any questions concerning the issues discussed in this memorandum, please contact KRX's OTC Clearing Rules and Regulations Team at +82-51-662-2626 and [hyelin.han@krx.co.kr](mailto:hyelin.han@krx.co.kr).