

UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

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1:37 pm, Jul 12, 2019

In the Matter of:)	CFTC Docket No. 19- 10
)	
Korea Exchange Inc.,)	
)	
Respondent.)	
)	

ORDER INSTITUTING PROCEEDINGS PURSUANT TO SECTION 6(c) AND 6(d) OF THE COMMODITY EXCHANGE ACT, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I. INTRODUCTION

The Commodity Futures Trading Commission (“Commission” or “CFTC”) has reason to believe that on or about February 19, 2018, Korea Exchange, Inc. (“KRX” or “Respondent”) violated Section 6(c)(2) of the Commodity Exchange Act (the “Act”), 7 U.S.C. § 9(2) (2012). Therefore, the Commission deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted to determine whether Respondent engaged in the violation set forth herein and to determine whether any order should be issued imposing remedial sanctions.

In anticipation of the institution of an administrative proceeding, Respondent has submitted an Offer of Settlement (“Offer”), which the Commission has determined to accept. Without admitting or denying any of the findings or conclusions herein, Respondent consents to the entry of this Order Instituting Proceedings Pursuant to Section 6(c) and 6(d) of the Commodity Exchange Act, Making Findings, and Imposing Remedial Sanctions (“Order”) and acknowledges service of this Order.¹

¹ Respondent consents to the entry of this Order and to the use of the findings of fact and conclusions of law in this Order and in any other proceeding brought by the Commission or to which the Commission is a party or claimant, and agrees that they shall be taken as true and correct and be given preclusive effect therein, without further proof. Respondent does not consent, however, to the use of this Order, or the findings or conclusions herein, as the sole basis for any other proceeding brought by the Commission or to which the Commission is a party or claimant, other than: a proceeding in bankruptcy or receivership; or a proceeding to enforce the terms of this Order. Respondent does not consent to the use of the Offer or this Order, or the findings or conclusions in this Order, by any other party in any other proceeding.

II. FINDINGS

The Commission finds the following:

A. Summary

The Commission granted KRX an exemption from registration as a derivatives clearing organization (“DCO”) in connection with its OTC derivatives clearing services on October 26, 2015. The Commission’s order² granting KRX the registration exemption (the “Exemptive Order”) required, among other things, that KRX must provide to the Commission, on an annual basis, within sixty days following the end of its fiscal year, a certification that it continues to observe, in all material respects the Principles for Financial Market Infrastructures (“PFMI”).³

The PFMI set standards for the operation of financial market infrastructures (“FMIs”) to foster financial stability and market transparency. Among other things, to limit systemic risk, PFMI Principle 4 sets a standard that a central counterparty (“CCP”), such as KRX, should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence.

Key Consideration 5 under PFMI Principle 4 sets a standard that a CCP should determine the amount and regularly test, on a daily basis, the sufficiency of its total financial resources available in the event of a default or multiple defaults in extreme but plausible market conditions through rigorous stress testing. The results of the daily stress testing should be used to evaluate the adequacy of the CCP’s financial resources and to adjust its total financial resources accordingly.

From 2016 through early 2018 (“relevant period”), KRX conducted required daily stress tests of its total financial resources, but failed to use these tests to evaluate the adequacy of and adjust its financial resources. By no later than October 2017, KRX knew that this failure was not consistent with its obligation under the Exemptive Order to observe the PFMI. KRX began considering remedial measures to correct its failures in October 2017, and changed its policies on December 18, 2017. However, KRX did not implement measures to remedy its failure until March 2018.

KRX sent a letter, dated February 19, 2018, to the Commission (the “February 19th Letter”), in which KRX’s President and Chief Executive Officer certified that as of December 31, 2017, KRX continued to observe the PFMIs in “all material respects” and “has complied with each of the terms and conditions stated in the Order of exemption from registration as a DCO as issued by the CFTC.” The February 19th Letter did not

² See *In re Petition of Korea Exch., Inc.*, Order of Exemption from Registration (Oct. 26, 2015), <https://www.cftc.gov/sites/default/files/idc/groups/public/@otherif/documents/ifdocs/krxdcoexemptorder10-26-15.pdf>.

³ See Bank of Int’l Settlements, Comm. on Payment & Settlement Sys. and Int’l Org. of Sec. Comms., Tech. Comm., Principles for Fin. Mkt. Infrastructures (Apr. 2012), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD377-PFMI.pdf>.

disclose either the failure to use the tests to evaluate the sufficiency of its total financial resources on a daily basis or the remedial efforts that were ongoing. By this certification to the Commission, KRX knowingly made statements of material facts which were false and misleading, or which KRX reasonably should have known were false and misleading, to the Commission, and omitted to state material facts necessary to make any statement of material fact not misleading, in violation of Section 6(c)(2) of the Act, 7 U.S.C. § 9(2) (2012).

B. Respondent

Korea Exchange Inc. (“KRX”), located in Busan, South Korea, operates the sole securities and derivatives exchanges in South Korea and provides clearing services for a variety of securities and exchange traded and over-the-counter derivative products. KRX started clearing South Korean Won interest rate swaps on March 3, 2014 and U.S. Dollar interest rate swaps on December 26, 2016 respectively. KRX was created through the integration of the Korea Stock Exchange, Korea Futures Exchange, and KOSDAQ Stock Market, under the Korea Stock and Futures Exchange Act. On October 26, 2015, the Commission granted KRX the Exemptive Order pursuant to Section 5b(h) of the Act, 7 U.S.C. § 7a-1(h) (2012). KRX is not registered in any capacity with the Commission.

C. Facts

Section 5b(h) of the Act permits the CFTC to conditionally or unconditionally exempt a clearinghouse from DCO registration for the clearing of swaps, if the clearinghouse is subject to “comparable, comprehensive supervision and regulation” by the Securities and Exchange Commission (“SEC”) or the appropriate government authorities in a foreign clearinghouse’s home country.

The Commission’s Exemptive Order required KRX to provide to the Commission, “on an annual basis, within 60 days following the end of its fiscal year,” a “certification that it continues to observe the PFMI in all material respects.”⁴ The PFMI set international standards for the design and operation of FMIs (such as CCPs) to enhance their safety and efficiency and more broadly, to limit systemic risk and foster transparency and financial stability. Korean authorities including KRX’s home country regulator, the Korean Financial Services Commission, have implemented a regulatory regime intended to incorporate the standards established in the PFMI.

To limit systemic risk, PFMI Principle 4 provides that a CCP such as KRX should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence. In particular, Principle 4 provides that such a CCP should maintain financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would potentially cause the largest aggregate credit exposure to the

⁴ See Exemptive Order at 4.

CCP in extreme but plausible market conditions.⁵ Pursuant to Key Consideration 5 of Principle 4, KRX should determine the amount and regularly test the sufficiency of its total financial resources through rigorous daily stress testing. The results of the daily stress testing are to be used to evaluate the adequacy of and adjust its total financial resources.

To observe the PFMI's financial resource coverage standards, KRX holds financial resources in its Joint Compensation Fund ("JCF") which KRX would evaluate and adjust periodically. However, while KRX conducted the requisite daily stress tests during the relevant period, it did not use the results of the tests to appropriately evaluate and adjust the funds in its JCF consistent with PFMI Principle 4.

KRX first suspected that its failure to use the results of the daily tests to adjust the funds in the JCF may not be consistent with PFMI Principle 4 in February 2017. By no later than October 2017, KRX confirmed this suspicion and understood that its practices were inconsistent with the PFMI. In December 2017, KRX changed its policies to be consistent with PFMI Principle 4, but did not implement changes to its practices until March 2018. KRX substantially implemented remedial measures by July 2018 to become consistent with PFMI Principle 4 and its Key Consideration 5.

By no later than October 2017, KRX knew that its failure to adjust its financial resources after conducting its daily stress tests was inconsistent with PFMI Principle 4. Despite this knowledge, KRX sent the February 19th Letter, in which its President and Chief Executive Officer certified that "[a]s of 31 December 2017, KRX continues to observe the PFMIs in all material respects" and "has complied with each of the terms and conditions stated in the Order of exemption from registration as a DCO as issued by the CFTC." By this certification to the Commission, KRX knowingly made statements of material facts which were false and misleading, or which KRX reasonably should have known were false and misleading, to the Commission, and omitted to state material facts necessary to make any statement of material fact not misleading, thereby violating Section 6(c)(2) of the Act.

III. LEGAL DISCUSSION

Section 6(c)(2) of the Act, 7 U.S.C. § 9(2) (2012), makes it unlawful:

for any person to make any false or misleading statement of a material fact to the Commission . . . including any report filed with the Commission under this Act, . . . or to omit to state in any such statement any material fact that is necessary to make any statement of a material fact made not misleading in any material

⁵ KRX is required by Korean law to meet a more demanding standard by maintaining a daily level of financial resources equal to the amount necessary to cover a scenario where the two of its members and their affiliates with the largest aggregate credit exposure fail to pay in extreme but plausible market conditions (the "cover 2" requirement).

respect, if the person knew, or reasonably should have known, the statement to be false or misleading.

To prove a cause of action under Section 6(c)(2) of the Act, the Commission must show that “a defendant (1) made a false or misleading statement or omission; (2) of material fact; (3) to the CFTC; (4) which he knew or reasonably should have known was false or misleading.” *CFTC v. Gramalegui*, No. 15-cv-02313, 2018 WL 4610953, at *23 (D. Colo. Sept. 26, 2018).

A statement is actionable under this Section when it is “either literally untrue or when it fails to include all information necessary to give the recipient a complete and accurate picture of the state of affairs communicated.” *Gramalegui*, 2018 WL 4610953, at *24. A statement or omission is material when it has “a natural tendency to influence, or [be] capable of influencing, the decision of the decision making body to which it was addressed.” *Id.* (quoting *United States v. Gaudin*, 515 U.S. 506, 509 (1995) (citation and internal quotation marks omitted)). When determining whether a defendant knew or should have known his statement was false or misleading, a defendant’s “history and background inform that determination, as do considerations of what a reasonable person would be expected to know in similar circumstances.” *Id.*

KRX knowingly made statements of material facts which were false and misleading, or which KRX reasonably should have known were false and misleading, to the Commission, and omitted to state material facts necessary to make any statement of material fact not misleading, by virtue of its February 19th Letter to the Commission certifying that “[a]s of 31 December 2017, KRX continues to observe the PFMI in material respects” and “has complied with each of the terms and conditions stated in the Order of exemption from registration as a DCO issued by the CFTC.” By no later than October 2017, KRX knew that its failure to adjust its financial resources after conducting its daily stress tests was inconsistent with its observance of PFMI Principle 4. KRX’s February 19th Letter, therefore, should have notified the Commission that throughout 2017, KRX failed to adjust its JCF in response to its daily stress tests contrary to PFMI Principle 4.

KRX’s misstatements and omissions in its February 19th Letter were material because the Commission granted KRX the registration exemption based on the understanding that KRX would comply with the terms and conditions set forth in the Exemptive Order, including the requirement that KRX must annually certify that it continues to observe the PFMI in all material respects. Whether KRX was complying with the PFMI in all material respects would “influence” the Commission’s decision to continue granting KRX a registration exemption.

IV. FINDINGS OF VIOLATION

Based on the foregoing, the Commission finds that Respondent violated Section 6(c)(2) of the Act, 7 U.S.C. § 9(2) (2012).

V. OFFER OF SETTLEMENT

Respondent has submitted the Offer in which it, without admitting or denying the findings of fact and conclusions of law herein:

- A. Acknowledges service of this Order;
- B. Admits the jurisdiction of the Commission with respect to all matters set forth in this Order and for any action or proceeding brought or authorized by the Commission based on violation of or enforcement of this Order;
- C. Waives:
 - 1. The filing and service of a complaint and notice of hearing;
 - 2. A hearing;
 - 3. All post-hearing procedures;
 - 4. Judicial review by any court;
 - 5. Any and all objections to the participation by any member of the Commission's staff in the Commission's consideration of this Offer;
 - 6. Any and all claims that it may possess under the Equal Access to Justice Act, 5 U.S.C. § 504 (2012) and 28 U.S.C. § 2412 (2012), and/or the rules promulgated by the Commission in conformity therewith, Part 148 of the Regulations, 17 C.F.R. pt. 148 (2018), relating to, or arising from, this proceeding;
 - 7. Any and all claims that it may possess under the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, tit. II, §§ 201-253, 110 Stat. 847, 857-74 (codified as amended at 28 U.S.C. § 2412 and in scattered sections of 5 U.S.C. and 15 U.S.C.), relating to, or arising from, this proceeding; and
 - 8. Any claims of Double Jeopardy based on the institution of this proceeding or the entry in this proceeding of any order imposing a civil monetary penalty or any other relief, including the Order;
- D. Stipulates that the record basis on which the Order is entered shall consist solely of the findings contained in the Order to which Respondent has consented in this Offer; and

E. Consents, solely on the basis of this Offer, to the Commission's entry of the Order in the form attached hereto that:

1. Makes findings by the Commission that Respondent violated Section 6(c)(2) the Act, 7 U.S.C. § 9(2) (2012);
2. Orders Respondent to cease and desist from violating Section 6(c)(2) the Act;
3. Orders Respondent to pay a civil monetary penalty in the amount of One Hundred-Fifty Thousand Dollars (\$150,000), plus post-judgment interest; and
4. Orders Respondent to comply with the conditions and undertakings consented to in the Offer and set forth below in Section VII of this Order.

Upon consideration, the Commission has determined to accept Respondent's Offer.

VI. ORDER

Accordingly, IT IS HEREBY ORDERED THAT:

- A. Respondent shall cease and desist from violating Section 6(c)(2) of the Act, 7 U.S.C. § 9(2) (2012).
- B. Respondent to pay a civil monetary penalty in the amount of \$150,000 ("CMP Obligation"), plus post-judgment interest, within ten days of the date of the entry of the Order. If the CMP Obligation is not paid in full within ten days of the date of entry of the Order, then post-judgment interest shall accrue on the CMP Obligation beginning on the date of entry of the Order and shall be determined by using the Treasury Bill rate prevailing on the date of entry of the Order pursuant to 28 U.S.C. § 1961 (2012).

Respondent shall pay the CMP Obligation and any post-judgment interest by electronic funds transfer, U.S. postal money order, certified check, bank cashier's check, or bank money order. If payment is to be made other than by electronic funds transfer, then the payment shall be made payable to the Commodity Futures Trading Commission and sent to the address below:

MMAC/ESC/AMK326
Commodity Futures Trading Commission
Division of Enforcement
6500 S. MacArthur Blvd.
HQ Room 181
Oklahoma City, OK 73169
(405) 954-6569 office
(405) 954-1620 fax
9-AMC-AR-CFTC@faa.gov

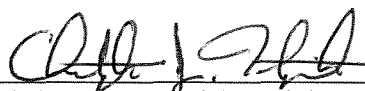
If payment is to be made by electronic funds transfer, Respondent shall contact Marie Thorne or her successor at the above address to receive payment instructions and shall fully comply with those instructions. Respondent shall accompany payment of the CMP Obligation with a cover letter that identifies the paying Respondent and the name and docket number of this proceeding. The paying Respondent shall simultaneously transmit copies of the cover letter and the form of payment to the Chief Financial Officer, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581; and

- C. Respondent shall comply with the following conditions and undertakings set forth in the Offer:
1. Public Statements: Respondent agrees that neither it nor any of its agents or employees under its authority or control shall take any action or make any public statement denying, directly or indirectly, any findings or conclusions in this Order or creating, or tending to create, the impression that this Order is without a factual basis; provided, however, that nothing in this provision shall affect Respondent's: (i) testimonial obligations; or (ii) right to take legal positions in other proceedings to which the Commission is not a party. Respondent shall undertake all steps necessary to ensure that all of its agents and/or employees under its authority or control understand and comply with this agreement.
 2. Undertakings: Respondent agrees to the following undertakings:
 - a. Respondent will engage the services of a qualified third party no later than sixty days after entry of the Order to comprehensively review Respondent's PFMI observance;
 - b. Within six months after retention, the third party referred to above will submit a written report in English providing its assessment of whether Respondent is observing the PFMI, to the CFTC, Division of Clearing and Risk, Attention Director of the Division of Clearing and Risk, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581;

- c. Two years after completion of its original written report, the third party will conduct a second review of Respondent, to assess the adequacy of Respondent's response to the PFMI issues identified in the original report; and
 - d. Within three months after beginning its second review, the third party will submit a written report in English, assessing the adequacy of Respondent's response to the PFMI issues identified in the original report, to the CFTC, Division of Clearing and Risk, Attention Director of the Division of Clearing and Risk, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.
- D. Cooperation with the Commission: Respondent shall cooperate fully and expeditiously with the Commission, including the Commission's Division of Enforcement, and any other governmental agency in this action, and in any investigation, civil litigation, or administrative matter related to the subject matter of this action or any current or future Commission investigation related thereto.
- E. Partial Satisfaction: Respondent understands and agrees that any acceptance by the Commission of partial payment of Respondent's CMP Obligation shall not be deemed a waiver of its obligation to make further payments pursuant to this Order, or a waiver of the Commission's right to seek to compel payment of any remaining balance.
- F. Change of Address/Phone: Until such time as Respondent satisfies in full its CMP Obligation as set forth in this Order, Respondent shall provide written notice to the Commission by certified mail of any change to its telephone number and mailing address within ten calendar days of the change.

The provisions of this Order shall be effective as of this date.

By the Commission.



Christopher J. Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission

Dated: July 12, 2019