Fostering Private Equity Using a Law-First Approach

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Abstract

In 2004, South Korean lawmakers introduced sweeping legislation to regulate Korean private equity. The regulatory approach can be best described as a law-first approach: the laws first clearly outline the terms of an ideal private equity structure, and then private equity managers and funds are required to comply with such terms as a condition to entry into the Korean private equity market. Elsewhere, private equity funds are sometimes referred to as shadow banks, with the descriptor "shadow" referring to the funds' ability to perform bank-like activities while remaining outside the regulatory purview. Several commentators, including the Bank of Korea, have criticized the Korean "law-first" regulatory approach as being heavy handed and imposing distortive barriers to entry. Instead, they suggest a migration to the United States' mode of regulation which they characterize as one where market metrics such as size, reputation, fees charged, and past performance regulate entry and exit from the market. In this Article, I argue that the law-first approach taken by Korean regulators was critical to the successful integration of a new product into the financial markets, and was a regulatory innovation that succeeded in bringing private equity funds from the shadow into the light. The Korean private equity example also shows how regulatory divergences can still result in market coherence, and the important role of financial and regulatory diffusion channels in achieving such coherence. As to the differences between the Korean regulatory approach and its foreign counterparts, I argue that they should be regarded not as aberrant behavior which must be conformed, but rather as an effort to push the envelope for private equity regulation which could serve as a useful benchmark for other jurisdictions.

Keywords

Korean private equity; private equity regulation; regulatory diffusion; regulatory innovation.

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I. Introduction

Private equity funds (PEFs) invest in the equity of companies that are not publicly-listed.[2] Using this strategy of investing in non-public equities, some private equity funds have been able to deliver spectacular returns to their investors.[3] Private equity is regarded as one of the largest, fastest-growing, and high-yielding asset classes in finance today.

The first appearance of private equity in South Korea (Korea) was Hambrecht & Quist (H&Q) Asia Pacific and Lombard Partners'1998 acquisition of Good Morning Securities, a South Korean financial services company.[4]

At this time, South Korea (Korea) had just experienced a financial crisis that was fueled by slowing exports and weakened confidence in the region.[5] The Korean government took a US$57 billion bailout package from the International Monetary Fund (IMF), World Bank (WB), Asian Development Bank (ADB), and certain IMF members.[6] The bailout package was accompanied by conditionalities, including raising the ceiling on aggregate foreign ownership in Korean equities from 26% to 55%.[7]

Foreign private equity firms were quick to capitalize on the opportunities created by the increased ceilings for foreign investment, which raised self-sufficiency concerns.[8] In addition, the IMF Crisis had also revealed the vulnerabilities of Korean firms, and Korean regulators saw *domestic* private equity as an appropriate vehicle to relieve some congestions in the Korean capital markets.[9] First of all, they viewed private equity as a way to pool and put to immediate use large amounts of capital that were held in reserve by domestic financial institutions at the time.[10] Second, private equity-led buyouts were seen as a promising avenue to privatize enterprises in which the

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[2] For a finance primer of private equity, see Josh Lerner and for a legal primer, see Levin & Rocap.

[3] Notably, the overall annual returns from private equity investment strategies for the Yale endowment fund was 30.6% from 1973 to 2006. RACHEL E.S. ZIEMBA & WILLIAM T. ZIEMBA, SCENARIOS FOR RISK MANAGEMENT AND GLOBAL INVESTMENT STRATEGIES 67 (John Wiley & Sons, Ltd. ed. 2007).

[4] Alex J. Stockham, *H&Q Asia Pacific Says Good-Bye to Good Morning in S. Korean Exit*, PRIVATEEQUITYCENTRAL.NET (April 9, 2002), http://www.hqap.com/PDF/news/H&Q%20Asia%20Pacific%20Says%20Good-Bye%20to%20Good%20Morning%20in%20S.%20Korean%20Exit.pdf.

[5] This crisis was preceded by remarkable growth (average annual real gross domestic product (GDP) growth rate of 10%) between 1962 and 1994. THE WORLD BANK, *Overview: Republic of Korea*, http://www.worldbank.org/en/country/korea/overview. For a comparative account of the 1997 Asian Financial Crisis and the 2007-2009 Global Financial Crisis, see KALLIDAIKURICHI SEETHARAM, A TALE OF TWO CRISES: A MULTIDISCIPLINARY ANALYSIS (Routledge 2013).

[6] Andrew Pollack, C*risis in South Korea: The Bailout; Package of Loans Worth $55 Billion is Set for Korea*, N.Y. TIMES (Dec. 4, 1997), http://www.nytimes.com/1997/12/04/business/crisis-south-korea-bailout-package-loans-worth-55-billion-set-for-korea.html; Sunghack Lim, *Foreign Capital Entry in the Domestic Banking Market of Korea: Bitter Medicine or Poison.* 39 KOREAN POLITICAL SCIENCE REVIEW __, (2005).

[7] Kunio Sanito, *Korea's Economic Adjustments under the IMF-Supported Program*, IMF (1998), https://www.imf.org/external/np/speeches/1998/012198a.pdf.

[8] Sohn (2008) (reporting that foreign private equity had invested more than US$6.6 billion in Korean firms).

[9] FSS PEF Handbook (2016) p. 10.

[10] FSS PEF Handbook (2016) p. 10. Contrast with U.S. approach that separates banks from private equity (Volcker Rule). But see February 3, 2017 Trump Executive Order.

government had taken controlling stakes.[11] Third, private equity was also seen as a way to execute ongoing governmental efforts to vitalize smaller and mid-size companies.[12] Fourth, private equity was seen a viable contender to diffuse some of the capital and power that had been concentrated in large Korean conglomerates (*chaebols*).[13] Lastly, as the size of the Korean national pension fund grew, there was a large demand for investment opportunities to meet the demands of these funds.[14]

Against this backdrop, in December of 2003, Korean lawmakers announced the planned implementation of new laws to launch and regulate a domestic private equity market. The Indirect Investment Management Business Act became effective on December 6, 2004, and on February 4, 2009, was folded into the Financial Investment Services and Capital Markets Act ("FSCMA").[15]

One notable feature of the Korean approach to regulating private equity was that regulators took a "law-first" approach.[16] The laws clearly outline the terms of an ideal private equity structure, and then require private equity managers and funds to comply with such terms as a condition to entry into the Korean private equity market. Korean regulators have the power to regulate not only entry, but also force exits, require extensive disclosure requirements as well as places detailed limits on the scope of permissible activities of private equity funds and managers.[17]

Several commentators, including the Bank of Korea, criticized the Korean regulatory approach as heavy handed and imposing distortive barriers to entry.[18] Instead, they suggest a migration to the United States' mode of private equity oversight which they characterize as one where market metrics such as size, reputation, fees charged, and past performance regulate entry and exit from

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[11] FSS PEF Handbook (2016) p. 10.

[12] "Private equity" is used here broadly to include both buyout and venture capital. Buyout refers to using high levels of borrowed money (leverage) and introducing substantial changes to management.

[13] FSS PEF Handbook (2016) p. 10.

[14] FSS PEF Handbook (2016) p. 10. OECD study of pension funds reports that (p.10) retirement systems (i.e., pension funds and public pension reserve funds) in the OECD held USD 30.2T in assets in 2014. Compare that to the combined GDP of OECD countries of $48.8T in that same year. Points to the growing role of retirement systems in the financial markets as sources of long-term capital. The OECD (p.11) expects this trend of accumulation of large reserves in pension funds to continue, particularly in emerging markets. Especially countries with mandatory pension systems and those where private pensions are relatively small. (p.12) And in this low-yield environment, global institutional investors are engaged in excessive search for yield, such as through private equity investments. OECD Business and Finance Outlook 2015.

[15] The provisions regulating private equity funds and managers are contained in the FSCMA as of the date of this writing.

[16] Law precedes the market. Cf. U.S. private equity is a good example of a market-first approach where private equity grew in the shadows of regulation. John Steele Gordon in "An Empire of Wealth: The Epic History of American Economic Power" explains that private equity firms entered the picture in 1930s specifically to fill gap created by bank regulations (Glass-Steagall Act, passed in 1933) which prevented merchant banks from being both a depository bank and investment bank (i.e., the Glass-Steagall Wall, as it is referred to, which came down in 1999). John Steele Gordon, A Short (Sometimes Profitable) History of Private Equity, The Wall Street Journal, Jan 17 2012.

[17] See Part II.

[18] 강정미 (Bank of Korea), 사모투자펀드 (PEF)의 현황과 과제.

market, with regulations reaching private equity funds only to the extent of their systemic risk implications.[19]

In this Article, I argue that the law-first approach taken by Korean regulators was critical to the successful integration of private equity firms and funds into the Korean financial markets. In doing so, I introduce the concept of phase-based regulation, which is that the *phase* of regulation, rather than the specific features of the product being regulated, is the most important determinant of regulatory strategy, particularly during the introductory (shaping) phases. If so, comparing the Korean regulation of first phase private equity with the U.S. regulation of later phase private equity is an incorrect comparative frame, and this comparison will necessarily overweight the differences between the two regimes.

In addition to the theoretical argument, I also present empirical evidence to show that the chilling effect of the law first approach that was feared by critics did not materialize. In 2010, Korean private equity funds had 20.3 trillion Korean Won (KRW) (US$20 billion equivalent) of funds under management, which represents a 200% growth in a less than 2 year period (compared to 10.5 trillion KRW in 2008).[20] This is particularly impressive when contrasted with the downward global trend in private equity where private equity fundraising has continuously declined, reverting to 2004 levels in 2010.[21]

Yet in 2015, the Korean Financial Supervisory Services (FSS) reformed private equity regulation in response to and to appease critics.[22] To the extent these criticisms take the Korean and U.S. approaches to regulating private equity at their face value without regard to the phase of the respective private equity markets, I argue that the recent Korean reforms may have gone too far.

This account of Korean private equity regulation is an apt example of what Paul Mahoney calls crisis-driven regulation, which refers to the phenomenon where as regulators move further and further away from the crisis that triggered reform, some of the controls, urgency and need for legitimacy start to breakdown.[23] This Article cautions against repeating of these past mistakes and makes suggestions for the next phase of private equity regulation in Korea and elsewhere.

Part II describes the legislative background, regulatory pillars, regulatory mechanics and the criticisms of Korean private equity regulation. Part III introduces the concept of phase-based regulation to guide the selection of the correct comparative framework. Using this framework, I compare Korean private equity regulations to another example of first phase regulation in the U.S. to demonstrate the similarities between the U.S. and Korean approaches. Part IV presents data to show that the chilling effect of Korean private equity regulation that was feared by critics has not materialized. In fact, Korea private equity has advanced to a level which makes it comparable and

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[19] 강정미 (Bank of Korea), 사모투자펀드 (PEF)의 현황과 과제.

[20] The Korea Times (2013)

[21] BAIN & COMPANY, GLOBAL PRIVATE EQUITY REPORT (2011), http://www.bain.com/Images/2011-02-24%20REPORT%20Global%20Private%20Equity%20report%202011%20-%20MEDIA.pdf.

[22] See Part II.d.

[23] PAUL MAHONEY, WASTING A CRISIS: WHY SECURITIES REGULATION FAILS (University of Chicago 2015).

indistinguishable from its foreign counterparts. Part V credits the role of financial and regulatory diffusion channels in allowing Korean private equity to achieve such market coherence even against the backdrop of a divergent regulatory scheme. Some differences which remain between Korean and other private equity markets are examined more closely to make suggestions for the next phase of private equity regulation in Korea and elsewhere.

II. Korean Private Equity Regulation

a. Legislative Background

The main impetus for Korean private equity regulation was two-fold. First, was the urgent need for a domestic counterweight to the foreign funds that were active in the domestic buyout markets.[24] Second, there was a need for a new regulatory regime and definition of private equity which could efficiently and effectively untangle some persisting challenges in the Korean capital markets that were exposed during the 1997 Asian Financial Crisis.[25]

The 1997 Asian Financial Crisis is known to many Koreans as the IMF Crisis in reference the US$57 billion bail-out package that was orchestrated by the IMF (contributing $21 billion), with the World Bank ($10 billion), Asian Development Bank ($4 billion) and certain IMF members contributing the balance.[26] In addition to repayment, the bailout package required structural changes to reform the region's banking system, improve corporate governance, break-up monopolies, and remove trade barriers.[27]

In this connection, Korea raised its ceiling on aggregate foreign ownership in Korean equities from 26% to 55%, and foreign private equity firms were quick to capitalize on these capital market liberalizations.[28] The first appearance of foreign private equity funds in the Korean takeover markets was Hambrecht & Quist (H&Q) Asia Pacific and Lombard Partners'1998 acquisition of Good Morning Securities, a South Korean financial services company.[29] The eventual sale of Good

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[24] Korean regulators' focus on private equity was helped by public sentiment and media reports of foreign capitalists abruptly exiting from their investments for short term gains without regard to the negative externalities to the Korean economy. E-Today News (2014), 이투데이 뉴스, 2014.5.20 작년 9조7천억 '실탄' 유입…M&A의 꽃이 되다. For an account of how the media shapes perceptions in financial crises see, Thomas Oberlechner, How the Media Shapes Perceptions and Fuels Psychology in Financial Crises, in KALLIDAIKURICHI SEETHARAM, A TALE OF TWO CRISES: A MULTIDISCIPLINARY ANALYSIS 106-120 (Routledge 2013)

[25] Park (2005), p.45

[26] Sanja Samirana Pattnayak and Alka Chadha, Tacking Financial Crises in Asia, in KALLIDAIKURICHI SEETHARAM, A TALE OF TWO CRISES: A MULTIDISCIPLINARY ANALYSIS 78 (Routledge 2013) (discussing the IMF, WB, and ADB bailout of Asian countries)

[27] Sanja Samirana Pattnayak and Alka Chadha, Tacking Financial Crises in Asia, in KALLIDAIKURICHI SEETHARAM, A TALE OF TWO CRISES: A MULTIDISCIPLINARY ANALYSIS 78 (Routledge 2013) (discussing the IMF, WB, and ADB bailout of Asian countries). The IMF's package of conditionalities have been criticized for failing to "take account of specific conditions in the affected country" and prescribing same "one size fits all" conditions across the board. Id at 87.

[28] Kunio Sanito, *Korea's Economic Adjustments under the IMF-Supported Program*, IMF (1998), https://www.imf.org/external/np/speeches/1998/012198a.pdf.

[29] Alex J. Stockham, *H&Q Asia Pacific Says Good-Bye to Good Morning in S. Korean Exit*, PRIVATEEQUITYCENTRAL.NET (April 9, 2002), http://www.hqap.com/PDF/news/H&Q%20Asia%20Pacific%20Says%20Good-

Morning Securities to Shinhan Financial Group resulted in the private equity funds realizing proceeds of $200 million on a $30 million initial investment.[30] While this is entirely consistent with the private equity model, the magnitude and timing of gains, together with the foreign private equity funds' repatriation of the profits through offshore channels to avoid paying Korean taxes,[31] led to these private equity managers being caricatured as vultures by the Korean media.[32]

Around the same time, other foreign private equity funds like Carlyle, Newbridge Capital and Lone Star were also active in the Korean takeover markets and acquired controlling stakes in household name firms, including banks, that were in desperate need of liquidity following the IMF Crisis.[33] During the five-year period between 1998 and 2003, foreign private equity is estimated to have invested more than US$6.6 billion in Korean firms.[34] This influx raised concerns that excessive reliance on foreign private equity could create a funding gap for Korean firms if such capital were to, consistent with the private equity model of ownership, abruptly and simultaneously exit to realize short term gains.[35]

In addition, the IMF Crisis had also revealed the deficiencies of Korean firms, and Korean regulators saw private equity as an appropriate vehicle to relieve some congestions in the Korean capital markets.[36] The main triggers of the 1997 Asian Financial Crisis were three-fold: the first was maturity risk for financial institutions as a result of heavy reliance on financial institutions by big conglomerates (chaebols); the second was currency mismatch risk as a result of Korean financial institutions borrowing in foreign currency but supplying credit in domestic currency; and the third were the power dynamics and political struggles among the state, big business, and non-bank financial institutions.[37]

It was hoped that private equity could pool and put to immediate use large amounts of capital that were held in reserve by domestic financial institutions at the time. Second, private equity-led

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Bye%20to%20Good%20Morning%20in%20S.%20Korean%20Exit.pdf.

[30] Alex J. Stockham, *H&Q Asia Pacific Says Good-Bye to Good Morning in S. Korean Exit*, PRIVATEEQUITYCENTRAL.NET (April 9, 2002), http://www.hqap.com/PDF/news/H&Q%20Asia%20Pacific%20Says%20Good-Bye%20to%20Good%20Morning%20in%20S.%20Korean%20Exit.pdf.

[31] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 589 (2013) ("When foreign funds sold these assets at high margins and repatriated the profits through offshore money channels without paying any Korean tax, there was a virulent domestic backlash").

[32] E-Today News (2014), 이투데이 뉴스, 2014.5.20 작년 9조7천억 '실탄' 유입…M&A의 꽃이 되다 ("외국계 PE가 자금 회수 과정에서 '먹튀' 논란을 빚자 국내에서 PE에 대한 인식은 '기업 사냥꾼', '투기자본'으로 전락했다."). Cf. LOMBARD, *FinanceAsia Achievement Awards 2002 - Deals of the year* (Dec. 17, 2002), http://www.lombardinvestments.com/media/media_20021217.shtml.

[33] E-Today News (2014)

[34] Sohn (2008)

[35] PE Short-termism. Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 581 (2013) ("the stinging backlash against foreign private equity funds in the wake of the Asian financial crisis is precisely the reason why domestically-managed funds have emerged as a more politically acceptable business form in this region.").

[36] FSS PEF Handbook (2016) p. 10

[37] Kurtulus Gemici, Social Origins of Financial Crises, in KALLIDAIKURICHI SEETHARAM, A TALE OF TWO CRISES: A MULTIDISCIPLINARY ANALYSIS 31 (Routledge 2013) (discussing the three factors that lead to the 1997 Asian Financial Crisis).

buyouts were also viewed as a promising avenue to privatize enterprises in which the government had taken controlling stakes. Third, private equity was also seen as a channel to bolster ongoing governmental efforts to vitalize smaller and mid-size companies. Fourth, private equity was seen a viable contender to diffuse some of the capital and power that had been concentrated in large Korean conglomerates (*chaebols*). Lastly, as pension funds grew, there was a demand for larger and longer term investment opportunities to meet the demands of these funds, and it was expected that private equity could fill this gap.[38]

For all of the foregoing reasons, there was a general consensus that Korean-label private equity would be beneficial to the domestic economy, not only as a counterweight to the growing presence of foreign investors in the South Korean takeover markets but also for long-term growth and prosperity for the Korean economy.

Against this backdrop, in December of 2003, Korean lawmakers announced the planned implementation of new laws to create a domestic private equity market. On December 6, 2004, the Korean private equity market was launched by the Indirect Investment Management Business Act, which is as of February 4, 2009 contained in the Financial Investment Services and Capital Markets Act ("FSCMA").

b. Regulatory Pillars

The Korean private equity regulatory strategy is one that can be described as a "law first" approach. It is the law, rather than markets, that set the metes and bounds of private equity funds in Korea. The necessity for law to move first was prompted by the then existing legal and regulatory framework which had foreclosed the opportunity for private equity firms to raise capital in South Korea.

While the attempt by Korean regulators to introduce a separate set of laws governing private equity funds may seem suppressive at first glance, a closer look at the then existing securities laws in Korea show that legal reforms were necessary to facilitate the growth of the private equity markets. Expansively drafted laws which formerly treated publicly and privately subscribed funds identically had created unintentional barriers to private equity fund formation.

The four steering principles (pillars) for designing the Korean private equity regulatory regime were[39]:

> (1) setting private equity standards that were not inconsistent with global standards;
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> (2) seeking industry feedback to ensure that the resulting structure would effectively facilitate the desired outcome of increasing takeover activity by private equity funds;
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> (3) clearly defining the regulatory standards for private equity; and

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[38] FSS PEF Handbook (2016) p. 10
[39] Park (2005), p.56

(4) minimizing the number of legal amendments needed and avoiding need for additional legal amendments in the future.

As demonstrated by the first principle, Korean regulators had decided from the outset that setting private equity standards that were not inconsistent with global standards would be a regulatory priority. In this connection, Korean regulators modeled private equity regulations based on the organizational structure of and contracts used by foreign private equity funds and relied on professionals with foreign private equity experience as advisers.[40]

As demonstrated by the second principle, the Korean private equity regulatory process was a collaborative effort which brought together practitioners, lawyers, academics, and researchers. These discussions sought feedback from industry and civic groups, including foreign fund operators. These efforts had the goal of maximizing industry and public buy-in at the outset, and regulators attempted to increase public understanding and support of its private equity vision by organizing and participating in debates hosted by interest groups and civic organizations.[41]

Connected to the third principle, the law outlines the terms of the desired private equity structure, and the participants, as a condition to entry into the Korean private equity market, must conform to such terms. It was this law-first approach of the Korean private equity regulatory strategy that was most heavily criticized[42].

Consistent with the fourth principle, Korean private equity regulation has taken a firm hand. There is a dedicated Private Equity Fund (PEF) team within the Financial Supervisory Service (FSS) that is under the oversight of the Financial Services Commission (FSC).

Also, the primary reason for relying on amendments, as opposed to new legislation, was for procedural efficiency considerations, to save time and ensuring that all funds would be regulated under one set of laws.[43]

c. Summary of Regulations

Below, I summarize the specific sections of the Financial Investment Services and Capital Markets Act ("FSCMA") which gives Korean regulators power to supervise, examine and shape private equity partners and funds.

A private equity fund is defined under FSCMA Article 269[44] as a fund that pools the capital of 49 or fewer investors for private equity investment purposes. This section also places restrictions on investment amounts (not to exceed 10 billion KRW per limited partner) and term of the private equity fund (15 years).[45] Private equity funds that satisfy the definition and wish to be treated as

[40] Part V.c.
[41] Park (2005), pp.46-48
[42] Part V.d.
[43] Park (2005), p.52
[44] FSCMA 269.
[45] FSCMA. Note that there are no similar regulatory limits on number of investors and ceilings on investments in U.S. case.

such, are required to register with the FSS PEF team within two weeks of incorporation.[46]

Each registration application was initially (later amended to a registration only regime in 2015[47]) subject to the review and approval by the FSS PEF team. Under this initial regime, the FSS PEF team had 30 days upon receipt of any private equity fund's registration application to make a decision and notify the applicant of the result and reasons therefor in writing and without delay. There are three grounds on which the FSS PEF team could reject a private equity funds registration application: first, if the applicant fails to meet the technical requirements for registration set forth in the Act; second, if the registration application contains false information; and third, if the applicant fails to comply with the FSC's requests for corrections. [48]

In addition, the FSS PEF team has the unilateral authority to terminate private equity funds. The FSS has the power to revoke the registration of the executive partner[49] of a private equity fund if the executive partner falls under a range of specified circumstances, including registrations made falsely or in an otherwise fraudulent manner or in cases where it is deemed likely that investors' interests will be seriously undermined.[50]

With respect to the fund itself, the FSCMA sets forth the conditions under which the FSS may revoke the private equity fund's registration.[51] They include registrations made falsely or in otherwise fraudulent manner, if the fund is dissolved, or where there is a possibility that investors' interests will be seriously undermined or if it is deemed that it is difficult for the fund to continue its existence.[52]

There are a variety of enforcement mechanisms that are available to the FSS if it decides to proceed against any partner or fund that falls within the circumstances described in the preceding paragraphs. With respect to the fund, the FSS PEF team has powers to issue a suspension, an order to transfer contracts, an order to correct or discontinue a violation, an order to provide public notice or disclosure of the violation, or a series of warnings and cautions. [53] With respect to the partner, the FSS PEF team may demand a dismissal, suspend the partners' duties, require salary reductions, issue reprimands, or issue a series of warnings and cautions. [54]

Once partners have paid in their contributions, the fund has six months to invest 50% or more of the contributed amounts in accordance with the methods set forth in the statute. [55] So not only are funds limited in what they can do (negative covenants), they are also required to do certain things up to a certain amount by a certain time (affirmative obligations). There are some exceptions in cases where the private equity fund can demonstrate difficulty in selecting an investable

[46] FSCMA 269.

[47] Private equity regulatory reforms were introduced on July 24, 2015 and implemented on October 25, 2015.

[48] FSCMA 268.

[49] The standard private equity structure is created by an investment manager/sponsor (sometimes referred to as an 'executive partner' in Korean private equity regulation) who solicits investors in the private equity fund to make investments in a portfolio of companies.

[50] Cf. U.S. investor protections which are targeted to unsophisticated investors (Ralston Purina).

[51] FSCMA 278.

[52] FSCMA 272-2.

[53] FSCMA 272-2.

[54] FSCMA 272-2.

[55] FSCMA 270.

enterprise, all subject to prior approval of the FSS PEF team.[56] Any exception from such guidelines must be reviewed and approved by the FSS PEF team or specifically carved out by the FSS PEF team.[57]

One example of such carveout is the 2009 amendment of FSCMA which relaxed certain restrictions on private equity activity, but only for funds specifically targeting smaller size companies and capital structure improvements. While private equity funds have some flexibility to manage the surplus fund left over after making an investment, the law requires that any such method of management must have no possibility of undermining the soundness in asset management of the private equity fund.[58]

Some permitted uses of the surplus include short-term loans, deposits in financial institutions, or investment in securities not to exceed 5% of the property of the private equity fund, in each case, as prescribed by Presidential Decree.[59]

Even with respect to any remainder, the private equity fund is restricted to investing in property that is specified in the statute, which includes exchange-traded derivatives or over-the-counter derivatives for avoiding risks in investment in securities issued by an investable enterprise, securities issued by a company specializing in investment and financing for social infrastructure, and other investments as may be prescribed further by Presidential Decree.[60]

Regulators also targeted the short term nature of private equity investments through activity and investment restrictions. The law specifies and restricts both the nature and length of private equity investments. For example, the FSCMA requires private equity firms to hold at least 10% of the equity securities issued by a portfolio company for at least six months, subject to two exceptions.[61] First, if the private equity fund fails to obtain 10% or de facto control within six months after it initially acquires equity securities of another company, it shall transfer all equity securities to another person, and shall report it to the FSS PEF team without delay.[62] Second, the private equity fund may dispose of such securities within the six month window if it is clearly foreseen that partners' interests will likely be undermined by holding the equity securities continuously, subject to prior approval of the FSS PEF team.[63] At least 50% of the private equity fund must be used for this type of investment activity within two years of formation.[64]

The FSCMA also imposes strict disclosures and fiduciary duties upon private equity funds. Article 272 of the FSCMA imposes a duty of good faith on each executive partner and specifically prohibits the executive partner from trading with the private equity fund, or furnishing the details of assets owned by the private equity fund to any person other than the partners for the benefit of

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[56] FSCMA 270.

[57] FSCMA 270(1) & (3).

[58] Emphasis added. FSCMA 270. Some of these restrictions were further relaxed in 2015 as described later in this Part.

[59] FSCMA 270(2).

[60] FSCMA 270(9).

[61] FSCMA 270(6).

[62] FSCMA 270(6).

[63] FSCMA 270(6).

[64] FSCMA 270(6).

some of the partners or a third party, in each case without the consent of all partners. [65] To verify compliance, each private equity fund must establish and report working rules of conduct to the FSS PEF team. [66] Upon review, the FSS PEF team has the power to order an amendment or correction to the provisions of the working rules of conduct if the FSS PEF team determines there is a possibility that partners' interests may be undermined.[67] The FSS PEF team is to separately maintain a register of private equity funds which shall be publicly disclosed on its website. [68]

To further counter general partners' moral hazard and known tendencies to use confidential information acquired in connection with the operation of the private equity firms for their private benefit at the expense of limited partners who had contributed funds, the laws require the delivery by general partners of periodic reports regarding private equity operation and assets to limited partners. [69] Such reports are to be accompanied by an explanation of the status of management and property, and the frequency of such reports are to be prescribed by Presidential Decree. [70] Further, the limited partners are given the ability to review the books and records of the private equity fund as well as any special purpose company in which the private equity fund invests. [71] Such right to inspect can go beyond the books and records of the company and reach the business affairs of the private equity fund upon approval of the FSS PEF team, if an executive partner has been incompetent or has violated his or her duties as an executive partner. [72]

d. Criticisms of Korean Private Equity Regulations

In 2006, a Bank of Korea report criticized the regulation of private equity funds in Korea and suggested a migration to the U.S. mode of regulation which it characterized as one where reputation, fees and track record regulates entry and exit from market.[73]

The main objection to Korean private equity regulation has been that heavy handed regulation could chill investments, discourage innovation and stall long-term growth. Another point of resistance has been that regulating private equity to require disclosures goes against its essence which is that ownership is secret. There is also the view that private equity firms will always find ways to engage in regulatory arbitrage, and this inevitable exploitation of regulatory loopholes will render the laws moot.

The National Assembly Research Service in its April 2014 publication explained that Korea's "relatively tougher regulations" have prevented the Korean private equity markets from reaching their fullest potential.[74] One year later, the Korea Capital Market Institute's May 2015 report set

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[65] FSCMA 272.
[66] FSCMA 272.
[67] Emphasis added. FSCMA 272.
[68] FSCMA 272.
[69] FSCMA 272.
[70] FSCMA 272.
[71] FSCMA 272.
[72] FSCMA 272.
[73] Kang (2006), p.25
[74] 김기홍 & 원종현, 이슈와 논점, 사모펀 활성화 대책의 주요 내용과 시사점 (2014. 4. 18) 국회입법조사처 발간 등록 번호 31-9735024-000624-14.

out an agenda for reform.[75] The Report pushes for lighter regulation of private equity funds which they say is consistent with foreign approaches.[76] Critical of barriers to entry and onerous registration standards, the Report suggests a shift from current safety and soundness based regulation to more operational risk focused regulation.[77]

III. Selecting the Proper Comparative Frame

The critics or Korean private equity regulation are correct to say that the Korean approach takes a much heavier hand than U.S. private equity regulation.[78] Indeed, Korea was the first country to require private equity funds to disclosure their assets, liabilities and transactions to a regulatory authority. But is U.S. private equity regulation the proper benchmark for Korean private equity regulation? I introduce here the concept of phase-based regulation to suggest that the better comparative frames for Korean private equity regulation is the U.S. business development company (BDC) regime. These two regulatory regimes share the same regulatory goal of introducing a new financial product into the financial markets (what I will sometimes refer to as "first phase regulation"). When looking through these frames, there are more overlaps between Korean and U.S. approaches than suggested by critics.

a. The Financial Innovation Spiral and Phase-Based Regulation

Financial products have a life cycle. Scholars studying financial innovations have generalized this phenomenon and termed it the 'financial-innovation spiral,' to describe the process by which financial products that are initially offered by established intermediaries migrate to markets once they have been seasoned by going through the information provision and standardization benefits provided by financial intermediaries.[79]

This spiraling effect has been observed across diverse areas of the financial markets, notably and recently in the derivatives markets.[80] Derivatives were initially traded on an organized exchange (where contracts tend to be standardized, fungible, limited, transparent and regulated) and then overwhelmingly over-the-counter (where contracts tend to be private, customized, opaque, with high levels of innovation and low levels of regulatory oversight).[81]

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[75] 박용린, 천창민, 안유미. 자본시장연구원, 글로벌 금융규제 흐름과 우리나라 금융규제개혁의 바람직한 방향. 2015.5 [2015 KCMI Report]; This is an update to Korea Capital Market Institute 2012 report outlines five areas, which includes private equity, that should be deregulated. 해외 선진 PEF의 운영현황과 시사점 –바이아웃(buyout)을 중심으로 – November 2012.

[76] 2015 KCMI Report, pp. xviii-xix.

[77] 2015 KCMI Report, pp. xix.

[78] Part III.b.

[79] See, e.g., See also Robert C. Merton, Operation and Regulation in Financial Intermediation: A Functional Perspective in PETER ENGLUND, ED., OPERATION AND REGULATION OF FINANCIAL MARKETS, 17, 29-30 (1993) [citing Finnerty, J.D. (1988), "Financial Engineering in Corporate Finance: An Overview," Financial Management, 17 (Winter): 14-33].

[80] FCIC Report, supra note 10, at 46-58.

[81] See, e.g., Bruce G. Carruthers, Diverging Derivatives: Law, Governance and Modern Financial Markets, J. COMPARATIVE ECON. 41 (2013) 386-400.

The concept of phase based regulation rests on the simple claim that even the same product should be subject to different regimes based on the stage where it is at on the financial innovation spiral. If evaluated through this lens, Korean regulation whose goal was to introduce private equity into markets is not at all different from the experience of U.S. regulators when the goal has been to introduce new products in to the markets.

b. Comparisons to U.S. Private Equity Regulation

What are special concerns that prompt financial regulation in the United States? Howell Jackson in his 1999 essay explains that the most important policy considerations in the field of financial regulation concerns the control of risks.[82] He goes on to describe the two primary justifications for regulation as first, the "inability of public investors to negotiate appropriate safeguards on their own behalf" and second, the "negative externalities associated with financial losses and institutional failures.[83]

When it comes to private equity, the widely accepted view has been that neither of these justifications for regulation apply. Private equity had burgeoned in the shadows of regulation, and private equity as it had developed, raised funds from sophisticated and wealthy individuals.[84] It was generally understood that these shadow entities fell outside of the publicly-funded safety net (FDIC and discount windows) otherwise available to traditional financial institutions, and that the distribution of costs and benefits of private equity were internalized.[85]

And in the absence of regulation, the shadow was able to grow to impressive, unprecedented levels. Many observers linked the absence of legal and regulatory interference as a necessary condition to such growth, and any efforts to regulate were met with arguments that it would kill innovation and prosperity. Instead, the main concern of regulators were to limit the systemic impact of private equity and other funds rather than to subject them to microprudential regulations.

Unlike the U.S. experience, Korean regulators were faced with a very different task. Korean regulators had to design laws to cultivate a domestic private equity market that was not yet in existence, and in fact one of stated aspirations of Korean regulators was to do better by addressing some of the moral hazards that had seeped into the global private equity industry. Given this background, the critiques of Korean private equity regulation solely based on its departure from U.S. standards, and the related calls to converge Korean PE regulation with US PE regulation, must be viewed with some skepticism.

c. Comparisons to U.S. First Phase Financial Regulation

[82] Howell E. Jackson, Regulation in a Multisectored Financial Services Industry, 77 WASH. U. L. Q. 319, 321 (1999).

[83] Howell E. Jackson, Regulation in a Multisectored Financial Services Industry, 77 WASH. U. L. Q. 319, 321 (1999).

[84] Cf. Today more private equity is publicly-listed. See Kim, A Typology of Publicly-Listed Private Equity (forthcoming 2017).

[85] Cf. Notably, the hedge fund Long Term Capital Management's failure in 1998 was met with bailout by banks orchestrated by the U.S. government.

Phase-based regulation suggests that comparing the first chapter of Korean private equity regulation with the last chapter of U.S. private equity regulation is thus not the correct comparative frame. Instead, we should compare Korean private equity regulation against other examples where regulatory aim is to foster growth in market. The claim I make here is that the phase of product should be the major determinant of the regulatory strategy that is taken, particularly at the first phase. The business development company (BDC) regulatory regime is one such example.

Congress enacted the Small Business Investment Incentive Act ("SBIIA") in 1980 to establish a new investment vehicle called a business development company (BDC).[86] The intended purpose of the SBIIA was to create a new type of investment vehicle that could promote the flow of capital to small, developing, and financially troubled companies which may not otherwise have access to conventional sources and the public capital markets.[87] Consistent with this purpose, a BDC is limited in the types of assets which it can invest in, as further explained below. And in turn, companies that satisfy the definition of a business development company are exempt from many of the regulatory constraints of the Investment Company Act of 1940 (the "ICA").[88] Notably, BDCs are able to operate with greater flexibility when it comes to dealing with their portfolio companies, issuing securities, and compensation, etc., compared to other investment companies.[89]

U.S. BDC regulation is similar to the Korea private equity regulatory regime in terms of its origins, motivations and scope. The following paragraphs compare the Korean and U.S. approach to private equity/BDC regulation across key dimensions, with an assessment of whether the Korean approach is similar, more restrictive or less restrictive (from the perspective of the private equity manager; and if more restrictive, a note about the competing rationale (if any)), compared to its U.S. counterpart:

Korean PE regulation	**US BDC Regulation**	**Assessment**
	Definition setting	
Limited 15 year term. Maximum 49 investors. Minimum contribution amount of each investor not to exceed 10 billion KRW.	None	More restrictive

[86] Senate. Rep. No. 96-958 accompanying S. 2990 (1980) ("The Committee is well aware of the slowing of the flow of capital to American enterprise, particularly to smaller, growing businesses, that has occurred in recent years. ... the need to reverse this downward trend is of compelling public concern").

[87] Public Law 96-477 (Oct. 21, 1980). In addition to the primary goal of facilitating the formation of capital for small, developing and troubled businesses that lacked access to public capital markets another benefit of BDCs has been that it has expanded the opportunity to invest in private equity and venture capital to public markets. While BDCs are not required to be a public company, the majority of BDCs raise capital from the public markets (i.e., it is listed and traded on a stock exchange). 1-12 Regulation of Investment Companies §12.01 ("A publicly offering BDC allows and adviser to raise quickly substantial capital for the strategy and to expand its potential audience beyond the traditional private fund high net worth and institutional audience.").

[88] Investment Company Act of 1940 regulates companies that engage primarily in investing, and requires these companies to register with and be regulated as an investment company by the SEC unless they fall under an exemption.

[89] See Sections 54 to 65 of the ICA.

Gatekeeping: Regulating Entry and Exit		
FSS shall make an entry of necessary matters in the register of private equity funds, and shall provide public notice of the contents of its decision through its Internet homepage, etc.	BDCs that are publicly-listed are subject to the periodic reporting requirements of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)), available through SEC's Edgar	Comparable
Activity Restrictions and Eligible Investments		
Removal of restrictions on investment activities for avoiding risks, investments that are used to finance social infrastructure and other methods so long as there is "no possibility of undermining the soundness in asset management of the private equity fund." 50% or more of the amount contributed must be managed by the methods set forth in paragraph (1) 1, 2, 5, 6 of Article 270 within six months from the day on which partners pay their contributions. PEF to continue to hold equity securities issued by an invested enterprise for six months or longer and shall not dispose of such equity securities within such period.	Expanded to address the impact of the Federal Reserve Board's 1998 amendments of the definition of eligible portfolio company under the Securities Exchange Act of 1934 (While a move in the right direction, note that it took the SEC 8-10 years to update the ICA rules to correct the unintended consequences of the FRB amendment.)[90]	Less restrictive (more investments are eligible) but more temporal restrictions (regulation specifies time periods by which certain investment must be made.)

The BDC regime can be seen as a regulatory endorsement of the private equity model of ownership. And when comparing the two regulatory regimes which have a shared regulatory objective of introducing new investment vehicle into markets, the U.S. and Korean approach to regulating private equity are not as distant as has been characterized by the latter's critics.

IV. Assessing the Chilling Effects of Law-First Approach

One of the main concerns of critics to the Korean private equity regulation was that the heavy hand of regulators would chill the markets. How can a product be regulated without extinguishing

[90] See Section 2(a)(46) of ICA for full definition

the product, and without allowing an escape hatch? This is a universal concern for financial regulators. Howell Jackson in his 1999 essay explains that "private actors will try to organize their affairs to be governed by lower-cost regulatory structures." [91] Indeed Professor Romano has pointed to this persistent tendency of private actors to engage in regulatory arbitrage as the biggest takeaway from comparative corporate legal scholarship.[92] In this Part, I look at the empirical data to evaluate the concerns that the law-first approach of Korean private equity regulation would chill the markets.

a. Early struggles

One feature of private equity is the significant presence of the sponsor (or key person). Often, a private equity firm is associated with one or few individuals and their track record. Blackstone's CEO has commented that "you find it is just twenty, thirty or fifty people worldwide who ultimately drive the industry or sector"[93] For this reason it is challenging to create a private equity market from scratch.

The first Korean private equity fund was established in December 2004 by Woori Bank (totaling 210 billion KRW in investments), but was prematurely terminated in October 2005 due to inexperience and inability to set investment targets.[94]

Like the Woori Bank fund, many other first generation Korean private equity funds suffered from the lack of a track record which created distrust between the managers and investors of the private equity funds and also made it difficult for investors to evaluate and compare different private equity opportunities.[95]

Eventually, to overcome these initial limitations and hurdles, Korean private equity funds relied upon the expertise, brand, and resources of financial institutions until they were able to build their standalone track-record.[96]

As the Korean private equity market matured, the investor base which was initially predominantly institutional (80.4% in 2005) shifted towards individual investors (with 56.3% of private equity fund investments being sourced from institutional investors in 2010).[97]

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[91] Howell E. Jackson, Regulation in a Multisectored Financial Services Industry, 77 WASH. U. L. Q. 319, 321 (1999).

[92] Roberta Romano, A Cautionary Note on Drawing Lessons from Comparative Corporate Law, 102 Yale L.J. 2021, 2029 (1993) ("A more useful way of characterizing the connection between politics and organizational form, particularly in the contractual context of business firms, is to recognize that private parties are persistent in devising institutions that circumvent, or at least minimize, political constraints on economic activity."). and also on p.2037 ("The most useful way to think about the relation between politics and economic organization, however, is to recognize that private praties are persistent in devising institutions that circumvent, or minimize the effect of, political constraints on economic activity. This is, in my opinion, the principal lesson to be learned from doing comparative corporate law.")

[93] Rothkopf, Superclass: The Global Power Elite and the World They are Making 45 (2008).

[94] Kang (2006)

[95] Sohn (2008), p. 36

[96] FSS (2011), p.14

[97] FSS (2011), p.14

b. Establishment

The number of domestic private equity funds grew from 15 in 2005 to 189 by 2011; and these funds have invested US$64 billion in the Korean markets since 2005. 70 of 85 private equity investments completed in 2011 were by domestic private equity funds (total value of deals over US$22 billion). By these measures, Korea was the 6th largest private equity market internationally.[98]

In 2012, there were 237 registered private equity funds with a total of $40 billion under management. This represents a 25% increase from the prior year.[99] And in 2013, Korean private equity funds had 42 trillion KRW of funds under management, which represents a 140 times growth in 10 years.[100] This is particularly impressive, when contrasted with the global trend in private equity where private equity fundraising has continuously declined, falling to 2004 levels in 2010.[101] As of December 2015, there were a total of 316 registered PEF, with total KRW58.5 trillion under management and KRW38.4 trillion called.[102]

Korean private equity has been successful, when measured against its initial goals. Domestic homegrown PE emerging as leaders on M&A scoreboard[103]. There is increased specialization by PEF based on property management strategy (buyout versus VC versus project-based) or industry (utility, IT, etc.). The number of portfolio companies increased to 139 in 2013. Targets of PEF investment are primarily domestic manufacturing companies. In 2010, of 263 targets, 238 were domestic firms, 25 foreign firms. [104] Korean PEF invested in a total of 140 companies in 2015 – manufacturing (100 companies) most heavily represented and also invested in foreign portfolio companies (about 10% of total invested amount). [105]

As stated at the outset, the impetus for regulation was to foster a Korean-label private equity that would be beneficial to the domestic economy, primarily as a counterweight to the growing presence of foreign investors in the South Korean takeover markets. And as a share of corporate financing, M&A and GDP within the Korean economy, private equity has succeeded in gaining significant ground since 2005.[106]

c. Signs of a Mature Market

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[98] Private Equity Growth Capital Council, Geographic Dispersion of Private Equity Investment in 2011 (2012)) (citing to Bain 2012, p.7).

[99] Kong (2014)

[100] The Korea Times (2013)

[101] Bain & Company (2011)

[102] FSS PEF Handbook (2016) p. 15. See also FSS Press Release dated April 25, 2016 (제목: '15년 PEF 동향 및 시사점). http://www.fss.or.kr

[103] 이투데이 뉴스, 2014.5.20 작년 9조7천억 '실탄' 유입…M&A의 꽃이 되다 ("국내 토종 PE들이 M&A시장에서 강자로 등극하고…")

[104] 금융위원회, 보도자료, PEF 제도도입 6년의 평가와 향후과제 (2011. 6. 7)

[105] FSS Press Release dated April 25, 2016 (제목: '15년 PEF 동향 및 시사점). http://www.fss.or.kr.

[106] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 593 (2013).

Notable in the Korean market is the active participation of repeat players. The rate of sponsors with prior private equity fund formation and operation experience who establish new funds has steadily increased from 51.4% in 2009 to 91.1% in 2013. The Financial Supervisory Service (FSS) explains that this trend is driven by institutional funds that make their investment decision based predominantly on the expertise of executive partner of the private equity fund.[107] Mandated disclosures about private equity funds' performance and investors that are publicly available have been credited as facilitating this decision-making process.

Second, the growth of blind pool (as opposed to deal-based) private equity suggest that the level of trust between the managers and investors of private equity funds have improved.[108]

Third, domestic homegrown private equity funds have emerged as leaders in the buyout and distressed markets.[109] The success of Doosan group where incumbent management was able to maintain control while securing 630 billion KRW of liquidity from Korean private equity firms was widely publicized.[110]

Other well-known examples include the private equity fund formed in 2011 by UAMCO and 7 banks which has purchased up to $2.3 billion of bad debts, the KBD Turnaround Fund formed in 2009 by Korea Development Bank (KDB) (the largest government-owned bank in Korea) to facilitate government-led restructurings and the state-run Kamco (Korea Asset Management Corp.) which is also in the business of buying up bad loans.[111]

In addition, Korean private equity firms have gained a foothold on the global private equity stage. Korean PE are actively investing in foreign firms. This trend was helped by the National Pension Service' (NPS) Corporate Partnership program under which NPS contributes to a PEF which then jointly invests (1:1) alongside a Korean corporation in overseas investments.

As a general matter, Korean pension funds and sovereign wealth funds have increasingly become interested in private equity. Korea's National Pension Service (NPS), with KRW519.7 trillion (USD449.6 billion) in assets, has been active in the selection of private equity funds to run venture capital investments (defined to be small, early-stage, emerging firms that are deemed to have high growth). Previously the NPS had appointed four private equity managers to run KRW700 billion of its funds.[112]

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[107] FSS (2014), pp.2 and 5

[108] A blind pool has no stated investment goal for the funds that are raised from investors. Instead, in a blind pool, money is raised from investors, usually trading on the name of a particular individual or firm, relying heavily on reputation and track record (Investopedia).

[109] E-Today News (2014)

[110] Sohn (2008), p.37

[111] http://www.bloomberg.com/news/2011-06-03/uamco-plans-ipo-by-2013-as-korean-buyer-of-bad-loans-sees-market-expanding.html

[112] Korean System Eyes VC Managers. Global Money Management. 7/25/2016, p1-1. 1p. http://web.b.ebscohost.com/ehost/detail/detail?sid=d8da7d48-b3cc-4eff-8831-e98efe7ef757%40sessionmgr120&vid=0&hid=129&bdata=JnNpdGU9ZWhvc3QtbGl2ZQ%3d%3d#AN=116992350&db=bth

Korea's Government Employees Pension Service (GEPS), with assets in excess of $6.6 billion, hired four domestic private equity and venture capital managers in November 2016. These are IMM Private Equity (account worth KRW 30 billion), VIG Partners (KRW 30 billion), AJU IB Investment (KRW15 billion) and one other undisclosed manager (KRW15 billion), each based in Seoul. GEPS selects managers using open mandates (solicited in Korean language). The fund has further announced that it looking for a combined KRW60 billion in two Korean conventional private equity mandates and a combined KRW30 billion in two Korean venture capital briefs. [113]

Korean private equity has developed its own innovations,[114] introducing a new program where individual investors with KRW 5,000,000 can invest in private equity funds. Announced by the Financial Services Commission (FSC) in May 29, 2016, FSC is working to revise regulations to permit a publicly-offered fund which invests into private equity funds.

V. Regulatory Divergence and Market Coherence

A comparison of Korean and U.S. private equity regulation shows that even divergent regulatory schemes can lead to market coherence. An examination of the early, establishment and maturity phases of the Korean private equity experience highlights the important role of financial and regulatory agents in achieving such market coherence.

Since the time of Alan Watson's influential writings on legal transplants to explain the diffusion of legal models in the colonial period,[115] new theories about diffusion in the post-colonial period have emerged. But any normative argument in favor of diffusion must be reasoned by first choosing the correct benchmark and then designing the proper channels to achieve the desired regulatory results. Part III discussed the choice of comparative framework; in this Part of the paper, I examine the choice of diffusion channels. Here, I rely on the work of Justin Robertson and Holger Spamann on financial returnees and contemporary legal transplants, respectively, to explain the patterns of financial and regulatory diffusion in Korean private equity.

a. Background

Korean private equity regulation can be seen as an attempt to legally engineer a regulatory ideal of private equity. Korean private equity regulation was both practical (emphasis on procedural efficiency) and principled (specifically identifies trouble areas and attempts to nip them in bud to achieve regulatory ideal) attempt at legal engineering.[116]

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[113]Korean Government Fund Seeks Domestic PE Managers. Global Money Management. 10/17/2016, p1-1. 1p. http://web.b.ebscohost.com/ehost/detail/detail?sid=dd06dd7c-a423-4d4d-8c4c-7694e5a97675%40sessionmgr120&vid=0&hid=129&bdata=JnNpdGU9ZWhvc3QtbGl2ZQ%3d%3d#AN=118859568&db=bth

[114] http://www.bizwatch.co.kr/pages/view.php?uid=23369

[115] Alan Watson, Legal Transplants: An Approach to Comparative Law (1993). For a survey of debate and the literature on diffusion (legal transplants) in comparative law see, Spamann (2009 BYU paper, Part III). Spamann explains choices which may explain how the transplanted versus original laws diverge even though originate from same. In doing so, reviews theories from comparative law, sociology, political science and economics which can explain why diffusion occurs, its importance, and how and to what extent it occurs through legal families (civil versus common law). Note Korea's position as hybrid (civil yet common law) jurisdiction.

[116] FSS PEF Handbook (2016) p. 16

Korea undoubtedly had the benefit of moving later. A clean regulatory slate meant lawmakers could set a regulatory ideal and then design laws to achieve that ideal. A regulatory ideal for private equity was determined by looking at the success and failures of foreign private equity. The goal was to maximize productive private equity activity while keeping private equity's known tendencies of moral hazards under control.[117]

Korean regulators took this opportunity to correct malpractices of private equity firms such as short termism and moral hazard by creating a system that values long-term ownership by private equity. The regulatory strategy taken indicates a clear intent to build a strict, consistent, rule-based framework for private equity regulation. And under a consolidated regulatory regime where a single supervisor had the power to approve and disqualify private equity, Korean regulators were free from turf wars.

The main concern was that general partners of private equity funds would use the confidential information acquired in connection with the operation of the private equity fund for their private benefit. This explains why law clearly regulates the actions of general partners (e.g. requiring periodic reports regarding private equity operation and assets to limited partners, and ability of limited partners to review the books and records of the PEF) and requires general partners by law to abide by such regulations. The biggest difference and one could say innovation of the Korean regime was that Korean regulators made all private equity registrant information publicly available, and was the first country to require this level of disclosure from private equity funds.[118]

And yet, the manner in which Korean private equity conducts its business, reforms executive pay and uses high leverage bears striking similarities to, and makes Korean private equity indistinguishable from, foreign (namely, U.S.) private equity.[119]

b. Financial Returnees

Justin Robertson identifies "financial returnees" as the transmission channel (key intermediary) for financial processes originating in Anglo-American markets.[120] His account aims to supplement the existing accounts of the Korean economy which he views as too narrowly focused on

[117] 박정훈, 사모투자전문회사 (Private Equity Fund), 도입배경 및 경과 (BFL 제 10호, 2005.3), p.51. For example, to resolve issues around the question of how (level) to regulate special investment vehicles (SIV, 투자목적회사), answer was to set only baseline standards which would allow PEFs to use SIV but focused on closing loopholes which would allow P-E to use SIVs to avoid legal restrictions which otherwise apply to PEFs. Park notes that setting rules to curb general partners' moral hazard was a special area of concern for policymakers.

[118] Where can you find

[119] Justin Robertson, Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds, 18 New Political Economy 579, 597 (2013) ("While Korean private equity manifests differences to the US model – with far fewer layoffs for example – the similarities in areas such as conducting majority control investments, installing new managers at increased pay levels, drawing on high levels of debt, foreign fundraising, lower capital gains taxation and the use of international tax havens are striking.").

[120] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579 (2013).

examining only the role of the state. [121] Financial returnees refer to elites returning to domestic finance after spending significant time in global finance. [122]

Robertson credits financial returnees for the impressive growth of the Korean domestic private equity sector. In particular, financial returnees are responsible for bringing about changes that are consistent with the Anglo-American model of capitalism.[123] While small in number, they have disproportionate impact on the economic direction of markets. 3 out of 4 of the partners and directors of MBK Partners, the largest Korean private equity firm, have received an American education and have worked for a US investment bank or PE fund.[124]

Robertson's ideas goes against the work of other scholars[125] that point to interests of local elites as contrary to global business.[126] Indeed, this resistance to foreign influence was what fueled the growth of the Korea private equity market. Why "financial returnees" are a special case can be explained by their hybridity.[127] Their greatest strengths are their ability to introduce the American way of doing private equity (their sponsoring or country) in a manner that is sensitive to local and cultural sensitivities of Korea (their home country).

This hybridity has allowed for more innovations in the Korean private equity markets. For example, unlike U.S. private equity firms that are not shy about flaunting their profits, Korean private equity has been much more low-profile, at the risk of offending regulators or the public.[128] These agents coupled with receptive posture of Korea government has helped to grow a market that is in line with foreign norms and trends while remaining compliant with cultural and regulatory norms of humility and strict disclosure.

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[121] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 583 (2013) – citing to e.g. Pirie, The Korean Developmental State: From Dirigism to Neo-Liberalism (2007) and Weiss, Guiding Globalisation in East Asia: New Roles for Old Developmental States, in L. Weiss ed., States in the Global Economy (2003).

[122] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 580 (2013).

[123] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 580 (2013).

[124] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 587 (2013).

[125] Gilson, Hansmann & Pargendler citing Olson (1982) "resistance of established economic and political elite to growth-promoting reforms"

[126] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 581 (2013). Citing to the work of Sklair, The Transnational Capitalist Class 91 (2001).

[127] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 581 (2013) ("Financial returnees are strategically situated at the intersection of the global and the national and confronting domestic structures that are proving surprisingly open to their efforts to construct private equity industries.")

[128] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 595 (2013).

Robertson credits financial returnees for creating a favorable impression of the U.S. mode of regulation among Korean regulators, courts[129], and banks.[130] This has helped to fill some noted gaps in Korean corporate governance[131] as well as motivate a movement away from a chaebol-dominated economy.[132]

The concern is that financial returnees may be so effective so as to erode the initial bounds set by the Korean private equity regulatory mandate. Many have pointed to how financial liberalizations championed by chaebols who were credited with achieving the remarkable transformation of the Korean financial economy as later catalyzing Korea's vulnerabilities during the 1997 Asian Financial Crisis.[133]

c. Regulatory Returnees

A separate project of Holger Spamann's looks at the background of the legal and regulatory agents.[134] Spamann examines data on countries' treatises and law reform projects, activities of legal cooperation and development aid organizations and student migration to confirm legal family ties and outlines possible channels of diffusion within legal families. [135]

Spamann refers to evidence of visible foreign influence (citations, involvement of foreign trained lawyers, evidence of copying of statutes) as formal diffusion. Then he examines the specific channels of diffusion, such as legal development and cooperation agencies, trade and investment flows, and student migration, which he refers to as substantive diffusion. This distinction helps shed light on tricky cases where one country follows a foreign model without explicit acknowledgement of the foreign influence versus one country that has a totally autonomously developed project which uses foreign model as technical simplicity or even decoy.[136]

The explanation that Spamann offers is that when there is an opportunity to change laws one of the sources that the country looks to for guidance is the other members of its legal family and

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[129] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 591 (2013) (citing to Korean court ruling that labor unions do not have grounds to sue private equity funds for debts placed on portfolio companies as further opening out he buyout model in Korea).

[130] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 591 (2013) ("Korean banks have since become active participants in leveraged finance and treat loans to the private equity industry as a profitable business line.").

[131] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 592 (2013).

[132] Justin Robertson, *Financial Returnees as New Agents in East Asia: The Case of Korean Private Equity Funds*, 18 New Political Economy 579, 581 (2013) and also 593 ("While it is reasonable to think that chaebol institutions might have assumed a dominant position in the private equity industry, no such outcome has materialized. Independent, returnee-led private equity firms currently sit unchallenged at the top of this sector.").

[133] See e.g., Kurtulus Gemici, Social Origins of Financial Crises, in KALLIDAIKURICHI SEETHARAM, A TALE OF TWO CRISES: A MULTIDISCIPLINARY ANALYSIS 37 (Routledge 2013) (explaining the South Korean economic crisis)

[134] Holger Spamann, Contemporary Legal Transplants – Legal Families and the Diffusion of (Corporate) Law, BYU Law Review (2009).

[135] Holger Spamann, Contemporary Legal Transplants – Legal Families and the Diffusion of (Corporate) Law, BYU Law Review (2009).

[136] Spamann, p.37.

that is the explanation for policy similarities that emerge across "civil law" versus "common law" lines.

In the Korean case, because there was no regulatory precedent to rely on, Korean lawmakers and regulators looked to the markets, and in particular the U.S. and U.K. examples, to determine the appropriate scope and method of regulation. Drafting a special set of rules to apply to private equity when no such framework existed elsewhere created both challenges and opportunities for Korean regulators. The clean slate allowed lawmakers to set a regulatory ideal and then design laws and tailor their application to achieve that ideal. Korean regulators took cues from the then leading foreign private equity firms to set the bounds of private equity regulation. Korean lawmakers carefully studied the limited partnership agreements of foreign private equity firms to determine which aspects of the prevailing private equity practice needed to be written into laws.

The Korean case is consistent with Spamann's account which sustains that it is not some inherent features of "civil law" versus "common law" traditions but rather the diffusion channel that explains the convergence. This is why for example, Korea is able to maintain a hybrid status between civil and common law status. While technically a civil law jurisdiction, it is treated like a common law jurisdiction according to the members of its legal family and the countries that it cooperates with and looks to for guidance. As network expands, the usual boundaries between common and civil law jurisdictions become less meaningful, and what matters are the internal and structural attributes of each legal system.

d. Next Phase of Korean Private Equity Regulation

While market coherence is observed, some differences remain. To evaluate concerns that capital will flee to a laxer regime, we need to pay attention to the specific ways in which a private equity fund can do more elsewhere that it cannot do in Korea due to a more restrictive regime. Are those restrictions sustainable or is there a reasoned basis for their reconsideration? And on the flipside, what can Korean private funds do that U.S. or other funds can't do? In this last subpart I examine some of the notable intended and unintended differences between the Korean private equity market and its foreign counterparts.[137]

Some differences are by design. In addition to looking to the successes, avoiding or mitigating the reported shortcomings of foreign private equity firms was another regulatory priority of South Korean regulators. Such shortcomings included moral hazard, short termism and investor abuse. In particular, curbing the moral hazard of the general partners of private equity firms was a special area of concern for policymakers.[138] The creation of a more far-sighted and stable private equity

[137] Mark Roe in his work noting the differences in corporate structure in Germany and Japan from that of the United States acknowledges how legal and institutional differences across nations make it difficult to say that one structure is more superior than the other and even if that were the case, could be successfully transplanted to another. Mark J. Roe, Some Differences in Corporate Structure in Germany, Japan, and the United States, 102 Yale L.J. 1927. Echoed by Romano in her critique of *Some Differences*: Roberta Romano, A Cautionary Note on Drawing Lessons from Comparative Corporate Law, 102 Yale L.J. 2021, 2030 (1993) (highlighting limitations of projecting impact of U.S. law reform from the experience of other countries that stem from differences in the political process among countries)

[138] Park notes that setting rules to curb general partners' moral hazard was a special area of concern for

market was an important goal for private equity regulations, even at the cost of more micro-managerial regulation. As I explained in Part III.c. some of the temporal restrictions accompanying activity restrictions should be reconsidered as Korean private equity moves on to later phases of the financial innovation spiral.

Also Korean private equity regulation has pushed the envelope in countering the moral hazard of private equity managers and providing increased protections to private equity investors. In some ways the Korean regulatory example shows the way as other jurisdictions consider and introduce new safeguards to apply lessons learned from recent 2007-2009 financial crisis.

Korean regulators have designed rules specifically aimed at combatting short termism and speculative behavior and other pernicious behavior of PEFs. Notably, there is a statutorily imposed and non-waivable duty of good faith and requirement of unanimous consent for related party transactions and disclosures of details of assets owned by the private equity fund to outsiders.[139] Furthermore, regulators require private equity managers to maintain and submit to them separate working rules of conduct. In the U.S., such matters are decided as specified in the organizational documents (freedom of contract and state imposed limits). While the Korean approach is intended to police the actions of general partners (by requiring periodic reports regarding private equity operation and assets to limited partners, and ability of limited partners to review the books and records of the private equity firm), the Korean regulations could actually go further by specifying how conflicts of interest are defined and addressed.

One important way in which Korea is less restrictive is in the area of bank-private equity interactions. In the U.S., the Volcker Rule (Section 619 of Dodd-Frank Act)[140] restricts commercial banking organizations' relationships with PEF (and hedge funds) and from certain

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policymakers. Park (2005), p.51. For example, to resolve issues around the question of how to regulate special investment vehicles (SIV), answer was to set only baseline standards which would allow PEFs to use SIV but focused on closing loopholes which would allow PE to use SIVs to avoid legal restrictions which otherwise apply to PEFs. The main concern is that general partners would use the confidential information acquired in connection with the operation of the PEF for their private benefit.

[139] Article 272 of the FSCMA imposes a duty of good faith on each executive partner and specifically prohibits the executive partner from trading with the private equity fund, or furnishing the details of assets owned by the private equity fund to any person other than the partners for the benefit of some of the partners or a third party, in each case without the consent of all partners. To verify compliance, Article 272 requires each private equity fund to establish and report working rules of conduct to the FSS PEF team. Upon review, the FSS PEF team has the power to order an amendment or correction to the provisions of the working rules of conduct if the FSS PEF team determines there is a possibility that partners' interests may be undermined. The FSS PEF team is to separately maintain a register of private equity funds which shall be publicly disclosed on its website.

To further counter general partners' moral hazard and known tendencies to use confidential information acquired in connection with the operation of the private equity firms for their private benefit at the expense of limited partners who had contributed funds, the laws require the delivery by general partners of periodic reports regarding private equity operation and assets to limited partners. Such reports are to be accompanied by an explanation of the status of management and property, and the frequency of such reports are to be prescribed by Presidential Decree. Further, the limited partners are given the ability to review the books and records of the private equity fund as well as any special purpose company in which the private equity fund invests. Such right to inspect can go beyond the books and records of the company and reach the business affairs of the private equity fund upon approval of the FSS PEF team, if an executive partner has been incompetent or has violated his or her duties as an executive partner. (FSCMA Article 272)

[140] [Discuss impact of Trump executive order on Volcker and DFA.]

proprietary and more speculative activities.[141] The Volcker Rule stems from the U.S. focus on regulating the systemic risks of private equity investments and potential harmful effect of private equity exposure on banks' safety and soundness.[142] In Korea, bank-private equity interactions are not only expressly permitted (e.g., FSCMA 269(7): "The Korea Development Bank and the Industrial Bank of Korea may make a contribution to a private equity fund to the extent that it conforms to the purpose of its establishment"), but has been the driver of private equity's success.

This brings us back to the concept of the financial innovation spiral that was introduced in Part III.a. Early Korean private equity relied on the expertise, brand, resources and financial backing of financial institutions. With a decade of past performance to support them, Korean private equity funds have migrated to the next phase where they can rely on their standalone track records and build new partnerships with individual and institutional investors at home and abroad.[143]

Conclusion

This Article pinpoints some of the theoretical and empirical limitations of the criticism of Korea's law first approach to regulating private equity. A careful inventory of the Korean experience, which was the first attempt to regulate private equity using a law-first approach, allows us to evaluate more recent efforts to reform private equity regulation.

My assessment of the Korean regulatory experience is that it was successful overall, especially when measured against the initially stated goals of such regulation. I review the criticisms about the Korean approach and provide theoretical and empirical evidence to show that concerns about market distortion and chilling effect of over-regulation have been overstated.

While there are some areas of Korean private equity regulation that would benefit from reassessment, the regulatory maneuvers used by Korean regulators are for the most part aligned with (and in some aspects more permissive than) first-phase regulation in the United States using BDC regulation as the benchmark. And the few areas where Korea takes a heavier hand, notably in furtherance of investor protections which are explicitly made available to sophisticated investors, the Korean outcome is an innovation that other jurisdictions can take cues from.

In the U.S. and elsewhere, private equity had long been treated as outside the scope of prudential regulation ad sophisticated investors as those who do not need protection. The latter proposition has been weakened by repeated investment foibles by these investors, including the widely reported Orange County bankruptcy, Madoff Ponzi scheme, and losses from the recent 2007-09 global financial crises. The Korean regulatory experiment provides a direct challenge to the idea that private equity cannot be effectively regulated, or that any attempt to regulate will be thwarted by private actors' efforts to reorganize themselves and exploit regulatory loopholes. And while a large part of Korea's success is attributable to the unique legal, regulatory political and

[141] The Volcker Rule restricts commercial banking organizations from certain proprietary ("of or relating to an owner or ownership") and speculative activities. Banking entity shall not engage in proprietary trading.

[142] Korean regulators did specifically consider in 2004 whether bank (especially government-run banks like KDB and Industrial Bank of Korea (IBK))/pension fund involvement should be restricted by law but decided to permit such overlaps and instead rely on bank/pension regulators and the market to oversee related systemic risks.

[143] FSS (2011), p.14

market conditions that were present at the time, this regulatory experiment shows one way to effectively execute private equity regulation when conditions are ripe.