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# Recent Trends and Regulations on Private Equity Funds in Korea

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## 1. Introduction

Private equity funds in Korea are heavily regulated even though they do not raise investment funds through public offering. In this paper, we examine recent trend in private equity funds in Korea and their features from regulatory perspectives. We also explore future policy direction to help Korean financial market achieve greater efficiency and stability.

## 2. Private Equity Funds in Korea

### 2.1. Private equity fund (PEF)

Private equity has a very broad and vaguely defined territory in financial nomenclature. We do not have the universally accepted definition for it. We consider two distinguished definitions of private equity fund on practical basis. The first definition focuses the way fund is raised and it is useful in legal and regulatory purposes. We call the first approach as definition of private equity fund from legal perspective. The second definition emphasizes the objects of investment private equity funds pursue and it is useful in understanding the investment behavior of private equity funds. We call the second approach as definition from economic perspective.

Under the definition from legal perspective, private equity fund refers to fund that is raised through private placement instead of public offering and covers all forms of indirect investment vehicles other than the ones raised though public offering[3]. Therefore, one can include into private equity funds various forms of investment vehicles such as venture capital fund, buyout fund, distress fund (vulture fund) and hedge fund.

Private equity funds are generally exempt from various regulatory restrictions imposed on the traditional collective investment vehicles to protect the investors from agency problem. For example, traditional instruments for indirect investment such as mutual funds or unit investment trusts are required to register at regulatory authority and to periodically reveal portfolio positions. Moreover, private equity funds are largely free from those complicated registration and disclosure regulations and have the flexibility in legal relationship between fund managers and investors as well as investment activities. They are free to pursue whatever investment strategies they may think serve for their investment objectives. They can buy and sell whatever assets or financial instruments they want to, trade any kind of "new" financial product such as structured derivative, engage in unrestricted short-selling, hold concentrated positions an any security without restriction, set redemption policies without restriction, and can adopt fee structure and compensation structure for management of the funds as long

[3] Mutual fund and unit investment trust are the examples of investment vehicle whose funds are raised through public offerings.

as that is acceptable to their investors. However, it is needless to say that private equity funds are not free from “all” kinds of regulations. Unless exemption is not granted in a explicit manner by law they are subject to general principles of laws regulating security markets and corporations.

The rationale behind the *laissez-faire* approach to regulation of private equity funds is simple. Investors responding to contract solicitation of private equity funds can be presumed to voluntarily choose not to enjoy the privilege of legal and regulatory protection offered to all investors. Respecting the explicit intention of investors, public authority steps aside and monitoring of private equity funds are relegated to investors. In economic context, agency problem is not regarded as a serious enough problem to call for public intervention in case of investment on private equity funds since able investors are assumed to exercise proper amount of monitoring efforts to balance the benefit of lowered agency problem and the cost of more intensive monitoring. Private equity funds should satisfy qualifications required by law or regulation to be exempted from the restrictions and duties imposed on indirect investment vehicles[4]

The alternative definition of private equity fund focuses on the “private equitiness” of investment target and investment style rather than the way fund is raised. Private equity fund is defined as an investment vehicle specializes in investing on equities of non-listed companies rather than listed companies whose securities are traded in a formal exchange. The definition does not belittle the importance of fund raising. A more accurate description would be that private equity fund refers to any type of investment fund that has raised its fund through private placement outside the public securities market and primarily targets at investing in equities of private companies.

Under this definition, private equity is considered to be a subcategory of “alternative” investments in contrast to “traditional” investments such as bonds and stocks of listed companies. Therefore, alternative investments include virtually all sorts of investments other than traditional investments. Bance (2003) offers a handy and clear classification of alternative investments into four categories; private equity funds, hedge funds, real estate investments and others.

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[4] Two most popular qualifications are restriction on the number of participating investors (100 in US and 30 in Korea) and the ability of participating investors (so-called qualified purchaser clause).

<Table 1> Classification of alternative investments

| Classification | Types |
|---|---|
| private equity funds | venture capital funds<br>buyout funds<br>mezzanine funds<br>special situation (distressed) funds |
| hedge funds | global macro funds<br>arbitrage funds<br>long/short equity funds<br>event driven funds<br>others (emerging markets, fund of hedge funds, quantitative) |
| real estate investments | office, commercial properties, residential properties, REITs etc. |
| others | commodities, currency, interest rate etc |

Source: Bance(2003)

## 2.2. PEF vs. hedge fund

The classification in <Table 1> excludes various types of hedge funds from private equity funds. Sharing many common features with private equity funds, hedge funs tend to invest in traditional securities traded in public market rather than in alternative investments.

Other than main investment instruments, there are two distinctive differences between PEFs and hedge funds; time horizon of investment, and liquidity of portfolio. Although we cannot exclude some exceptions to the general pattern, private equity funds are long-term investors and hedge funds are short-term traders[5]. Both strategies have the potential for large return but investment principles and skills sets are different. It is very difficult to find an exceptionally talented manager to excel in both areas. Therefore, investors, in general, regard them as two different financial products and

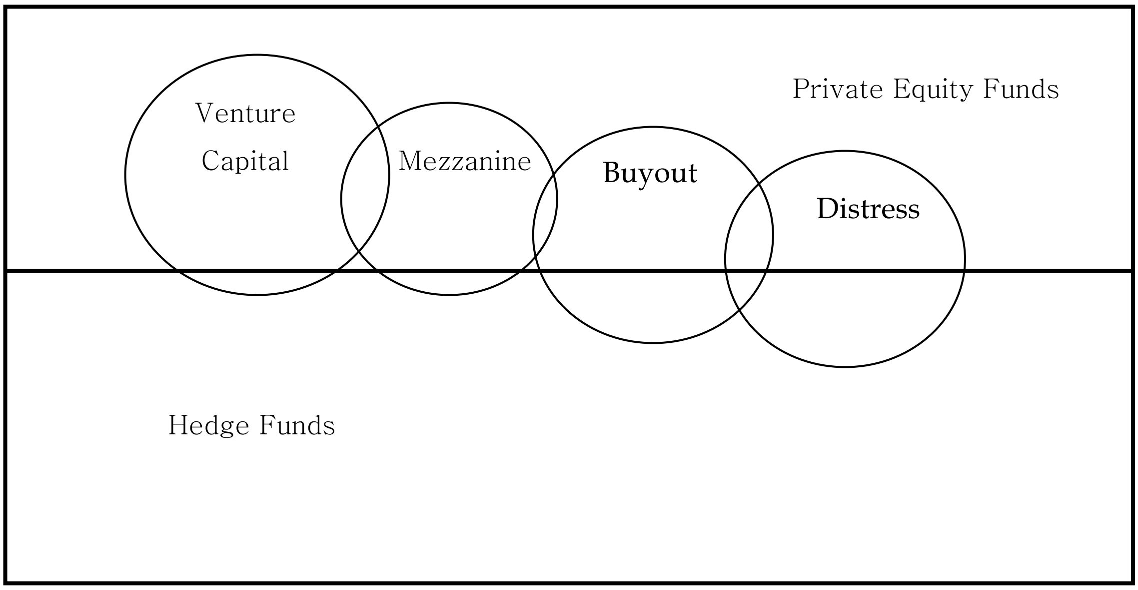
[3] The distinction becomes clear when we take a hedge fund pursuing arbitrage strategy. An arbitrage fund takes the strategy to pursue large return by taking advantage of small, sometimes miniscule, mis-pricings. Therefore, it is a very active trader in the market and willing to engage even in day trading depending on market conditions.

expect different investment results. While PEFs invest in extremely illiquid assets, hedge funds can offer their investors faster access to their money and allow them to withdraw at least part of their investments on a quarterly or annual basis. It is possible because investment portfolios managed by hedge funds consist of assets with relatively high liquidity such as bonds and stocks of listed companies.

One can easily see that time horizon and liquidity of investments are closely connected. If a fund has an investment strategy in illiquid assets, then it needs to lock up the investors for a considerable amount of time so that it does not have to liquidate investment before the profit opportunity matures in order to respond to investors' request for withdrawal.

Even with the clear conceptual distinction between PEFs and hedge funds, hedge funds have occasionally crossed over to realms of PEFs and it is sometimes quite difficult to see clear practical borderline between them. For example, there are some hedge funds that invest in equity of distressed firms or seek buyout strategy, which are thought to be the main investment strategies of PEFs. Metrick (2006) offers <Figure 1> to illustrate the difference between PEFs and hedge funds along with the tendency of crossover among them.

<Figure 1> Alternative Investments




Source Metrick(2006)

## 2.3. Various forms of PEFs

### 2.3.1. Venture capital funds

Venture capital funds refer to investment vehicles to invest in private equities or equity-linked securities of firms in an early or expansion stages of growth[6]. Venture capital funds are financial intermediaries that take investors' capital and invest it directly in portfolio companies with distinctive characteristics that can be summarized as 3-H's; high growth potential, high tech, high risk. In addition, the primary goal of venture capital funds is to maximize investment return by exiting investment through sale or initial public offering of private equities of investment target. Venture capital funds also play a very active role in monitoring and consulting companies in the investment portfolio to enhance the firm value so that they guard the value of their investment.

### 2.3.2. Buyout funds

Buyout funds targets at both listed and non-listed companies in acquiring equities and related assets. In case of private equities, buyout funds typically focus on the companies in status between post-expansion and pre-IPO stages[7]. In both of the cases, companies under pressure due to managerial inefficiency in spite of high potential for growth are the main subjects of investment.

Buyout funds are pursuing various investment strategies, but the key strategy adopted by most buyout funds is that they acquire the majority share of the target companies and take the control of them. A serious of vigorous efforts to drive off inefficiencies and enhance the value of target companies follow. Buyout funds realize the return by selling the investment share or core assets. This "Buy and build" strategy is the route most buyout funds follow.

However, small minority of buyout funds do not seek control of target companies. Instead, they pursue the strategy to leave the incumbent to maintain the control power

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[4] National Venture Capital Association (NVCA) Yearbook (2005) offers a classification of growth stages of a firm in conjunction with the roles played by venture capital funds. The classification consists of three main stages and six sub stages. The flow starts with "Early Stages" with three sub stages; seed, start-up, and other early stage. The next main stage is "Expansion Stages", also called MID-Stages. The last main stage is "Last Stages" with two sub stages; late and bridge.

[7] That belongs to "Late Stages" in NVCA's classification.

but to retain enough power to influence the decision of incumbent executives, if they want.

Buyout fund is the largest categories of private equity funds in terms of total fund under management. In most of large buyout investments, the investors put up the equity stakes typically less than half of total purchase price and take leverages by borrowing the rest from banks and public capital market and mezzanine investors[8].

### 2.3.3. Mezzanine funds

Mezzanine fund is an investment vehicle that pursues return by investing in equity or debt issued by companies in late stages with relatively stable source of income. The investment is typically in the form of subordinate dent junior to bank loans with additional acquisition of equity-linked securities such as options, warrants, and convertible bonds. There is another form of mezzanine investment under which investors participate with purchase of subordinate debts along with some equity and related instruments to provide another layer of debt financing for highly leveraged buyouts.

### 2.3.4. Distress funds

While buyout funds and mezzanine funds focus on investment in companies that cannot realize its growth potential for managerial inefficiency or show the sign of impending troubles, distress funds, also called special situations funds, concentrate on investment in companies already under distress. They acquire control of the distress companies through equity investment or purchase of distressed bonds and try to revive the distress companies by pursuing vigorous restructuring or strengthening of financial structure. They realize very high return on their investment through capital gains.

## 2.4. "PEFs-in-Korea"[9] and Privately Placed Fund

### 2.4.1. Venture Capital Investment Fund

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[8] This is a description of leveraged buy outs (LBOs).

[9] Detailed descriptions of each alternative investment in Korea can be found the next chapter. The investment vehicles discussed in this section do not match the descriptions of typical PEFs found in US or other countries. However, we call them PEFs-in-Korea to emphasize the similarity with typical PEFs.

A Korean version of venture capital fund can be found in "Venture Capital Investment fund (VCIF)" introduced in 2001 after the revision of "Law on Supporting the Establishment of Small and Medium Sized Enterprises". VCIF is a limited partnership established by "Venture Capital Investment Company (VCIC)" as general partner and other investors as limited partners. VCIC is a corporation registered at Small and Medium Business Administration and its sole objective is to participate in VCIF as general partner. The law prescribes very complex and detailed restriction on activities of VCIC and VCIF. Since VCIC are allowed invest only in establishment of SMEs and venture capital and subject to very restrictive regulations that is almost equivalent to the ones on investment fund raised through public offering, except for the main investment target and legal structure, VCIF in Korea has little in common with venture capital fund in US or other countries.

### 2.4.2. Corporate Restructuring Company Fund

What "Corporation Restructuring Company Fund" (CRC Fund) is to VCIF as to what "Corporate Restructuring Company" is to VCIC. Each pair shares the same legal structure and very similar regulations on business activities. The only difference is that the CRC funds are allowed to invest only in acquisition of control of distress companies. Like VCIC, CRC fund has the same legal structure as private equity funds with CRC or other qualified investors such as Korea Asset Management Corporation (KAMCO) as a general partner and other investors as limited partners. But its activities and investment decision are strictly regulated by law and it is hardly the case that CRC funds occupy advantageous status over funds established by public offering in terms of more favorable regulatory environment.

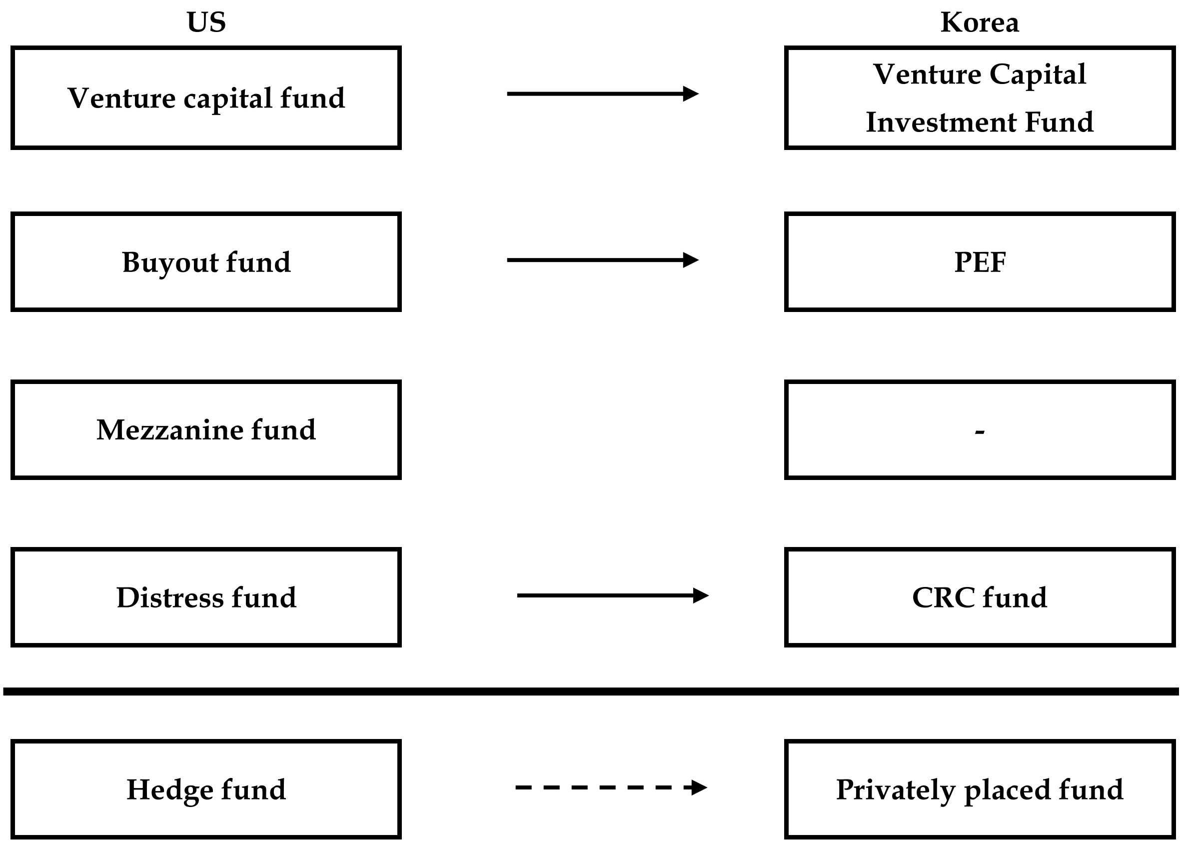
### 2.4.3. Private Equity Investment Fund (PEF)

PEF in Korea has much narrower scope than PEFs in traditional sense typically found in US in terms of investment target and business activities. PEF was first introduced in 2005 through revision of "Collective Investment Scheme Law" as a form of buyout funds in that the law strictly restricts investment objects of PEF to acquisition of equities, listed or not, with the intention of participating, directly or indirectly in management of companies whose equities PEF invested in. PEFs in Korea are still under many restrictive regulations unfound in other countries though the financial regulator has much less tight grip on them compared to other forms of investment vehicles.

### 2.4.4. Privately Placed Fund

"Collective Invest Scheme Law" in Korea requires any investment vehicle that pools funds from individual(s) to be managed solely by asset management companies licensed by the financial regulator. Unlike US, the law does not grant general exemptions for investment vehicles established by private placement. On the contrary, the law subjects both privately placed and publicly offered investment vehicles to unitary set of regulations and grants to investment vehicles qualified for private placement clause exemption from most of disclosure requirements and restrictions on investment activities. Even though privately placed funds have different ownership and business structures from traditional hedge funds, they are the investment vehicles closest to hedge funds in that virtually no restrictions on investment activities are imposed and disclosure requirement is set at minimum level.

<Figure 2> "PEFs in Korea": comparison with US



<Table 2> Comparison of "PEFs in Korea"

| | VCIF | CRC Fund | PEF |
|---|---|---|---|
| Law | Law on Supporting the Establishment of Small and Medium Sized Enterprises | Industrial Development Support Law | Collective Invest Scheme Law |
| Structure | GP +LPs | GP + LPs | GP + LPs |
| GP qualification | VCIC | CRC, KAMCO | No restriction |
| Regulatory Authority | Small and Medium Business Administration | Financial Supervisory Commission | Financial Supervisory Commission |
| Registration | Yes | Yes | Yes |
| Investment Asset | Equity (restricted) | Equity and debt of distressed firms | Equity |
| Investment Style | Portfolio investment | Buyout | Buyout |
| Leverage | Not allowed (1000% for VCIC) | Not allowed | Within 10% of capital |

## 2.5. Trends in Private Equity Market in Korea

### 2.5.1. Private equity market in Korea

According to PriceWatehouseCoopers' survey on global private equity market, private equity market in Korea was ranked 13th in 2005 in terms of investment value of private equity funds, which was a significant drop from 7th position in 2002. Still, it is the fourth largest market in Asia following China, Japan, and Singapore.

Private equity market in Korea set to fast growth path after the economic crisis in 1997. Capital account liberalization made it possible for players in global market to freely invest in Korea and Korean private equity markets, especially turnaround/distressed market and buyout market to attract mass investment from global players. In fact, foreign private equity funds such as New Bridge Capital and Carlyle were the major players in corporate restructuring process unfolded after the economic crisis.

<Table 3> Size of private equity market in Korea

(billion US Dollars)

| Year | Investment Value | Fund Raised |
|---|---|---|
| 2002 | 1.95 (7) | 0.36 |
| 2003 | 2.84 (8) | 0.27 |
| 2004 | 1.56 (12) | 0.37 |
| 2005 | 2.10 (13) | 2.52 |

Note: The ranking in global private equity market
Source: Global Private Equity Report, PriceWaterhouseCoopers, Various years

The government policy to strengthen venture capital sector also contributed to growth of private equity market in Korea. Korean government found a new engine for growth in information based high technology sector and took various measures to stimulate the growth of the sector. To provide legal basis for the policy efforts, Fostering Venture Companies Law and Supporting Establishment of Small and Medium Sized Enterprises Law were revised in 1998 and 1997, respectively. The central theme of legal overhaul was to set venture capital as the central instrument to help adequate inflow of capital into the targeted sectors. Venture capital market flourished in late 1990's under the support and guidance of the government.

Even with steady increase in inflow of money into private equities, the position of Korea in global market has been consistently deteriorated. The two factors that had contributed to fast growth of venture capital market also contributed to decline of Korean market in global private equity market. Kosdaq bubble (IT bubble) bust occurred in 2001 and venture capital market nosedived into a long depression period. Moreover, the corporate restructuring process that had been sparked by the economic crisis in 1997 and made mobilization of capital in mass scale necessary reached maturing stage after successful turnaround of many distressed firms in early 2000's.

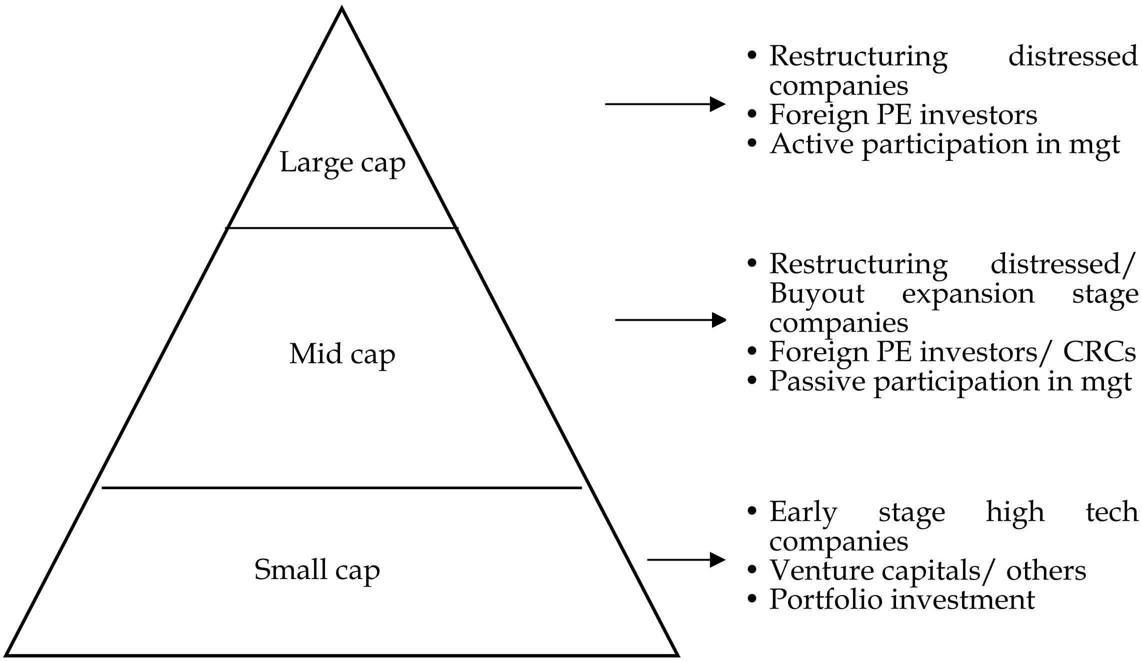
### 2.5.2. The structure of private equity market in Korea

Three types of PEFs have been showing strong activities especially after the economic crisis in 1997. They are distress/turnaround funds, buyout funds, and venture capital funds.

Distressed/turnaround funds pursued the investment strategy that took over distressed companies with large market capitalization such as financial companies, telecom services, and large manufacturing firms. The market was dominated by foreign private equity funds and offshore hedge funds. In most of the cases, funds secured the majority share to control the troubled companies[10] that used to be the icons of successful economic development Korea had achieved and pursued vigorous restructuring measures to turn around the distressed situation[11]. The market is also called "large cap market" indicating the size of investees.

The next category is "mid cap market" where the participating private equity funds focused on acquiring minority share of companies in expansion stage. They were also involved in restructuring of already distress companies of medium size. The investees[12] in this market were not everyday name in Korean economy but in most of the cases were once hailed as strong candidate for future stardom. Except for several restructuring deals, investors took passive position in management of the companies. Foreign private equity funds and local CRC funds were the main player in the market.

<Figure 3> Structure of private equity market in Korea




Source: Ilshin Investment (2004)

10 Korea First Bank, Boram Bank, LG Card, Good Morning Securities, Hansol PCS, GNG Network, to name a few.
11 Funds participated in the restructuring process also as portfolio investors in several cases.
12 Nongshim, Locus, CJ39 Shopping, Medison, and Simm Tech are the examples.

Local venture capital funds took the bottom in echelon of private equity markets. As portfolio investors, they acquired private equities of high tech, high expected return, high risk unlisted companies. Their deals were relatively small not exceeding 5 million US dollars in investment value.

### 2.5.2. PEFs-in-Korea: domestic players

#### 2.5.2.1. VCIFs

Venture capital investment companies in Korea can invest in private equities directly or indirectly by participating in venture capital investment fund as a partner, general or limited. <Table 4> illustrates investment activities of local venture capital funds registered at the Financial Supervisory Commission. The first noticeable pattern found in <Table 4> is the fact that the overall investment activity of venture capital has been slumped since 2002. Less than 0.7 trillion KRW are injected into venture capital investment, in 2006. That was a considerable drop from more than 2 trillion KRW in 2000. The slumping investment implies that venture capital industry in Korea has not yet fully recovered from the aftermath of the collapse of Kosdaq bubble in 2000.

Another tendency we would like to point out is that the center of gravity in venture capital industry has gradually moved toward venture capital funds from venture capital investment companies. More than 80% of new fund was financed thorough CVIFs in 2006 and CVIFs became the main investment vehicle. Many industry observers argue that the surge of CVIFs reflects the improved risk management in the industry.

<Table 4> Venture capital investment

(billlion KRW)

<table>
<tr><th colspan="2"></th><th>2000</th><th>2001</th><th>2002</th><th>2003</th><th>2004</th><th>2005</th><th>2006</th></tr>
<tr><td rowspan="2">Remaining Investment</td><td>CVIC</td><td>1,868</td><td>1,617</td><td>1,413</td><td>1,118</td><td>901</td><td>651</td><td>615</td></tr>
<tr><td>CVIF</td><td>1,001</td><td>1,419</td><td>1,619</td><td>1,619</td><td>1,662</td><td>1,491</td><td>1,391</td></tr>
<tr><td rowspan="2">New Investment</td><td>CVIC</td><td rowspan="2">2,008</td><td rowspan="2">889</td><td>157</td><td>132</td><td>84</td><td>123</td><td>114</td></tr>
<tr><td>CVIF</td><td>460</td><td>479</td><td>480</td><td>542</td><td>514</td></tr>
</table>

Note: CVIF stands for venture capital investment fund and CVIC for venture capital investment company.

Source: KVCS

<Table 5> New VC investment by industry

(billlion KRW, %)

| | Q1/06 | Q1/07 |
|---|---|---|
| Information/communication | 76.2 (39.8) | 52.2 (29.4) |
| Manufacturing | 37.3 (19.4) | 60.6 (34.1) |
| Entertainment | 41.6 (21.7) | 22.8 (12.8) |
| Biotechnology | 19.8 (10.3) | 9.6 (5.4) |
| Service/Education | 13.9 (7.2) | 23.6 (13.4) |
| Wholesale/Retail | 1.6 (0.8) | 4.6 (2.6) |
| Others | 1.6 (0.8) | 4.1 (2.3) |
| Total | 192.0 | 177.5 |

Note: 1) The table compares the allocation of new investment funds in the 1st quarter of 2007 with 1st quarter of 2006.
2) The shares are in parentheses.
Source: KVCS

Information technology and communication, manufacturing and entertainment industries attracted a majority chunk of venture capital investment in Korea. Contrary to common expectation, biotechnology has not been a big attractor of venture capital investment yet.

2.5.2.2. CRC funds

Approximately 6.7 trillion KRW were invested in corporate restructuring from 1999 to 2005. 55.6% of them were directly invested by CRC to acquire equities or debts of distressed companies and the remaining 44.4% were indirection investment through CRC funds in which CRC participated as a managing (general) partner or one of non-managing (limited) partners. However, like in venture capital market, the role of private equity funds, CRC funds in this market, steadily increased. The increasing importance of CRC funds in corporate restructuring market coincided with the increasing share of equity acquisition over debt undertaking in composition of investments on corporate restructuring as shown in <Table 7>.

Flow of new investment into corporate restructuring market peaked in 2001 and jumped down by more than 50% in 2003. That reflects the fact that restructuring of large distressed companies that arrived in mass scale following the economic crisis in 1997 has entered the final stage. As a matter of fact, it is estimated that out of 2.3 trillion

KRW invested in corporate restructuring, approximately 60% had been directed into overtaking troubled SMEs and restructuring them.

<Table 6> investment on corporate restructuring

(billion KRW)

| | | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|
| CRC | New Investment | 162.2 | 497.5 | 1,391.4 | 679.3 | 248.9 | 222.6 | 276.4 |
| | Accumulated investment | 162.2 | 659.7 | 2,051.1 | 2,730.4 | 2,979.3 | 3,201.9 | 3,478.3 |
| CRC Fund | New Investment | 122.6 | 295.7 | 271.8 | 523.2 | 323.0 | 559.2 | 683.6 |
| | Accumulated investment | 122.6 | 418.3 | 690.1 | 1,213.3 | 1,536.3 | 2,095.5 | 2,779.1 |
| Total | New Investment | 284.8 | 793.2 | 1,663.2 | 1,202.5 | 571.9 | 781.8 | 958.5 |
| | Accumulated investment | 284.8 | 1,078.0 | 2,741.2 | 3,943.7 | 4,515.6 | 5,297.4 | 6,257.4 |

Source: Ministry of Commerce, Industry and Energy

<Table 7> Composition of CR investment

(billion KRW)

| Year | Equity Acquisition | Debt Acquisition | Total |
|---|---|---|---|
| 2002 | 7,574 | 4,451 | 12,025 |
| 2003 | 4,519 | 1,200 | 5,719 |
| 2004 | 5,467 | 2,351 | 7,818 |
| 2005 | 7,229 | 2,356 | 9,585 |

Source: Ministry of Commerce, Industry and Energy

The investment on corporate restructuring is a typical example of high risk-high return profile. According to an estimate provided by Ministry of Commerce, Industry, and Energy, the average annual return from investment on corporate restructuring was 25.67% with the standard deviation 92.09%[13] between 1999 and 2005.

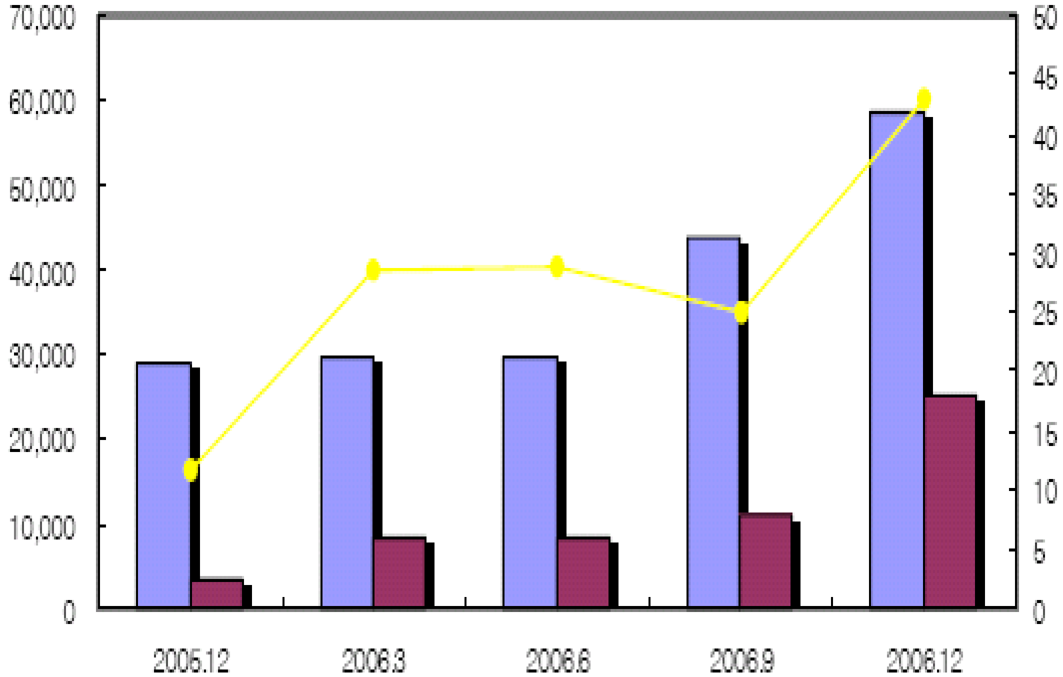
[13] The average annual return of KOSPI 200 index was 21.66% with standard deviation 46.49% during the same period.

2.5.2.3. PEFs

PEF was first introduced to Korea in 2004 through the revision of Collective investment Scheme Law in October, 2004. The total number of private equity funds registered at the Financial Supervisory Commission as required by the Law reached 25 at the end of 2006. Since most of them are still in fund raising stage or investment stage[14], it is too early to make a verdict on the performance of PEFs[15].

Total committed investment by domestically registered PEFs in 2006 reached 5.9 trillion KRW, which was more than 100% increase from 2.89 trillion in 2005. In the mean time, 2 trillion KRW of new investment were executed in 2006 and accumulated investment had reached 2.5 trillion at the end of 2006. As a result of rapid increase in investment, 43% of all committed investment was materialized by the same time.

<Figure 4> Structure of private equity market in Korea




Note: 1) The blue bars indicate the fund committed and the violet bars the fund invested. The yellow line indicates the ratio of fund invested to the committed.
2) The units are hundred million Korean Won for the vertical axes on left and % for the one on right.
Source: Kang (207)

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14 Lifecycle of a private equity fund consists of four stages; fund raising, investment, monitoring and value addition, and exit.

15 The first case of return realization of private equity investment occurred in 2006 and the return is expected to reach as high as 54% for the investment.

Recent surge of PEF activities stems from easing of various restrictions on PEFs and revitalization of domestic M&A market. For example, thanks to the revision of Collective Investment Scheme Law in June, 2006, it is no possible for a venture capital investment company to assume the role of the general partner in a private equity fund without restrictions. Moreover, minimum amount of investment by limited partners is lowered and investment in bad loans is also allowed once debt-equity swap is committed.

Foreign investors are leading the industry. Most of the general partners working for bigger PEFs are foreign investors. And few domestic investors participating in PEFs are willing to assume the roles of strategic investors.

## 3. Regulation of private equity funds in Korea

### 3.1. Brief theoretical discussion; consumer protection and system risk

Why regulate PEFs? The legal distinction between publicly offered securities and privately placed ones is premised on the basic philosophy that the investors who actively responded to solicitation of PEFs are wealthy and they should be free to make their own decisions[16] unhindered by government intervention and the accompanying costs, and in return should have to bear the full consequences of their investment decisions.

Despite the general principle clearly described above, there is still some debate about whether privately placed funds should be subject to greater regulations. Specifically, the debate was sparked by growing concern on unregulated activities of hedge funds in global financial market. However, the basic reasons for the concern are also valid for other forms of privately placed funds such as private equity fund.

The debate on the regulation of privately placed fund is generated by two concerns. First, there is a concern that those funds may at times destabilize the financial system and even cause systemic crisis[17]. The second concern is that recent innovations in capital market have eroded the effectiveness of investor protection regulation by enabling "unqualified investors" to easily access to investment opportunity offered by investment vehicles supposedly reserved for wealthy "qualified investors". Some commentators even go further and argue that greater government protection of investors is needed even if investment on privately placed funds is restricted to qualified investors. They argue that even qualified investors are not sophisticated enough to understand the meaning of investment contracts and financial risks associated with privately placed funds.

On the contrary, observers who are against greater regulation on privately placed funds argue that financial market is powerful and flexible enough to make those concerns baseless anxiety. They argue that sporadic events such as LTCM crisis do reveal fundamental weakness of the financial system; high leverage taken by privately

16 The minimum investment on PEF is 1 billion KRW.

17 This kind of concern was primarily triggered by the near collapse of a hedge fund named Long Term Capital Management in September 1998 and subsequent intervention of Federal Reserve to facilitate a bailout scheme by creditors.

placed funds and inability of financial market to screen unhealthy leverages from healthy ones. However, that does not justify imposition of more strict regulation on privately placed funds. It is argued that the cost of responding to remote possibility of systemic crisis initiated by those funds with stronger grip on them easily outweighs the expected benefit and government should turn its attention to alternative policy to cope with the problem such as stronger surveillance on baking sector that usually turns out to be the ultimate liquidity provider for unregulated investment vehicles.

There is a large group of experts who are strongly opposing to greater regulation on privately placed funds based on concerns for investor protection. They argue that even though recent financial innovations made the traditional borderline blur and infiltration of alternative investments could be a legitimate reason to raise a serious question on the effectiveness of the current regulatory framework for investor protection, it may be socially beneficial to expand the availability of alternative investments to more investors and the risks associated with these investments are likely to be no greater than those associated with most fund investments. However, some critics with softer position acknowledge that it may be useful to provide investors with greater exposure transparency. In particular, registered alternative investment vehicles should be required to disclose information about the nature of investments in their portfolios, their portfolio diversification, a likely exposure investors have to key economic factors and to losses incurred by the investment vehicles in their portfolios.

## 3.2. Evaluation of regulatory framework in Korea

### 3.2.1. Heavy regulation of PEFs

The most noticeable feature of the current regulatory framework in Korea is that PEFs are already regulated very heavily compared to the ones in most of other counties. In some sense, the arguments concerning the redesign of regulatory framework is meaningless in Korean context. Most of the regulations on PEFs advocated by commentators in both sides have already been implemented and even stronger regulations are not difficult to find.

Examples for excessively stronger regulations on PEFs are abundant. Any private equity fund should be a buyout fund under all circumstances since Collective

Investment Scheme Law allows only buyout strategies for registered PEFs. The maximum leverage PEFs can take is restricted to 10% of total capital paid in even if they are supposed to pursue buyout strategy. Therefore, leverage buyout strategy is not an option a general manager of a private equity fund even if it is popular and has already become "bread-and-butter" for buyout type PEFs in global market.

As a result, it is very difficult to find "fundamental" differences between private equity funds and publicly offered investment vehicles from the regulatory point of view. Rather, upon examining laws and regulations governing investment instruments, one can easily conclude that financial regulatory system in Korea does not acknowledge the possibility of fundamental differences between private equity funds and publicly offered investment vehicles. For example, Collective Investment Scheme Law declares that any investment vehicle, privately placed or publicly offered, that pools funds from individual(s) should be managed solely by asset management companies licensed by the Financial Supervisory Commission. The Law subjects both privately placed and publicly offered investment vehicles to the same regulations and make distinction between two classes of investment vehicles by granting to investment vehicles qualified for private placement clause exemption from most of disclosure requirements and restrictions on investment activities.

### 3.2.2. Segmentation of private equity investments

As discussed in 2.4., various forms of PEFs are already in action in Korean financial market. However, all of them became legitimate financial instruments only after the explicit recognition by law. Each type of PEFs is recognized and hence regulated by different law dedicated to fulfillment of specific policy goals[18]. As a natural consequence, market for private equity investment is highly fragmented and it is impossible to crossover the boundaries prescribed by law unless explicitly allowed by law.

### 3.2.3. Considerations for specificity of Korean financial market: separation of banks and non-financial companies

Further complications were added to regulatory framework for PEFs due to unique environment of Korean financial market.

[18] <table 2> offers an evidence for the argument.

Banking Law in Korea prohibits non-financial companies from holding more than 5% of shares with voting right. Following American tradition of separation of banking and other sectors, the regulation was instituted to block illegitimate appropriation of bank's fund for the use of majority shareholders who possess large interests outside the bank.

When the discussion on the introduction of PEFs started, there was a heated debate on the possibility that large conglomerate in Korea, *chaebuls*, may use PEFs as instruments to evade the regulation and virtually "own" banks. To block the rooms for abuse of PEFs for illegitimate purpose, various restrictions were imposed on PEFs such as restriction on PEFs' holding of bank shares and special restrictions on PEFs owned by *chaebuls*.

### 3.3. Policy directions

Advocates[19] for the current system argue that the complicated and seemingly excessive regulations on PEFs are necessary to guard the fragile financial market from fraudulent practices and secure strong but stable growth of the market. However, a lot of critics obstacle to development of financial market.

In order to efficient and stable markets for PEF in Korea, it is very important that the current fragmented regulatory framework should be unified/harmonized under the principle that balances pursuit of efficiency with the fundamental purposes of financial regulation.

Another important task policy maker should pay their close attention is introduction of hedge fund. The easiest way to achieve the goal is to add another form of special collective investment scheme that match the descriptions of hedge fund to Chapter 5 of Collective Investment Scheme Law. By doing so, the regulatory authority would offer to investors another investment vehicle with different set of regulatory framework. That would make the current framework more complicated and even more serious inefficiency will follow. Instead, we suggest that the monopoly of asset management companies in operation of pooled investment be abolished. More specifically, the operation of investment fund raised through public offering should be left to asset management companies licensed by law but allow other investors, institutional or

[19] In fact, dominant majority of them are financial regulators.

individual, to freely establish an operate investment fund in whatever form they want as long as it does not match the description of public offerings and grant exemptions from most of regulations imposed on collective investment scheme except for the ones necessary to guard against systemic crisis and abuses of investors. Any willing investor is then free to rather solicit investment to establish a hedge fund or participate in one.

International Conference

# Recent Trends and Regulations on Private Equity Funds in Korea

August, 2007 C.G.Park, S.K.Hur Korea's Leading Think Tank KDI

## CONTENTS

## Introduction

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❖Objectives

- PEF in Korea: Recent Trend and Regulation
- Characteristics of Regulatory Framework: Past, Present, and the Future

CONTENTS

## Classification of PEF

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- Legal Classification (by fund raising method)
  - public offering vs. private placement
- Economic Classification (by types of investment instruments)
  - Traditional vs. alternative investment
  - Traditional investment: Stock and Bonds of listed companies
  - Alternative investment: PEF, hedge fund, real estate investments and others (Bance(2003))

## Alternative investments

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<Table 1> Classification of alternative investments

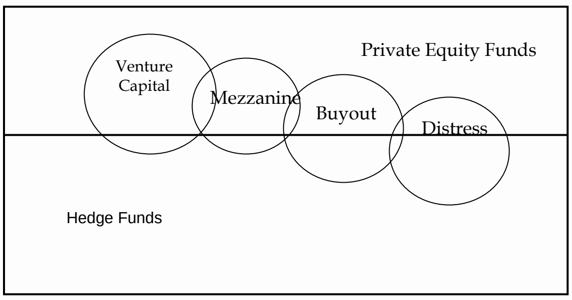
| Classification | Types |
|---|---|
| private equity funds (equity acquisition) | venture capital funds<br>buyout funds<br>mezzanine funds<br>special situation (distressed) funds |
| hedge funds (arbitrage) | global macro funds<br>arbitrage funds<br>long/short equity funds<br>event driven funds<br>others (emerging markets, fund of hedge funds, quantitative) |
| real estate investments | office, commercial properties, residential properties, REITs etc. |
| others | commodities, currency, interest rate etc |

Source: Bance(2003).

## PEF vs. Hedge Fund

- Two Differences
  - Time horizon of investment
  - Liquidity of Portfolio
- Close connection between Time horizon and Liquidity of portfolio
- The conceptual distinction of PEF from hedge fund is not valid in reality.
  - Presence of Cross-over funds

## Crossover of PEF and Hedge Fund




Source: Metrick(2006)

## Various Forms of PEFs

- Venture capital funds
  - unlisted/small/early stage/high growth potential
  - portfolio investment in 3H companies(high growth potential, high tech, high risk)
  - Monitoring and consulting portfolio companies but not participating in managerial decisions
  - Realizing maximum return by sale or IPO of private equities of investment target

## Various Forms of PEFs

- Buyout funds
  - Both listed and unlisted
  - mid-stage(post-expansion/pre-IPO)
  - take over management control/LBOs
- Mezzanine funds
  - equity/subordinate debt issued by companies with relatively stable source of income
- Distress funds
  - Turnaround of distressed firms

## PEFs-in-Korea

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- VC funds/buyout funds/distress funds
  - Instituted by laws (government): policy objectives
  - Heavily regulated: quasi-PEFs
  - Government support

## PEFs-in-Korea

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| US | | Korea |
|---|---|---|
| Venture capital fund | → | Venture Capital Investment Fund |
| Buyout fund | → | Private Equity Investment Fund |
| Mezzanine fund | | - |
| Distress fund | → | Corporate Restructuring Company fund |
| Hedge fund | - - - → | Privately placed fund |

# Comparison of PEFs-in-Korea

| | VCIF (VC fund) | CRC Fund (distress fund) | PEF (buyout fund) |
|---|---|---|---|
| Law | Law on Supporting the Establishment of Small and Medium Sized Enterprises | Industrial Development Support Law | Collective Invest Scheme Law |
| Structure | GP +LPs | GP + LPs | GP + LPs |
| GP qualification | VCIC | CRC, KAMCO | No restriction |
| Regulatory Authority | Small and Medium Business Administration | Financial Supervisory Commission | Financial Supervisory Commission |
| Registration | Yes | Yes | Yes |
| Investment Asset | Equity (restricted) | Equity and debt of distressed firms | Equity |
| Investment Style | Portfolio investment | Buyout | Buyout |
| Leverage | Not allowed (1000% for VCIC) | Not allowed | Within 10% of capital |

# Market Size

- High growth of Private Equity market after the Financial Crisis
- Followed by the Recent decline
  - Bust of KOSDAQ bubble in 2000
  - Completion of large scale Corporate Restructuring

<Table> **Size of private equity market in Korea**

(billion US Dollars)

| Year | Investment Value | Fund Raised |
|---|---|---|
| 2002 | 1.95 (7) | 0.36 |
| 2003 | 2.84 (8) | 0.27 |
| 2004 | 1.56 (12) | 0.37 |
| 2005 | 2.10 (13) | 2.52 |

Note: The ranking in global private equity market
Source: Global Private Equity Report, PriceWaterhouseCoopers, Various years

## Market Structure

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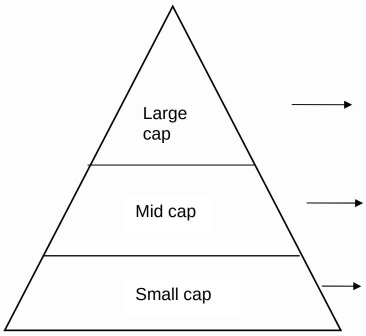
Differentiated by type, size, and player




Restructuring distressed companies
Foreign PE investors
Active participation in mgt

Restructuring distressed/ Buyout expansion stage companies
Foreign PE investors/ CRCs
Passive participation in mgt

Early stage high tech companies
Venture capitals/ others
Portfolio investment

Source: Ilshin Investment (2004)

## Performace: VC funds

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- Recent slowdowm
  - Bust of KOSDAQ bubble
  - better risk management
- VCIF as the main investment vehicle

**<Table> Venture capital investment**

(billion KRW)

| | | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|
| Remaining Investment | CVIC | 1,868 | 1,617 | 1,413 | 1,118 | 901 | 651 | 615 |
| | CVIF | 1,001 | 1,419 | 1,619 | 1,619 | 1,662 | 1,491 | 1,391 |
| New Investment | CVIC | 2,008 | 889 | 157 | 132 | 84 | 123 | 114 |
| | CVIF | | | 460 | 479 | 480 | 542 | 514 |

Note: VCIF stands for venture capital investment fund and VCIC for venture capital investment company.
Source: KVCA

## Performace: VC funds

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<Table> New VC investment by industry

(billlion KRW, %)

| | Q1/06 | Q1/07 |
|---|---|---|
| Information/communication | 76.2 (39.8) | 52.2 (29.4) |
| Manufacturing | 37.3 (19.4) | 60.6 (34.1) |
| Entertainment | 41.6 (21.7) | 22.8 (12.8) |
| Biotechnology | 19.8 (10.3) | 9.6 (5.4) |
| Service/Education | 13.9 (7.2) | 23.6 (13.4) |
| Wholesale/Retail | 1.6 (0.8) | 4.6 (2.6) |
| Others | 1.6 (0.8) | 4.1 (2.3) |
| Total | 192.0 | 177.5 |

Note: 1) The table compares the allocation of new investment funds in the 1st quarter of 2007 with 1st quarter of 2006.
2) The shares are in parentheses.
Source: KVCS

## Performance: CRC Funds

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- Recent slowdowm
  - Near completion of large scale CR
- CRC Fund as the main investment vehicle

<Table> investment on corporate restructuring

(billion KRW)

| | | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|
| CRC | New Investment | 162.2 | 497.5 | 1,391.4 | 679.3 | 248.9 | 222.6 | 276.4 |
| | Accumulated investment | 162.2 | 659.7 | 2,051.1 | 2,730.4 | 2,979.3 | 3,201.9 | 3,478.3 |
| CRC Fund | New Investment | 122.6 | 295.7 | 271.8 | 523.2 | 323.0 | 559.2 | 683.6 |
| | Accumulated investment | 122.6 | 418.3 | 690.1 | 1,213.3 | 1,536.3 | 2,095.5 | 2,779.1 |
| Total | New Investment | 284.8 | 793.2 | 1,663.2 | 1,202.5 | 571.9 | 781.8 | 958.5 |
| | Accumulated investment | 284.8 | 1,078.0 | 2,741.2 | 3,943.7 | 4,515.6 | 5,297.4 | 6,257.4 |

Source: Ministry of Commerce, Industry and Energy

# Private Equity Funds in Korea

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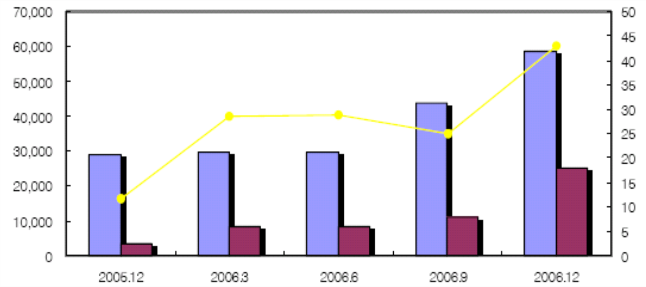
- Surge in PEF investment: de-regulation and active M&A market
- Are they truly "buyout funds? – passive role in management
- Major players: foreign investors registered at FSC or not

**<Figure> Structure of private equity market in Korea**




Note: 1) The blue bars indicate the fund committed and the violet bars the fund invested. The yellow line indicates the ratio of fund invested to the committed.
2) The units are hundred million Korean Won for the vertical axes on left and % for the one on right.
Source: Kang (2007)

CONTENTS

## Rationales for regulating PEFs?

- Concern on systemic risk
  - LTCM
  - High leverage
  - Objection: Banks are the ultimate liquidity provider. Tighter monitoring on banks will prevent the occurrence of such a systemic crisis.
- Concern on investor protection
  - Financial innovation/ public's access to PEFs
  - Objection: better disclosure is enough!
- Balancing trade-off between efficiency(flexibility) and financial stability
- Watching fire across the river!

## Evaluation of Korean Case

- PEFs are already heavily regulated.
- Segmentation of PEF market
  - Positive listing system + instrument to pursue policy goals
  - Complex and uneven regulations
- Consideration for specificity of Korean economy
  - Seperation of banks from non-financial companies, especially *chaebul*

## Future Directions

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- Unification of regulatory framework for PEFs
  - As well as Looser grip on "privately placed" funds
- Abolishing the Monopoly of Asset Management in case of Private Placement
  - However, still the protection devices against systemic crises and abuses of investors should be maintained or be fortified if necessary.

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