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Investor Protection in Korean Capital Market through Disclosures and Litigation*

*Kyung-Hoon Chun***

Abstract

The Korean securities market faces an ever-increasing demand from investors for transparent and legitimate operation. As a result of legislative, administrative, and judicial endeavors to protect investors in the securities market, both disclosure schemes and substantive grounds for claims are in place, producing a significant number of administrative sanctions and court judgments of civil liability for defective disclosures. It is noteworthy that electronic disclosures have significantly contributed to the transparency of the market, which was made possible by Korea's highly-developed broadband Internet environment. Furthermore, an increasing number of lawsuits against gatekeepers such as accounting firms and underwriters are requiring far more due diligence on their side, which is another positive step in investor protection. Still, insufficient incentive to sue remains one of the biggest hurdles for remedies through litigation. Proposals to revitalize class actions, such as lifting procedural barriers and offering pecuniary incentives to the lead plaintiff and its counsel, should be seriously considered.

Key Words: securities regulations, disclosure, securities litigation, capital market, investor protection

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** School of Law, Seoul National University

I. Introduction

As one of the 15 largest economies in the world in terms of GDP,[1] Korea has experienced dramatic changes in its financial system in recent decades. Until the 1997 Asian financial crisis, Korea's financial system was primarily bank-based, meaning that the government utilized a few major commercial banks to provide funds to certain industries that it had selected for nurturing. With the 1997 crisis, however, the banking sector began to prioritize profitability, for example by focusing on high-yield household lending as opposed to long-term corporate lending, which has increased companies' need to utilize direct financing in the capital market. In line with the growing importance of the capital market, the amount and ratio of foreign investment have also increased significantly. Issuers are confronting growing demands from investors and regulatory authorities alike for more transparency and stricter compliance with laws and regulations.

Despite growing importance of laws and regulations for investor protection in the capital market of Korea, relevant literatures are scarce in English. To the author's knowledge, virtually no academic literatures written in English provide comprehensive information on the current Korean law relevant to this issue. A few non-academic reference books on Korean capital markets published in English[2] and the English translation of selected statutes available at a few government-run websites[3] may be helpful, but they do not intend to provide organized explanations or analyses of the relevant Korean law.

This paper aims to fill such vacuum, by explaining, analyzing, and

1) Korea is ranked eleventh in terms of nominal Gross Domestic Production (GDP) by the International Monetary Fund (2015) and thirteenth by the World Bank (2014). In terms of GDP on a Purchasing Power Parity basis (PPP), Korea is ranked thirteenth by the International Monetary Fund (2015) and the World Bank (2014).

2) *E.g.*, Korea Financial Investment Association, 2015 CAPITAL MARKET IN KOREA (2015); Financial Supervisory Service, FINANCIAL SUPERVISORY SERVICE HANDBOOK 2015 (2015).

3) *E.g.*, *see Korea Legislation Research Institute*, http://elaw.klri.re.kr/eng_service/main.do; *Financial Services Commission*, http://www.fsc.go.kr/eng/new_financial/securities.jsp?menu=0203&bbsid=BBS0087 ; *Ministry of Government Legislation*, http://www.law.go.kr/eng/engMain.do.

evaluating the laws and regulations of Korea regarding disclosure schemes and securities litigation from the perspective of investor protection in the capital market. Given such a purpose, the main focus of this paper is to provide a clear and precise overview of Korean laws and regulations on disclosure schemes and securities litigation, not only black-letter rules but also the way they are actually enforced. Proposing any unique idea as an independent academic work is beyond the purpose of this paper. In this regard, after providing general background information on Korea's capital market and its regulators (II), the paper examines the current status and effectiveness of the securities regulations on disclosures of material information (III). It then discusses substantive law (IV) and enforcement procedures (V) concerning shareholder litigation as a means of protecting minority investors, followed by some closing remarks (VI).

II. Overview of the Korean Capital Markets

1. Market Size

The Korea Exchange (KRX), the sole securities exchange operator in South Korea,[4] has three business divisions: the Stock Market Division (also known as KOSPI), the KOSDAQ Market Division,[5] and the Derivatives Market Division. The KOSPI and KOSDAQ markets are the two major stock exchanges in South Korea. The market capitalizations and number of listed companies of the KOSPI and the KOSDAQ markets as of the end of 2015 are shown in Table 1.

Direct financing through the capital market by Korean companies amounted to KRW 131,114 billion in 2015, of which corporate bonds accounted for 93.9% (KRW 123,102 billion) while equities accounted for

4) Although Article 373-2 of the Financial Investment Services and Capital Markets Act entitles the Financial Services Commission to issue licenses for securities exchanges other than the KRX, the KRX still remains as the sole securities exchange operator licensed in Korea.

5) KOSDAQ Market Division is responsible for operating KOSDAQ market as well as KONEX market, a new market established in 2013 for small and medium sized enterprises.

Table 1. Size of Stock Exchanges in South Korea (End of 2015)

	Number of Listed Companies	Market Capitalization (KRW million)
KOSPI	770	1,242,832,089
KOSDAQ	1,152	201,631,307
Total	1,922	1,444,463,396

Source: Korea Exchange (www.krx.co.kr) (KRW 1,100 = approximately USD 1)

6.1% (KRW 8,012 billion).[6] The equity financing in 2015 includes 116 initial public offerings (IPOs) with the total amount of KRW 3,157 billion.[7]

2. Regulators

Korea's securities markets are regulated by the Financial Services Commission (FSC), the Securities and Futures Commission (SFC), and the Financial Supervisory Service (FSS), all operating under authority granted by Korea's primary legislation on the securities market, the Financial Investment Services and Capital Markets Act (CMA),[8] and the Act on Establishment of the Financial Services Commission (FSCA). Roughly speaking, the FSC is in charge of policy matters, the SFC, as a sub-commission of the FSC, decides on matters relating to the inspection and supervision of the securities market and financial institutions, and the FSS is engaged in the actual inspection, supervision, and enforcement activities under the direction of the FSC and the SFC.

6)Financial Supervisory Services, Press Release (Jan. 26, 2016), available in Korean at http://www.fss.or.kr/fss/kr/promo/bodobbs_view.jsp?seqno=19176&no=188&s_title=직접금융&s_kind=title&page=2.

7) *Id.* at 7.

8) The CMA was enacted in 2007 by consolidating six separate statutes, namely, Securities and Exchange Act, Futures Trading Act, Indirect Investment Asset Management Business Act, Trust Business Act, Merchant Banks Act, and Securities and Futures Exchange Act. *See* Joon Park, *Consolidation and Reform of Financial Market Regulation in Korea: Financial Investment Services and Capital Markets Act*, 6 National Taiwan University Law Review 91 (2011).

1) FSC

The FSC is Korea's principal supervisory authority over the financial industry. The FSC has been given a broad statutory mandate to carry out two main functions: (i) deliberation and resolution of financial issues and (ii) guidance and supervision of the FSS.[9] Under this mandate, the FSC has the authority to draft and amend financial regulations, issue and revoke the licenses of financial institutions, and deliberate and decide upon policy matters relating to financial institutions and the securities and futures markets. In practice, matters relating to the securities and futures markets are largely delegated to the SFC.

The FSC is led by nine commissioners, including a Chairman and a Vice Chairman, who each serve a three-year term, and consists of five bureaus and one division with over 150 civil servants. The Chairman is appointed by the President upon the recommendation of the Prime Minister (FSCA, Article 4(2)). The Vice Chairman is appointed by the President on the recommendation of the Chairman of the FSC. Out of the remaining seven commissioners, two are standing members and five are non-standing members including one industry representative. The FSC is an independent government agency staffed by civil servants who are barred from holding any political positions or engaging in any commercial activity while in office. The nine commissioners are also barred from participating in any resolution that may raise a conflict of interest.[10]

2) SFC

The SFC, as a sub-commission within the FSC, is responsible for the oversight of the securities and futures markets. The SFC's principal mission is to investigate markets abuses, such as insider trading and price manipulation in the securities and futures markets, and to establish accounting standards and audit standards (FSCA, Article 19). Actual enforcement functions are delegated or directed to the FSS. The SFC consists of five members who are appointed by the President for a three-year term. The Vice Chairman of the FSC concurrently holds the position of Chairman of the SFC (FSCA, Article 20(2)).

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9) Financial Supervisory Service, FINANCIAL SUPERVISORY SERVICE HANDBOOK 2013 13 (2013).

10) *Id*. at 17.

3) FSS

The principal role of the FSS is to enforce resolutions of the FSC and SFC under those agencies' direction, and to carry out direct inspection and supervision of financial institutions and the securities market (CMA, Article 24(1)). As one of its primary activities, the FSS investigates market abuses and unfair trading such as insider trading and price manipulation in the securities and futures markets. In order to carry out these tasks, it has the authority to order the submission of documents, to compel an individual to testify, and to investigate financial statements, books, documents and any other items necessary for its investigations. Upon approval from the FSC, the FSS may also recommend to financial institutions that they dismiss officers and managers who are found responsible for violating laws and regulations.

The FSS is headed by a Governor who is appointed by the President upon the recommendation of the Chairman of the FSC (FSCA, Article 29(2)). As of December 2015, it was staffed by 1,844 persons who (unlike the FSC) are not civil servants, which number includes more than 100 lawyers and more than 200 certified public accountants (CPAs). In January 2015, the FSS recruited 49 new staff members including 4 lawyers and 14 CPAs. The competition rate for the seats allocated for college graduates was 68:1. This shows that at least the younger employees of the FSS are being recruited from a highly competent pool of candidates.

Most of its budget is covered by commissions collected from financial institutions and market participants, such as supervision expense sharing with regulated financial institutions and issuance expense sharing with securities issuers. The Bank of Korea also provides funding for the FSS. Unlike in certain jurisdictions, the FSS cannot levy fines or seize unlawful profits for its own accounts. Similarly, its performance, as measured by the amount of fines collected or the number of convictions, has no direct effect on its budget or revenues. Table 2 summarizes the FSS's revenues and expenditures in recent years.

Overall, the FSS is endowed with a relatively stable budget, and more and more positions are being filled with qualified employees. Its governance also attempts to maintain independence from both politics and industry. Although there are many aspects that the FSS can still improve (e.g., bureaucratic partitioning within the agency, an overdependence on

Table 2. Summary Financial Statements of the FSS

		2009	2010	2011	2012	2013	2014
Operating Revenue		242,713	227,604	239,069	253,777	269,916	271,235
	Supervision Expense Sharing	159,636	145,666	148,966	173,684	192,658	194,990
	Issuance Expense Sharing	72,280	71,247	79,500	69,457	66,659	65,739
	Bank of Korea Funding	10,000	10,000	10,000	10,000	10,000	10,000
	Other Fees	797	691	603	636	599	506
Non-Operating Revenue		7,283	6,325	8,460	7,626	6,661	5,363
Total Revenue		237,915	233,929	247,529	261,403	276,577	276,598
Total Expenditure		237,915	233,929	247,529	261,403	276,577	276,598
Profit		0	0	0	0	0	0

Source: www.fss.or.kr/fss/kr/open/finance/settle.jsp. (Unit: KRW 1 million)

regulatory as opposed to civil sanctions, insufficient staffing and expertise in certain practice areas), the FSS is currently playing, and is expected to continue to play, an important role in maintaining a sound securities market and protecting minority investors in the market.

III. Disclosure Schemes

1. *Disclosure in the Primary Market*

1) Registration Statement and Prospectus

A public offering of securities, whether initial or not, may be undertaken only after a registration statement (*jeung-gwon-shin-go-seo*) is filed with and accepted by the FSC (CMA, Article 119(1)). The registration requirement is waived for small offerings, below KRW 1 billion (CMA, Article 119(1)) or in public offerings of certain securities such as government and municipal bonds (CMA, Article 118). Certain qualified issuers may file a shelf registration statement for offerings to be made over the following year (CMA, Article 119(2)).

The registration requirement applies only when an issuer makes a "public" offering, which is defined as an offering made to 50 or more persons. For purposes of counting the number of offerees, sophisticated institutional investors and those with access to corporate information such as large shareholders, directors, and statutory auditors[11] are excluded. An offering to fewer than 50 persons may also be deemed a public offering if the securities are likely to be further transferred to more than 50 persons within one year of issuance.

In addition to a registration statement, when making a public offering, the issuer must prepare and file a prospectus (*tu-ja-seol-myeong-seo*) with the FSC and keep it at its offices, or other places designated by Prime Ministerial Decree, for inspection by investors (CMA, Article 123(1)). Then, the issuer must deliver a copy of the prospectus to each investor before selling securities, without the need for a request by the investor (CMA, Article 124(1)). While the registration statement is prepared mainly for review by the regulator, the prospectus is intended for investors. In other words, the registration statement and the prospectus target different audiences. In substance, however, these two documents have much in common and there should be no inconsistencies between them.

2) Sanctions for Non-Compliance

The CMA provides three types of sanctions for omissions or misrepresentations made in connection with a public offering: (a) administrative sanctions, (b) criminal liabilities and (c) civil liabilities. If the FSC finds a registration statement to be inadequate, it may issue an order to revise it (CMA, Article 122(1)).[12] If there is a material misstatement or omission of material fact in the registration statement or prospectus, or if the issuer fails to submit a registration statement or prospectus, the FSC may take one or more of the following measures (CMA, Articles 132,

11) A statutory auditor (*gamsa* in Korean), also referred to as an internal auditor, is an internal organ of Korean stock company who supervises the directors and the management. It is functionally similar to *kansayaku* of Japanese corporate law.

12) More specifically, the FSC may issue an order to revise if the registration statement fails to follow the prescribed form, contains material misstatements or omissions, or is so unclear as to impair reasonable judgment of the investors or cause material misunderstanding.

429(1)):

- Give a warning or caution
- Suspend or prohibit the issuance, offering or sale of the securities in question
- Restrict further issuance of securities for up to one year
- Recommend dismissal of the responsible directors or officers
- Report the matter to or file a criminal complaint with the criminal authorities (usually the prosecutors' office)
- Impose an administrative fine (*gwa-jing-geum*)

Of these measures, the FSC has recently preferred to utilize administrative fines for violations of disclosure requirements. A fine may be up to 3% of the amount of the public offering, not exceeding KRW 2 billion (CMA, Articles 429(1), 125(1)). For example, during the latter half of 2015, the FSC sanctioned two companies in the primary market for failing to submit registration statements by imposing administrative fines of KRW 345 million and suspending the issuance of the securities for three months, respectively.

The FSC/FSS is not allowed to settle with the issuer or responsible persons. However, since the FSC has various ways to sanction the issuers and has some discretion in selecting the types and determining the amounts of sanctions, it is not surprising that the regulators and the issuer sometimes engage in discussions of the scope and degree of the sanctions, which may resemble settlement proceedings. The current law does not envision such additional measures as disgorgement of profits or creation of a fund to indemnify investors (like the "fair fund" found in the US).

In addition to administrative sanctions, the CMA provides for a wide range of criminal sanctions relating to disclosure requirements in the primary market. Any public offering made without filing a registration statement is subject to imprisonment for up to five years or a criminal fine of up to KRW 200 million (CMA, Article 444(xii)). Failure to file or deliver a prospectus in a public offering is subject to imprisonment for up to one year or a criminal fine of up to KRW 30 million (CMA, Article 446(xxii)). Material misstatements or omissions in a registration statement or a prospectus are subject to imprisonment for up to five years or a criminal

fine of up to KRW 200 million (CMA, Article 444(xiii)). CPAs, appraisers, and credit rating agencies that signed or certified a registration statement or prospectus with the knowledge of material misstatements or omissions are also subject to imprisonment for up to five years or a criminal fine of up to KRW 200 million (CMA, Article 444(xiii)). Proceedings for such criminal sanctions are usually initiated by an FSC report to the prosecutors' office. Criminal sanctions are actively sought for market abuses such as insider trading and market manipulation, but rather sparingly used for violations of disclosure requirements.

Finally, an investor who suffers a loss due to any material misstatement or omission in a registration statement or prospectus may claim damages against those responsible for such misstatement or omission, including directors, underwriters, external auditors, and credit rating agencies (CMA, Article 125). Issues relating to such civil liabilities are discussed in Part IV below.

2. Disclosure in the Secondary Market

1) Periodic Reports

Companies listed on the KOSPI market and the KOSDAQ market must submit to the FSC/FSS and the KRX (i) annual business reports (*sa-eop-bo-go-seo*) within 90 days after the end of each business year; (ii) semi-annual reports (*ban-gi-bo-go-seo*) and (iii) quarterly reports (*bun-gi-bo-go-seo*) within 45 days after the end of the respective period (CMA, Article 160). Thus, if a company's business year is the same as the calendar year (which is true for more than 95% of Korean listed companies), it must submit an annual report by the end of March, a quarterly report by mid-May, a semi-annual report by mid-August, and another quarterly report by mid-November. Roughly corresponding to the Form 10-K and Form 10-Q found in US securities law, these reports are required to include, among other things, financial statements and information on major shareholders and officers. Table 3 shows the typical structure of the annual report prescribed by the FSS.

Table 3. Required Elements in Annual Reports[13]

Contents	Details
Overview of the company	Company's purpose, history, change in capital, number of shares issued, status of shares in terms of voting rights and dividends
Details of business	Scope of business, main products and source materials, sales and production, facilities, major contracts for management and R&D
Matters concerning finance	Balance sheets, sales during the pertinent time period, income statements and cash flow statements
Audit opinion	External audit opinion on financial statements and matters that may have an impact on financial statements
Organization of company, including board of directors	Rights of the board of directors (BOD) and other important aspects of the company's organization; personal information of directors, resolutions of BOD meetings and other committees under the BOD, and executive remuneration
Matters concerning shareholders	The stock ownership status of the largest shareholders and shareholders holding 5 % or more of shares, minority shareholders at year-end, and shareholder distribution chart showing the proportion held by major shareholders
Matters concerning executives and employees	The personal information and job descriptions of executives, the number of employees, the total amount of annual remuneration paid to executives and employees, and the status of any labor unions
Transactions with interested parties	Matters concerning transactions in cash, securities, and buying or selling of real estate or operations
Matters concerning investor protection	Matters concerning ongoing litigation related to the company, contingent liabilities incurred through litigation at home or abroad, other matters that may have a direct impact on the profit and loss of the company, and matters concerning administrative restrictions

2) Current Reports

Listed companies are also required to notify the FSC/FSS of material events no later than one day after the event occurs (CMA, Article 161(1)). Events subject to such a "current report" requirement (*ju-yo-sa-hang-bo-go-*

13) Korea Financial Investment Association, 2013 Capital Market in Korea, 299 (2013).

seo, which is directly translated as a "major items report") include: (i) a refusal to pay notes or checks issued by the company, (ii) a suspension of checking account transactions, (iii) a suspension of all or important parts of business activities, (iv) a filing for bankruptcy or corporate rehabilitation proceedings, (v) dissolution, (vi) a board resolution for an increase or reduction in legal capital, (vii) a merger or comprehensive stock swap, (viii) a board resolution to transfer or acquire material assets or businesses,[14] (ix) a board resolution to acquire or dispose of treasury stocks, (x) a lawsuit being filed (as either defendant or plaintiff) that is likely to have a material impact on the company, and (xi) a board resolution to issue convertible bonds, bonds with warrant, or exchangeable bonds.

It is not always clear whether a certain event is sufficiently ripe for disclosure. For instance, if the board of directors approved a non-binding memorandum of understanding for the sale of material assets, there may well be differing opinions as to whether such an event is subject to the speedy disclosure requirement in the form of a current report. On the one hand, disclosure of a non-binding agreement may be premature and even somewhat misleading. On the other hand, non-disclosure of such an agreement may prompt use of non-pubic material information by an insider. There is no clear court decision or ruling on this point, but it would be possible to disclose such an agreement with a full explanation of its non-binding nature by way of voluntary disclosure, rather than in the form of a statutorily required current report.

3) Sanctions for Non-Compliance

As with the primary market, the CMA provides three types of sanctions for non-compliance with the regulations for secondary market disclosures: (a) administrative sanctions, (b) criminal liabilities and (c) civil liabilities. If a periodic report or a current report is not filed or there is a material misstatement or omission in such reports, the FSC may take one or more of the following actions against the company (CMA, Articles 164, 429(3)):

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14) If the value of the assets to be transferred or acquired is 10 % or more of the total asset of the company, then such assets are deemed "material." If the revenue from the business to be transferred or acquired is 10% or more of the total revenue of the company, then such business is deemed "material" (CMA Enforcement Decree, Article 171(2)).

- Issue a warning or caution
- Order a public notice and correction
- Restrict further issuance of securities for up to one year
- Recommend dismissal of the directors or officers responsible
- Report the matter to or file a criminal complaint with the criminal authorities (usually the prosecutor's office)
- Impose an administrative fine (*gwa-jing-geum*)

Of these measures, the administrative fine appears to be the most frequent choice of the regulator in its actual practice. In the latter half of 2015, the FSC sanctioned 15 companies for violation of disclosure requirements in the secondary market, mainly for failure of or delay in submitting current reports and omission of important items in current reports. In 12 cases, the FSC imposed administrative fines ranging from KRW 3 million to KRW 63 million, depending on the severity of the case, and in three cases restricted public offerings for certain periods (three months in two cases and two months in one case).

In addition to the administrative sanctions, failure to file a periodic report or a current report is subject to imprisonment for up to one year or a criminal fine of up to KRW 30 million (CMA, Article 446 (xxviii)). CPAs, appraisers, and credit rating agencies that signed or certified a periodic report or a current report with the knowledge of material misstatements or omissions are subject to imprisonment for up to five years or a criminal fine of up to KRW 200 million (CMA, Article 444 (xiii)). Proceedings for such criminal sanctions are usually initiated by an FSC report to the prosecutor's office. Unlike cases of market abuses such as insider trading and market manipulation, however, criminal sanctions are only sparingly used for violations of disclosure requirements.

Finally, an investor who suffers a loss due to any material misstatement or omission in periodic reports or current reports may claim damages against those responsible for such misstatement or omission (CMA, Article 162). Issues relating to civil liabilities are discussed in Part IV below.

3. Disclosure Pursuant to Exchange Rules

1) Types of Disclosure

In addition to the periodic and current reports that are statutorily required under the CMA, listed companies must disclose important matters in accordance with the Disclosure Rules of the KRX. Disclosure under the KRX rules can be categorized into (i) timely disclosure (*su-shi-gong-shi*), (ii) voluntary disclosure (*ja-yul-gong-shi*), (iii) inquired disclosure (*jo-hoe-gong-shi*), and (iv) fair disclosure (*gong-jeong-gong-shi*).

Timely disclosure is required for certain important events prescribed by the KRX. (i) A decision to invest in new facilities in the amount of 10% or more of a firm's equity, (ii) a natural disaster that affects 5% or more of its total assets, (iii) a change in the largest shareholders, and (iv) termination of transactions with a major client that accounts for 10% or more of revenues, are just some examples of matters prescribed for timely disclosure in the KRX rules. The disclosure items are usually prescribed in quantitative terms, leaving little discretion for either the company or the KRX to determine whether a particular event is sufficiently significant.

Voluntary disclosure refers to disclosure made by the company at its discretion when the company believes that certain matters might have a material impact on investment decisions made by investors. *Inquired disclosure* refers to disclosure made by the company upon inquiry by the KRX when the KRX inquires in order to confirm rumors or press exposure or to clarify causes for abrupt changes in stock price or trading volume. *Fair disclosure* is similar to what is required under Regulation FD in the US to prevent information asymmetry between sophisticated investors and general investors. That is, listed companies that wish to provide designated people such as institutional investors or analysts with important information not yet disclosed must first disclose it to ensure that all market participants have access to the same information at the same time.

In 2015, in the KOSPI market, 11,513 timely disclosures, 1,497 voluntary disclosures, 1,404 fair disclosures, and 200 inquired disclosures were made. In the same year, in the KOSDAQ market, there were 12,010 timely disclosures, 2,902 voluntary disclosures, 1,072 fair disclosures, and 302 inquired disclosures. The total number of disclosures made pursuant to the

KRX rules in 2015 was 14,614 in the KOSPI market and 16,286 in the KOSDAQ market, which translates into 19.0 cases per company in the KOSPI market and 14.1 cases per company in the KOSDAQ market.[15)]

2) Sanctions for Non-Compliance

Violation of the disclosure obligations under KRX rules, such as (i) a failure to make a timely disclosure, an inquired disclosure, or a fair disclosure (including material misstatements or omissions in disclosure); (ii) a withdrawal of a disclosure already made; and (iii) a correction of disclosures already made, may be sanctioned by the KRX. The KRX may designate such an issuer as an "unfaithful disclosure company" and impose demerit points. In addition, the KRX may also impose a monetary penalty[16)] of up to KRW 30 million for non-compliance with disclosure obligations. Once designated as an unfaithful disclosure company, the KRX may take one or more of the following measures:[17)]

- Publicly announce the unfaithful disclosure five consecutive times in the Stock Market Magazine from the day that the company is designated as such
- Attach "Un" or "Unfaithful disclosure company" for one month on the table of market quotations in the *Stock Market Magazine* and on electronic stock information terminals
- Publicize the company's name, violation, and demerit points on the KRX's electronic disclosure system (KIND) for one year
- Require training for the company disclosure officer(s) responsible for the violation
- Request submission of an improvement plan

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15) KRX press release dated January 15, 2016 (available in Korean).

16) This is neither a criminal fine nor an administrative penalty in nature. Rather, it is a monetary sanction imposed by the KRX on its members pursuant to its own regulations.

17) Before December 2005, accumulation of a certain number of demerit points automatically resulted in delisting. Now the KRX does not automatically delist unfaithful disclosure companies. Although the KRX still has the authority to delist an unfaithful disclosure company if it violated disclosure obligations regarding significant matters intentionally or with gross negligence, companies are rarely delisted due to violation of disclosure obligations alone.

- Suspend trading for unfaithful disclosure companies that have received more than five demerit points

In 2012, 30 companies were designated as unfaithful disclosure companies in the KOSPI market, based on 43 violations, and 68 companies were designated as such in the KOSDAQ market, based on 76 violations. A review of these sanctions reveals that the KRX usually focuses on technical violations rather than the merits of disclosures. The KRX thus tends to sanction failure to make disclosures, or the delay, withdrawal, or correction of disclosures, rather than scrutinizing false or misleading information contained in the disclosures.

4. Electronic Disclosure System

Since 2001, the FSS has mandated electronic filings of all disclosure reports and documents through the Data Analysis, Retrieval and Transfer (DART) system. Disclosure filings through DART (http://dart.fss.or.kr) are freely available to the public, which is also available in English (http://englishdart.fss.or.kr). Disclosure filings in the primary market (e.g., registration statements, prospectuses), the secondary market (e.g., annual, semi-annual, and quarterly reports and current reports) as well as those under the KRX rules (e.g., timely, inquired, voluntary, and fair disclosure) are all available through DART. In addition, disclosures required under separate statutes, such as reports on major intra-group transactions required under the Monopoly Regulation and Fair Trade Act, are integrated into this system. Moreover, financial statements of non-listed companies subject to an external audit requirement are also accessible in DART.[18)]

Generally regarded as having a user-friendly interface, this system is quite actively used by both the general public and business experts such as

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18) Pursuant to the Act on External Audit of Stock Corporation (**AEA**), a company falling under certain prescribed criteria (e.g., (i) listed companies, (ii) companies with total assets exceeding KRW ten billion, (iii) companies with total assets exceeding KRW seven billion as well as total debt exceeding KRW seven billion and (iv) companies with total assets exceeding KRW seven billion and with 300 or more employees) must have its financial statements audited by an external auditor (AEA, Article 2).

securities analysts and institutional investors. Although the contents of such disclosures are sometimes insufficient, the DART system has been successful in terms of increasing accessibility and has contributed substantially to the transparency of the capital market. The KRX also operates a similar electronic system called KIND (http://kind.krx.co.kr), which is also available in English (http://engkind.krx.co.kr).

5. Remarks on the Regulatory Disclosure Scheme

As discussed above, Korean law and exchange rules require disclosure of material information in various forms that may have significance for investors' decisions in both the primary and the secondary markets, such as registration statements, prospectuses, current reports, and ad hoc disclosures. Although such disclosures are not always satisfactory in terms of their content, they are at least easily accessible through an electronic system open to all current and prospective market participants. Disclosures are collected and analyzed by market experts, such as analysts of securities firms and institutional investors, who in turn provide processed information to the public in the form of analysts' reports. Both the regulators and KRX, the exchange, continuously supervise and monitor such disclosures and exercise their authority to sanction violations of disclosure requirements.

All in all, Korea's regulatory systems for its securities markets appear to be in good working order. However, they alone cannot ideally protect investors because of insufficient incentives and a lack of recovery effects. Victims of the violations, who usually have greater incentives to seek recourse against the violators than most regulators do, cannot enforce the regulations by themselves. Moreover, any administrative or criminal sanction will not compensate for the damages sustained by the investors. In other words, while administrative and criminal sanctions such as monetary penalties may have a deterrent effect, they do not have any recovery effect whatsoever.[19] Therefore, investor protection cannot be complete without an

19) As discussed above, there is no system like 'fair fund' which can serve the interests of the affected investors by using money collected from the violators. Both administrative and criminal fines are simply attributed to the government.

effective system that allows litigation by the harmed investors. The next part of this paper delves into this issue.

IV. Substantive Grounds of Claims for Investor Litigation

1. General

Under Korean law, an investor who desires to file a suit for deficiencies in an issuer's disclosures may resort to several legal grounds: (i) general tort liability under the Korean Civil Code, (ii) liability of the issuer's board members under the Article 401 of the Korean Commercial Code (KCC), (iii) liability of the external auditors under the Act on External Audit of Stock Corporation (AEA), and most importantly, (iv) liability of the issuer and other related persons under the CMA for defective disclosures. According to the prevailing view and Supreme Court rulings, none of these remedies preludes resort to any of the others.[20] After the first three grounds are briefly outlined, the fourth ground receives a more detailed treatment.

2. Tort Claims under the Civil Code

Article 750 of the Korean Civil Code provides that "anyone who caused damage to others by an intentional or negligent illegal act shall compensate for such damage." Due to this broad definition, tort liability may arise in various situations more flexibly than in jurisdictions under Anglo-American legal traditions. Thus, tort claims may be asserted against the issuer and/or its officers, auditors, etc. who are responsible for the defective disclosures. The plaintiff, however, must prove the defendants' misconduct, their negligence or intent, the amount of damages, and causation. Therefore, tort claims under the Civil Code not especially effective in the context of securities litigation.

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20) For example, liability under the CMA or general tort liability does not prelude liability under the other and, thus, a claimant may argue one or both of them (Supreme Court, 96da41991, Sep. 12, 1997). Of course, however, double recovery will not be permitted for a single injury.

One of the few merits of this option is the relatively longer statute of limitations, which is the earlier of (i) three years from gaining awareness of the damage and the tortfeasor or (ii) ten years after the tortious act. In addition, the lack of a strict standing requirement and flexibility in the cause of action may be attractive to a plaintiff who does not satisfy the requirements for the other three types of claims.

3. Claims against Directors under the KCC

Under the KCC, a director owes a fiduciary duty to the company that consists of a duty of care and a duty of loyalty. A breach of these duties may result in civil liability of a director to the company if the company incurred damage (KCC, Article 399) or to a third party if such third party incurred damage (KCC, Article 401). Article 401 is often relevant in investor litigation, because shareholders and bondholders have successfully sued directors of an issuer for accounting irregularities that led to defective disclosure on the grounds of Article 401, as discussed in greater detail below.

1) Elements of Claim

A director may be held liable to a third party if the damage incurred by such third party is caused by the director's intentional or grossly negligent failure to perform his or her duty (KCC, Article 401). That does not mean that the director owes any duty directly to the third party. Rather, a third party who incurred damages due to the director's breach of his or her duties to the company may directly sue the director. As a typical example, if a director prepared false financial statements for the company, as by overstating assets or understating liabilities, and an investor bought the company's bonds relying upon those false financial statements, the bondholder may assert a claim against the director based on Article 401, since the director breached the duty to prepare correct financial statements and that breach caused damage to the bondholder who relied on false statements.[21)]

21) *See*, e.g., Supreme Court, 2007Da31518, Sep. 11, 2008.

Since the KCC has adopted a concept similar to a "de facto director" or a "shadow director" (KCC, Article 401-2), the following persons can also be held liable under Article 401 even if they do not formally hold the position of a director: (i) a person who, by taking advantage of his or her influence on the company, directs a director to execute the business of the company in a particular manner; (ii) a person who has executed the business of the company in the name of a director; (iii) a person who has executed the business of the company using a title regarded as having authority to execute the company's business. "Influence" is the key term in item (i), while "title" is the key term in item (iii). Thus, a person who directed defective disclosures by using his or her influence on the company or who made defective disclosures as an officer with a title of apparent authority may be held liable under Article 401 even if he or she is not formally a director.

2) Scope of Liability

Several issues exist as to the scope of such liability. No one doubts that a creditor of a company constitutes a third party. However, commentators' views vary as to whether the company's shareholders may be regarded as third parties under Article 401. The prevailing view answers this question in the affirmative. Commentators also dispute whether such liability extends to "indirect" as well as "direct" damage. "Indirect damage" refers to damage caused to a third party as a consequence of damage inflicted on the company. For example, if the company's value decreases due to a director's misconduct, the company's shareholders incur indirect damage as a result of the decline in corporate value. The courts have held that the shareholders are not able to claim damages for indirect damage against an offending director under Article 401.[22] In such cases, shareholders would have to rely on a shareholder's derivative suit (KCC, Article 403).

A recent Supreme Court decision[23] sheds some light on the distinction between direct and indirect damage, as well as on its application to a defective disclosure case. Shareholders of a KOSDAQ-listed company filed a lawsuit against one of its directors (who was actually managing the

22) Supreme Court, 91Da36093, Jan. 26, 1993.

23) Supreme Court, 2010Da77743, Dec. 13, 2012.

company) based on Article 401. The facts can be summarized as follows: (i) the plaintiff purchased shares on the exchange (Tranche 1); (ii) the defendant embezzled corporate assets and made false disclosures about the company's financial status that did not reflect the embezzlement, such that the stock price of the company was much higher than it would have been if correct disclosures had been made; (iii) the plaintiff purchased additional shares (Tranche 2) on the exchange without knowing about the embezzlement and false disclosures; and (iv) the misconduct later became known to the market and the stock price plummeted. The Supreme Court held that the damage related to Tranche 2 was "direct damage" payable under Article 401 because the plaintiff was defrauded into paying an unfairly high price, while most of the damage related to Tranche 1 was simply "indirect damage" and could not be claimed under Article 401 because it was simply a reflection of the damage incurred by the company; that damage could be claimed by the company itself or through a shareholder's derivative action.

In order to make a claim under Article 401, the plaintiff must prove at least gross negligence on the part of the director as well as causation and the amount of damages, which taken together are quite burdensome. However, Article 401's long statute of limitations (ten years from the date the damage was incurred) may be attractive to investors who have missed the shorter statute of limitations for other claims. Such a claim may be also attractive when the issuing company has become insolvent but its directors or a controlling shareholder remain solvent.

4. Claims under the AEA

The AEA provides a basis for a claim against an "external auditor."[24] An external auditor refers to an accounting firm or a registered audit team composed of CPAs in charge of the external audit of a company. Under the AEA, all listed companies and selected non-listed companies satisfying certain criteria must appoint an external auditor and have their financial statements audited. After completion of an audit, the external auditor must

24) Korean law uses the term "external auditor" in order to distinguish it from an "internal auditor" (also known as a "statutory auditor") required by the KCC.

prepare an audit report, which includes an auditor's opinion, audited financial statements, and notes to the financial statements. Such audit reports are available in the DART system to the public, whether or not the audited company is a listed firm.

1) Elements of Claim

If an external auditor causes damage to a company due to negligence in the performance of his or her duties, he or she is held liable for such damage to the company (AEA, Article 17(1)). If an external auditor, by failing to record important matters or making a false statement in an audit report, causes any damage to a third party who trusted and utilized the audit report, the external auditor is also held liable for damage to that third party (AEA, Article 17(2)). This demonstrates that "reliance" is one of the elements of the third party's claim under the AEA, unlike claims under the CMA, which are discussed below. If, however, false statements in the audit report on the consolidated financial statements are attributable to the fault of external auditors of different companies (e.g., a subsidiary or an affiliate company included in the consolidated financial statements), the auditors responsible for those statements are held liable.

As a matter of principle, external auditors carry the burden of proof. In other words, in order to avoid liability, external auditors must prove that they did not neglect their duties (AEA, Article 17(7)). However, the burden of proof shifts to the plaintiff (thus, the plaintiff must prove the external auditor's negligence) if the plaintiff is (i) the company that appointed the external auditor, (ii) a financial institution, (iii) an insurance company, (iv) a merchant bank, or (v) a mutual savings bank (AEA, Article 17(7)). The AEA is silent on a precise definition or standard of negligence, but it is generally accepted that a lack of "due care as a faithful manager" (Civil Code, Article 681) would constitute negligence for the purpose of the AEA.

If directors or statutory auditors of the company are also found liable for the same matter, the external auditor is jointly and severally liable with them. However, defendants whose misconduct was not intentional are only proportionately liable, in proportion to their level of responsibility as apportioned by the court (AEA, Article 17(4)).[25)]

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25) This apportionment provision was newly added on December 30, 2013 to alleviate the

2) Implications for Investor Protection

An AEA claim has relevance to our topic because an audit report prepared by an external auditor must be attached to certain disclosure documents, such as registration statements and annual reports.[26] Thus, investors who later find material misstatements or omissions in the audited financial statements attached to or included in a registration statement or an annual report may assert claims against the external auditor, which is particularly useful if the issuer itself has already become insolvent. In addition, AEA claims may arise even if the issuer is a non-listed company, so long as the investors can show that they somehow relied on the audit report when purchasing the securities in question. Recently, an increasing number of lawsuits have been filed against accounting firms, including the "Big Four" firms,[27] exposing those firms to significant risk.

In a striking example, the Seoul Central District Court recently ordered Samil PricewaterhouseCoopers, a PWC member firm in Korea, to pay approximately KRW 14 billion to 137 plaintiffs who were shareholders of a now-delisted company that had traded on KOSDAQ market, on the grounds including the fact that the accounting firm failed to detect fictitious sales when auditing the firm's financial statements.[28] The defendant argued that it should not be blamed for failing to detect such irregularities because the company deliberately delivered false documents for an audit. The court, however, did not accept that argument and ruled that the accounting firm should have further confirmed, via inquiries to the buyers or site visits or otherwise, whether the sales were genuine given that the broader circumstances created reasonable suspicion as to the credibility of the sales information.

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liability of the external auditor. It was modeled after the apportionment provisions of the US's Private Securities Litigation Reform Act of 1995.

26) If the audit report is attached to the secondary market disclosures (e.g., periodic reports or current reports), Article 170 of the CMA comes into play for the liability of the external auditor. However, since Article 170 of the CMA refers to and imports Article 17 of the AEA anyway (with special provisions regarding presumption of damages and rebuttal of such presumption), this paper disregards technicalities and proceeds as if Article 17 of the AEA is directly applied.

27) Namely, KPMG, PricewaterhouseCoopers, Deloitte, and Ernst & Young.

28) Seoul Central District Court, 2012Gahap20272, Oct. 31, 2013, (as of October 2016, pending at Seoul High Court).

External auditors must establish a joint fund for damages or purchase an insurance policy in order to guarantee the release of such liabilities (AEA, Article 17-2(1)). The statute of limitations for claims against the external auditor is the earlier of (i) one year from the date when the claimant has become aware of the relevant fact or (ii) three years from the date when the audit report was submitted (AEA, Article 17(9)).

5. Claims under the CMA

Under Article 125 (for primary markets) and Article 162 (for secondary markets), the CMA provides powerful grounds for claims relating to defective disclosures. An issuer, its directors, underwriters, and certain "gatekeepers" like external auditors, are held jointly and severally liable for damages incurred by investors due to material misstatements or omissions in disclosures, in both the primary and secondary markets. Compared to the claims under KCC Article 401 (targeting a director) and AEA Article 17 (targeting an external auditor), the claims under the CMA apply to a much wider range of defendants and impose significantly lighter requirements on those seeking recourse.

1) Conducts Subject to Liability

(1) Primary Market

Under Article 125, "false statements about material matters" or "omissions of material matters" in registration statements or prospectuses are subject to liability for damages. Such false statements or omissions in any amendments or attachments to these documents are also subject to the same liability. The CMA does not expressly address whether such liability extends to *misleading* statements. According to the prevailing view, however, misleading statements that are likely to cause a misunderstanding by investors also constitute "false statements" that fall under this article.[29] On the contrary, failure to submit a registration

29) Konsik Kim & Sunseop Jung, JABONSHIJANGBEOB [CAPITAL MARKETS LAW], Duseong-Sa, 231 (3rd ed., 2013); Jai Yun Lim, JABONSHIJANGBEOB [CAPITAL MARKETS LAW], Bak Young Sa, 422 (2014). Court cases rarely touch upon "misleading statements" or "forward-looking statements." Almost all the court cases in Korea on liability for defective disclosures involve

statement or deliver a prospectus does not fall under the "false statements or omissions" referred to in this article.

Materiality is required for both false statements and omissions. The CMA defines "material matters" as "matters that may produce a significant impact on the investor's reasonable judgment or the value of the relevant financial investment instrument" (CMA, Article 47(3)). Based on this definition, courts must determine whether the misstated or omitted matters had a significant impact on the investor's decision to buy or sell the securities.

The CMA provides a safe harbor for *forward-looking statements*, which are not subject to liability so long as (i) the statements are clearly identified as forward-looking statements, (ii) the grounds for such forecasts or prospects are clearly stated, (iii) the statements are made in good faith based on reasonable grounds or assumptions, and (iv) there is a warning clause that the actual outcome may differ from the estimates (CMA, Article 125(2)). Such a safe harbor, however, does not apply in the context of an initial public offering (CMA, Article 125(3)).

(2) Secondary Market

Under Article 162, "false statements or presentations of material matters" or "omissions of material matters" in annual reports, semi-annual reports, quarterly reports and current reports, as well as any amendments or attachments to such documents, are subject to the same liability; however, among such attachments, audit reports prepared by an external auditor are specifically carved out because they are treated separately under Article 170 of the CMA and Article 17 of the AEA, as discussed above. Disclosures made pursuant to the KRX rules are not subject to liability under Article 162. The rules for misleading statements, the materiality requirement, and forward-looking statements in the secondary market are identical to those for the primary market.

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false statements, in particular inaccurate financial statements, such as overstated assets, overstated revenue and understated debt.

2) Parties Subject to Liability

(1) Primary Market

According to Article 125, the following persons can be held liable under the CMA:

- The issuer of the offered securities;
- Any director of the issuer at the time of the filing of the registration statement, regardless of whether he or she was actually involved in its preparation and filing;
- Any de facto director under Article 401-2 of the KCC who directed or executed preparation of the registration statement;
- Any CPA, appraiser, credit rating specialist,[30] lawyer, patent attorney, or tax attorney, who certified with his or her signature that the descriptions in the registration statement or its attachments were true and correct (including any organization to which such a person belongs);
- Any person who consented to include his or her statement of evaluation, analysis, or verification in the registration statement or its attachments and confirmed such statement;
- Any underwriter of a public offering (if there are multiple underwriters, only the lead underwriter is liable); and
- Any person who prepared and delivered the prospectus.[31]

(2) Secondary Market

According to Article 162, the following persons can be held liable:

- The issuer;
- Any director of the issuer at the time of the filing of the relevant report, regardless of whether he or she was actually involved in its preparation and filing;
- Any de facto director under Article 401-2 of the KCC who directed

30) In practice, however, a credit rating specialist is not required to sign the registration statement or its attachments. Thus, in spite of this provision, a credit rating agency will not be held liable under the current practice, either in the primary or secondary markets.

31) It actually refers to the issuer.

or executed preparation of the relevant report;

- Any certified public accountant, appraiser, credit rating specialist, lawyer, patent attorney, or tax attorney who certified with his or her signature that the descriptions of the relevant report and its attachments were true and correct (including an organization to which such a person belongs); and
- Any person who consented to include his or her statement of evaluation, analysis, or verification in the relevant report or its attachments and confirmed such statement.

3) Claimants

(1) Primary Market

Investors who "acquired the securities" may assert claims for damages as long as the other elements are met (Article 125(1), CMA). Those who acquired the securities directly from the issuer at the offering clearly fall into this category. There are conflicting opinions among scholars, however, as to whether those who acquired the securities on the exchange (i.e., in the secondary market) may also assert a claim for defective disclosures in the offering documents. In cases where false statements in registration statements were at issue, the Supreme Court ruled that those who purchased the securities in the secondary market do not have claims under Article 125 of the CMA, on the ground that this claim is designed to protect only investors participating in the primary market.[32] Moreover, if the investor acquired the securities in the primary market, he or she does not need to continue to hold the securities at the time of making his or her claim.

(2) Secondary Market

Investors who "acquired or disposed of the securities" may assert claims for damages as long as the other elements are met (Article 162(1), CMA). Unlike primary market disclosures, the Supreme Court, in a case where false statements in an annual report were at issue, held that those who purchased securities in the secondary market do have a claim under

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32) Supreme Court, 99Da48979, May 14, 2002; Supreme Court, 2001Da9311, Sep. 24, 2002.

Article 162 of the CMA.[33] The language of the CMA ("or disposed of") clearly indicates that the claimant does not need to hold the securities at the time of making a claim.

4) Defenses

Against claims under Articles 125 and 162 of the CMA, defendants have a *due diligence defense*. The investor does not need to prove negligence by the defendants; rather, a defendant must prove that "he or she was unable to discover such false statements or omissions even if he or she exercised reasonable care" (Articles 125(1) and 162(1)). The Supreme Court elaborated that such a defense can be accepted when "(i) the defendant conducted an inspection reasonably expected from the status of the defendant, (ii) there were reasonable grounds for the defendant to believe that there were no false statements or omissions, and (iii) the defendant actually so believed."[34] Based on such tests, the court does not easily accept this defense. In addition, a defendant is not liable if he or she proves that the claimant *knew* the facts at the time of acquisition (or, in case of the secondary market and where the claimant is a person who sold the securities, at the time of sale) (Articles 125(1) and 162(1)).

5) Causation

There are two types of causation. The first is *transaction causation*, meaning the claimant purchased or sold the securities based on the defective disclosure. The second is *loss causation*, meaning the investor suffered a loss because of the defective disclosure. The second issue is discussed in *6)* below, as an issue of damages calculation.

Regarding "transaction causation," let us assume three situations: (i) the investor knew the disclosure was defective and acted anyway, (ii) the investor reviewed the disclosure and relied on it without knowledge of the defect, or (iii) the investor did not review the disclosure at all. In situation (i), as discussed in *4)* above, the CMA clearly denies the investor's claim so long as the defendant can prove that the claimant had such knowledge. In situation (ii), transaction causation definitely exists, but the question is

33) Supreme Court, 2008Da31751, Nov. 27, 2008.

34) Supreme Court, 2006Da81981, Sep. 21, 2007.

whether claimants need to prove that they did not know of the defect(s) at issue. The prevailing view rejects placing such a burden on investors.[35)]

In situation (iii), the defendant might argue that there was no causation by proving the investor could not have relied on the defective disclosure because he or she never looked at it. However, such an argument unduly compels investors to review every disclosure before making a sale or purchase decision. In addition, defective disclosures may constitute "fraud on the market" and may have indirectly affected the claimant's investment decision. Therefore, even if the defendant succeeds in proving that the claimant never looked at the defective disclosure, as in situation (iii), causation is not likely to be denied. Although there is no clear court holding, that appears to be the prevailing view among commentators.[36)]

6) Calculation of Damages

Even if all the other elements of a claim are met, claimants still have to prove the amount of damages suffered, which may not be an easy task. In order to alleviate such difficulties, the CMA provides a special provision for calculating damages in both the primary and secondary markets (Articles 126 and 162(3)(4)). The amount of damages is presumed to be "the price actually paid by the claimant to purchase the security" minus "the market price of the security at the time of closing the proceedings of the lawsuit." If the claimant sold the security before the closing of the proceedings, the subtracted amount is "the sale price."

This calculation, however, is merely a rebuttable presumption. Notwithstanding this presumption, the defendant may avoid or reduce liability by proving that all or part of the presumed damages were not caused by the material misstatements or omissions. In other words, the CMA allows a defense of the "absence of loss causation" so long as the defendant proves that absence and thus rebuts the presumption.

Loss causation is often debated before the courts, which sometimes accept that the defendant has rebutted the presumption by acknowledging the absence of loss causation. In a case where the window dressing in the annual report was at issue, the Supreme Court ruled as follows:

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35) *See* Kim and Jung, *supra* note 29 at 243.

36) *See* Lim, *supra* note 29 at 457; Kim and Jung, *supra* note 29 at 244.

> Generally, in a case where the normal share price was formed after the window dressing accounting had been revealed, its shock effect disappeared, and the price increase due to such false information all eliminated, then there exists no causation between the window dressing accounting and the share price changes after the date normal share price was formed … The loss amount in this case is the amount which is calculated by deducting "the share price as of the date when the normal share price was formed" from "the purchase price."[37)]

To understand this ruling, let us assume that the claimant acquired the shares at KRW 100, that the stock price gradually increased to KRW 120, and that it suddenly plummeted to KRW 60 after the window dressing became known to the market. Then, after a few days of price fluctuation, the price became relatively stable around KRW 70. A lawsuit was filed, and after several months, the price was KRW 40 at the time of the closing of the proceedings at which time the claimant still held the shares. According to the CMA, the damages are presumed to be KRW 100 minus KRW 40, or KRW 60. According to the Supreme Court ruling, however, the damages would be only KRW 30 because what happened after the price was stabilized at KRW 70 was not caused by the defective disclosure.

7) Statute of Limitations

Claims under Articles 125 and 162 are time-barred at the earlier of (i) one year from the date when the claimant became aware of the relevant fact or (ii) three years from the date when the registration statement became effective (in the case of the primary market) or three years from the date when the relevant report was submitted (in the case of the secondary market).

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37) Supreme Court, 2008Da92336, Aug. 19, 2010; Supreme Court, 2006Da16758, Oct. 25, 2007.

V. Enforcement of Claims

Based on the substantive legal grounds discussed above, an increasing number of lawsuits have been filed against issuers, directors, accounting firms and underwriters. In order to facilitate and expedite such suits, a class action scheme was introduced in 2005, but it has not been actively used. After an explanation of the technical mechanism for filing a class action in Korea, the reality concerning enforcement will be discussed, followed by short notes on cross-border enforcement.

1. Securities-Related Class Actions

1) Background

A class action is now permitted under Korean law for specific types of lawsuits, including securities-related suits. Prior to the enactment of the Securities Class Action Act (SCAA) (enacted in 2003 and effective as of 2005), a Korean court would adjudicate multiple complaints with similar contents against the same defendant simply by consolidating them procedurally. The court judgment had to apply only to the pertinent case, and only those individuals that instigated legal actions as plaintiffs benefited from the decision. The SCAA was enacted to address such difficulties and to facilitate the recovery of damages incurred by investors.

The SCAA applies only to specific claims with respect to listed companies: (i) damage claims for defective disclosures in the primary market (registration statements and prospectuses) and the secondary market (periodic reports),[38] (ii) damage claims for insider trading, stock price manipulation, and certain other types of market fraud; and (iii) damage claims against the external auditor for improper auditing.

2) Filing of Action and Commencement of Proceedings

A person who desires to be a lead plaintiff must file both a complaint and an application for court approval of the class action (SCAA, Article

38) Defective disclosures in the current reports are not subject to the SCAA.

7(1)). Once the complaint is filed, the court must notify the relevant securities market of the filing of the suit in order to protect minority investors by ensuring that they have an opportunity to participate in the pending suit (SCAA, Article 7(4)). Furthermore, the court is required to place a public notice in a nationally circulated daily newspaper regarding, among other things (i) the fact that a class action has been filed, (ii) the scope of the class, and (iii) the nature and basis of the claim (SCAA, Article 10(1)).

A class action may begin only after the court has given its approval. All of the following requirements must be met in order for the court to grant such approval: (i) the lawsuit must involve 50 or more class members that collectively possess at least 0.01% of the total outstanding securities issued by the company, (ii) the claims of the class members must involve common questions of law and fact, and (iii) the lawsuit must constitute an appropriate and effective means of realizing the rights of the class members or protecting their interests (SCAA, Article 12(1)). Upon issuing its approval, the court must notify the class members of the basic information on the lawsuit. The court must also notify the class members that they may file an opt-out application (SCAA, Article 18(1)).

3) Lead Plaintiff

The lead plaintiff, who takes the lead in the class action on behalf of the class members, is designated by the court upon application. If there are multiple applications, the court will designate the lead plaintiff, who is expected to represent the interests of the class in the fairest and most proper way. The court may, on its own initiative or pursuant to application by others, order the lead plaintiff to cease his or her role in the event that he or she fails to represent the interests of the class members properly (SCAA, Article 22(1)).

In order to prevent abuse of the class action option, any person that has participated in any securities class action as a lead plaintiff at least three times during the previous three years is barred from serving as the lead plaintiff, unless permitted by the court (SCAA, Article 11(3)). The same disqualification applies to the plaintiff's counsel (SCAA, Article 11(3)). Thus, a lawyer can be appointed as a counsel of the class action plaintiff at most three times over a three years.

4) Calculation of Damages

The SCAA provides that damages should be calculated based on the CMA or other relevant laws, and further provides that "where a court finds it difficult to accurately calculate damages … it may compute the damages by the methods of sample, average or statistical calculation or by other reasonable methods, taking into consideration all circumstances involved" (SCAA, Article 34(2)), which considerably lightens the claimants' burden of proof regarding damages and grants broad discretion to the court.

5) Settlement and Judgment

Withdrawal or settlement of the lawsuit requires approval from the court (SCAA, Article 35(1)). A final judgment will be binding on all of the class members, except for those class members that had explicitly chosen to opt out (SCAA, 37(1)).

6) Distribution of Collected Assets

When the court finds for the plaintiff and the lead plaintiff enforces the judgment against the defendant, the court will appoint a distribution agent (SCAA, Article 41). Such agents are required to distribute, under the supervision of the court, the assets collected by the lead plaintiff from the defendant, after deducting attorneys' fees. Upon application from the lead plaintiff, the distribution agent, or a class member, the court has the discretion to reduce attorneys' fees, taking into consideration all circumstances (SCAA, Article 44(3)).

Every class member reports his or her claim to the distribution agent. If the aggregate reported claim exceeds the amount collected from the defendant, class members will share the collected amount on a pro rata basis (SCAA, Art 45). On the other hand, any surplus after the distribution will be returned to the defendant (SCAA, Article 55).

2. *Remarks on the Reality of Enforcement of Claims*

1) Rarity of Class Actions

The enactment of the SCAA was a hotly debated issue that caused great

deal of resistance from the business community in the early 2000s.[39] They argued that such a law would result in a large number of frivolous suits with little substantive merit, citing the US as a cautionary example. Strict procedural requirements in the SCAA (e.g., court approval at the outset, disqualifications of a lead plaintiff or plaintiff's counsel) were put in place to allay these concerns. Almost 12 years after the act came into force, however, it has turned out that these worries were unfounded. Between January 2005 and November 2016, only nine class actions have been filed, out of which five cases are pending after approval.

This lack of class actions may be attributable to various factors, such as (i) strict procedural requirements, (ii) an insufficient number of specialized counsel, and most importantly, (iii) a lack of incentive. Many experts point to the lengthy proceedings for obtaining court approval as the major procedural barrier. The rule barring more than three cases over three years, which applies to both the lead plaintiff and to plaintiff's counsel, is also a significant hurdle.[40] In terms of incentives, given that (i) Korean law does not acknowledge punitive damages, (ii) the lead plaintiff cannot take a larger portion of any assets recovered, and (iii) attorneys' fees may not be fully reimbursed from the assets recovered from the defendant, hardly anyone would have enough incentive to organize and file a class action.

2) Lawsuits Other Than Class Actions

Although class actions have proven to be very rare, securities litigation based on one of the foregoing substantive grounds (but not class actions procedurally) are generally increasing. Although no reliable statistics are available, the number of such lawsuits must be far greater than that of class actions. This shows that the class action under the SCAA provides so little benefit to damaged investors that they simply do not use the mechanism, resorting instead to traditional lawsuits.

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39) Regarding various arguments raised by the opponents to this legislation, *see* Dae Hwan Chung, *Introduction to South Korea's New Securities-Related Class Action*, 30 J. Corp. L. 165, 170 (2004).

40) In the United States, the restriction is less stringent for lead plaintiff, limiting lead plaintiffs to no more than five securities-related class actions within any three year period. Such a restriction, however, does not apply to lead plaintiff's counsel. Dae Hwan Chung, *supra* note 39 at 174-175.

The question then is whether such traditional proceedings are sufficient to realize the investor's claims granted on substantive grounds. We can briefly review this issue from the perspectives of information and incentive.

First, let us look at the issue of information. Electronic disclosures provide important clues, but it is still very difficult for investors to acquire information about the internal processes and decisions of an issuer that may have led to the defective disclosures. In Korea, administrative proceedings and, to a lesser degree in the context of disclosures,[41] criminal proceedings play a significant role in this regard. Administrative and criminal sanctions on a company for false disclosures would prompt litigation by the investors, and the pieces of fact found by the regulators would serve as powerful grounds for the claims. In addition, documents gathered or prepared by the regulators for such sanctions can be used as evidence in litigation by employing one of the following methods: (i) a plaintiff may ask the court to request relevant documents from the regulators or (ii) although subject to more restrictions, a plaintiff may directly request the regulator to provide such information. Given this mechanism, enforcement actions by regulators have obvious positive impacts on private litigation in terms of access to information.

Second, let us move on to the issue of incentive. Securities litigation tends to be more active when there are sufficient incentives to sue. Factors such as the amount of damages, the amount of costs (including attorneys' fees) recoverable from the losing party, and court fees to be paid for filing a suit may all affect investors' incentive to sue. As shown above, the CMA provides a rebuttable presumption of the damages to ease the burden of proof, but the lack of punitive damages in Korea keeps investors' incentive to sue at a much lower level than in US.

It is sometimes suggested that the rule stipulating that the loser pays court costs discourages litigation. Under Korean law, the losing party must reimburse the winning party for his or her litigation costs. Among those costs, however, attorneys' fees are only partly reimbursable according to a

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41) For insider trading, stock price manipulation and other market abuses, the role of criminal sanctions is crucial. Thus, information gathered and produced in criminal proceedings is often used as important evidence in civil litigation for such market abuses. For deficient disclosure cases, criminal sanctions are only sparingly used.

complex formula prescribed by the Supreme Court. For example, for a suit that claims KRW 1 billion in damages (roughly USD 0.9 million), the amount of attorneys' fees that the winning party may seek from the losing party cannot exceed KRW 12 million (roughly USD 11,000). Therefore, the loser pays rule does not appear to be a major deterrence for filing a suit in Korea in the context of securities. On the contrary, the restriction on the amount of reimbursable attorneys' fees sometimes reduces the incentives for the plaintiff and plaintiff's counsel to sue, because even if they win the suit, they can only obtain reimbursement of a small portion of the attorneys' fees from the defendants.

Court fees (in the form of stamp duty) paid to the court at the time of filing a lawsuit depends on the amount of claims but are not prohibitively high. For a claim exceeding KRW 1 billion, the stamp duty is 0.35 % of the claim amount plus KRW 55,000. This means that, for a claim equivalent to USD 1 million, the stamp duty is approximately USD 4,000.

All in all, although court fees and litigation costs are not prohibitively high, the lack of punitive damages and restrictions on reimbursable attorneys' fees (and, in case of the class action, the court's ability to reduce those fees) generally limits incentives to sue. As such, securities litigation in Korea has not always been initiated purely out of pecuniary interests. Rather, many such suits have been organized and sponsored by certain NGOs, apparently out of particular socio-political motives designed to expose and penalize market abuses. Although there are not yet a large number of specialized plaintiff's lawyers, as there are in the US, a few small law firms led by minority shareholder activists are gaining fame for actively representing minority investors in derivative suits and securities suits.

3. Cross-border Enforcement

Geographic borders have had less and less significance in the operation of securities markets around the globe.[42] As of September 2016, equity securities of 16 foreign firms are listed on KRX exchanges (both KOSPI and

42) T.L. Hazen, The Law Of Securities Regulation, Revised Fifth Edition 730 (West Group 2006).

KOSDAQ markets), including 12 Chinese firms, two US firms, one Japanese firm, and one Laotian firm. Conversely, securities issued by many Korean firms are listed on foreign exchanges, mostly in the form of depositary receipts.

Regarding the extraterritorial application of securities laws of Country A, one approach is based on the conduct of foreign persons within Country A, while the other focuses on the effects within Country A of conduct occurring in foreign countries. Article 2 of the CMA adopts the latter approach by stating that "this Act applies to the conduct occurring in foreign countries which has effects on the domestic [market]."[43] Then, will any defective disclosures made in Korea by a publicly traded foreign company listed on the KRX be subject to the jurisdiction of a Korean court and investor claims under Korean law? This question includes the issues of jurisdiction and governing law.

As for jurisdiction, the International Private Act, Korea's main statute on the conflict of laws, adopts the "substantial connection" test (Article 2(1)). This test requires a review of fairness, convenience and predictability in enforcing parties' rights, as well as the efficiency and effectiveness of the judgment.[44] If investors participating in Korean capital market were defrauded by defective disclosures made in Korea, a "substantial connection" to Korea will most likely be found.

As for governing law, the International Private Act states that tort liability is governed by the law of the place of tortious act (Article 32(1)). Claims under the AEA and the KCC regarding defective disclosures will be treated in accordance with tort liability for the purpose of determining the governing law. In addition, the CMA clearly declares the "effect approach" in Article 2 as already mentioned. Therefore, if a case is brought to a Korean court regarding false disclosures made by a foreign issuer in the Korean securities market, all four substantive grounds (tort, KCC, AEA, CMA) will be reviewed under Korean law.

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43) For further details of the extraterritorial application of the CMA, *see* Kun Young Chang, *Extraterritorial Application of the Korean Capital Markets Act: Lessons from Securities Regulations in the United States*, 23-1 Asia Pacific Law Review 67 (2015).

44) Supreme Court, 2006Da17539, Jul. 12, 2013; Supreme Court, 2010Da18355, Jul. 15, 2010; Supreme Court, 2006Da71908, May 29, 2008, etc.

In 2012, a Chinese company named China Gaoxian (more precisely, the Singaporean holding company of China Gaoxian), was delisted from the KRX only three months after its listing, due to a scandalous accounting fraud: its registration statement indicated over KRW 100 billion in cash or cash equivalents, but it turned out that it had almost no cash or cash equivalents. A lawsuit was filed by investors against the underwriters (claims under the CMA and tort claims), the accounting firm (claims under the CMA and the AEA), as well as the KRX (tort claims), and the plaintiffs won against 1 one underwriter while claims against other defendants were not accepted by the court.[45] The issuer, China Gaoxian's Singaporean holding company, was not named as a defendant because it would have almost certainly been impossible to enforce any award against it, but if it had been sued before the Korean court, the court would have had to accept its jurisdiction and applied Korean law.

If, in turn, any Korean company listed abroad makes false disclosures in that market, and a foreign court renders a judgment against the issuer and/ or its officers, such a judgment will be enforced in Korea so long as a few conditions are met: (i) the judgment must be final, (ii) the international jurisdiction of such foreign court must be recognized based on the principles of Korean law and international treaties, (iii) the defendant must have received service of the complaint and the court orders in a lawful and reasonable manner, (iv) such judgment must not violate the good morals and public policy of Korea, and (v) there must exist a mutual guarantee for enforcement of the judgment between that foreign country and Korea (Civil Procedure Code, Article 217).

VI. Concluding Remarks

The Korean securities market faces an ever-increasing demand from investors for transparent and legitimate operation. As a result of legislative, administrative, and judicial endeavors to protect investors in the securities

45) The first instance decision was rendered by Seoul Southern District Court on January 17, 2014 and the appellate court decision was rendered by Seoul High Court on November 24, 2016. The case numbers are not publicly available.

market, both regulatory schemes and substantive grounds for claims are in place, producing a significant number of administrative sanctions and court judgments of civil liability for defective disclosures. It is noteworthy that electronic disclosures have contributed significantly to the transparency of the market, which was made possible by Korea's highly-developed broadband Internet environment. Furthermore, the increasing number of lawsuits against gatekeepers such as accounting firms and underwriters are requiring far more due diligence on their side, which is another positive step in investor protection. Still, insufficient incentives to sue remain one of the biggest hurdles for remedies through litigation. Proposals to amend the SCAA to revitalize class actions, such as lifting procedural barriers and offering pecuniary incentives to the lead plaintiff and its counsel, should be seriously considered.