

Challenges for Regulatory Improvements on Private Fund Distribution

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Korea's private fund distribution has Korea-specific features in investor qualification, investment recommendations, and sales channels. The recent cases of large-scale redemption freezes could have been the result of those features adversely affecting the efforts to help a customer-oriented sales process to take hold. Going forward, a bold policy action is required to break free from the repeated pattern of a crisis of confidence where private fund market inefficiency such as high information asymmetry is transferred to investors. What's proposed is to scale down the "qualified retail investor" scheme while broadening the scope of the "professional retail investor" scheme. Also, it's worth considering applying the current investment recommendation regulation to all retail investors regardless of whether they are professional or ordinary investors. With regard to the distribution channel, it is now time to review how large-scale channels and direct channels divide their roles as do other markets. What seems necessary at the current stage is a strategy to establish a direct channel via prime brokers that could provide systematic support to incubation funds for new asset managers, while existing large-scale channels reorganize their product lineup centering on private funds with proven track records in a bid to regain its reputation and confidence as a wealth management service provider.

A privately placed fund is far more prone to fraudulent and unlawful practices due to its higher information asymmetry between the managers and the investors, compared with

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a publicly offered fund. Hence, the market for private funds has traditionally been led by institutional investors who are equipped with professional and systematic tools for producing information and tolerating risk with regard to investment targets and strategies. Although some retail investors qualified as a professional investor participate in the market, their proportion is quite low. The most important factor to consider in a policy of opening the private fund market to retail investors is to make the distribution policy fully reflect the characteristics of private placements and retail investors. Based on the assumption that the wave of recent redemption freezes in Korea is somewhat related to some distinctive features in Korea's private fund scheme such as investor qualifications, investment recommendations, distribution channels, etc., this article tries to propose some ideas that could improve Korea's private fund distribution scheme going forward.

Broaden the scope of “professional investors” to retail clients

The most important policy decision in allowing retail investors to invest in a private fund would be how to define the qualifications of retail investors in terms of their capability of information production and risk tolerance. Admittedly, the recent redemption freezes by some funds have raised skepticism over allowing retail investors to directly purchase private funds. However, no country with a developed private fund market has banned retail investors. Rather, the systems and experiences of developed economies demonstrate that a well-defined qualification requirement could protect retail investors and broaden investor choices. For example, the US Securities Exchange Commission finds that retail investors have accounted for around 10% of private funds (net worth) for several years, which is far higher than Korea's 5–6%.

What's viewed important in treating a retail investor as a professional investor includes investment experience (information production capability), and income and assets (risk tolerance capability). The US has a dual classification scheme to define professional investors. For investing in a private fund established under Section 3(c)(1) of the Investment Company Act, an investor should have risk tolerance capability to be considered an accredited investor: More specifically, he or she should have a net worth of at least \$1 million (with the spouse), and an annual income of at least \$200,000 (alone) or at least \$300,000 (with the spouse) in each of the two most recent years. Private funds established under Section 3(c)(7) of the Investment Company Act use investment experience as a “qualified purchaser” requirement. A qualified



purchase should have at least \$5 million investment outstanding. Although the US does not require risk tolerance and information production at the same time, the EU requires both for retail investors to be considered a professional investor.¹⁾ Korea also has recently revised its professional investor scheme adopting the EU approach.

Another policy consideration in this area is whether to ban retail investors unqualified as a professional investor from investing in a private fund or not. The answer is no in the US where private funds established under Section 3(c)(1) of the Investment Company Act can be invested by up to 35 “sophisticated investors”. The “sophisticated investor” requirement consists of qualitative criteria about an individual’s information production capability, instead of investment experience (investment outstanding). Sophisticated investors refer to lawyers, certified professionals, and other industry experts who have advised private funds. This is also part of Europe’s professional investor requirement. In any case, individual investors meeting the requirement are very few, taking up a very small proportion that cannot be extended to a great number of unspecified individuals.

Korea also has a “qualified retail investor” scheme that is likened to the sophisticated investor classification in the US that allows certain ordinary investors to invest in a private fund. However, Korea’s scheme—unlike the US sophisticated investor scheme—requires a minimum investment of KRW 300 million. This is somewhat insufficient to prove an investor’s capability of information production and risk tolerance. Because the minimum investment itself does not show anything about an investor’s funding source, financial condition and knowledge, which is prone to a problem. Qualified retail investors, as opposed to professional investors, are estimated to account for a higher proportion of investors in the private funds whose redemptions have been suspended recently.²⁾

Given the recent market developments including overseas cases, Korea’s recent redemption freezes and the insufficient qualified retail investor requirement, a desirable policy direction towards sound market development should be to broaden the scope of professional investors to retail investors (“professional retail investors”) in the private fund market. Korea’s recent revision on the professional investor scheme includes a broad range of indicators that help

1) To be considered a professional investor, an investor should meet at least two conditions of the followings: Over 10 transactions on quarterly average for the past four consecutive quarters; over 500,000 euro of financial assets (savings included); or over one-year work experience in the financial industry.

2) Because Korea’s current private fund sales data do not divide retail investors into subcategory, it is hard to confirm whether they are qualified or professional investors.

identify an investors' information production and risk tolerance capability. By adjusting regulatory levels, it aims to broaden the scope of prospective investors. By contrast, the qualified retail investor scheme is still regarded insufficient to protect investors despite its increase in the minimum investment from KRW 100 million to KRW 300 million. Hence, a desirable regulatory approach is to limit the potential target of qualified retail investors, either by adopting the professional investor scheme or by benchmarking the qualitative criteria for US sophisticated investors (certifications, industry experts, etc.) for redefining the existing requirement.

Applying investment recommendation regulation to all investors

Although the aforementioned qualification requirement for retail investors aims to set a limit of investors who can protect themselves as a responsible investor for the sake of investor protection and sound market development, the investment recommendation regulation seeks to achieve investor protection by establishing a fiduciary rule which a private fund distributor is obligated to abide by. Korea's Financial Investment Services and Capital Markets Act (FSCMA) lists up rules with regard to product distribution (appropriateness rule) and recommendations (duty to provide explanation, suitability rule). A critical policy decision to make in this area is whether to apply this regulation to all or only retail investors. Following the footsteps of the EU, Korea basically applies the regulation to retail investors only, excluding professional investors. The picture gets more complicated if investors are divided into retail and institutional. While retail ordinary investors are subject to the investment recommendation regulation, professional retail investors are not. Qualified retail investors are subject to the duty to provide explanation.

Compared to the US regulation, Korea's investment recommendation regulation on retail investors hardly appears in line with the global standard. The US has neither the investment recommendation law nor rule that discriminates ordinary investors from professional ones, and retail investors from institutional ones. The only investment recommendation requirement is the criteria that constitute clients' best interest, as part of the fiduciary duty of an investment adviser directly distributing financial products. The criteria consist of three elements: First, any material fact that has interests conflicting with those of clients should be disclosed; second, a financial investment adviser needs to find out its client's wealth, investment experience and purpose to judge whether its advice is suitable for the client; and third, the three criteria



apply to any financial investment adviser under fiduciary duty, regardless of the type of funds (private or public) and investors (retail or institutional). Furthermore, as the SEC introduced Regulation Best Interest—stronger than the suitability principle—at the end of the previous year, private banks and broker-dealers selling private funds are also subject to the regulation of investment advice that is similar to a fiduciary duty regardless of their client types. This means the US applies a far stricter fiduciary duty or a best interest standard of conduct to investment recommendations on private and public funds than Korea does.

In comparison, Korea's current sales environment is somewhat disadvantageous to retail investors buying private funds because distributors are not subject to the investment recommendation regulation that is applied to public funds only, although private fund managers like other asset management companies are subject to the same duty of fiduciary and loyalty.

Taken together, it's right time for Korea to consider following the footsteps of the US, especially at a time when Korea saw private funds freeze redemptions. The investment recommendation regulation should be applied to everyone regardless of investor type. Desirably, the same regulation should be applied to all investors—regardless of whether they are professional retail, qualified retail, or even institutional investors.³⁾ The US case mentioned above provides Korea an important implication that discriminative application of the investment recommendation regulation has nothing to do with the distinction between private and public funds, and that such a distinction is unimportant. Certainly, there might be concerns about applying the investment recommendation regulation to every entity, which some argue could increase compliance burden of sales channels and discourage the market. However, the regulatory improvement at the beginning of this year⁴⁾ obligates a distributor to check investor type of its client and notify the client of the fact that the client can be treated as a retail investor

3) However, it appears unnecessary to subject institutional investors to the investment recommendations regulation applied to retail investors because institutional investors are capable of due diligence based on their own resources and expertise in monitoring whether an asset management company complies with its fiduciary duty or not.

4) Still based on the existing framework of the FSCMA that applies the investment recommendations regulation differently to retail ordinary/qualified/professional investors, the recently released revision exempts distributors from the duty of appropriateness, suitability, and explanation for professional investors. Instead, distributors are obligated to notify the investor the fact that the investor could request to be treated as an ordinary investor, and to audio record the investor stating he or she fully understands the fact (Financial Services Commission, November 20, 2019, New Investor Protection Measures and New Standards for Professional Retail Investors, Press Release). With regard to the duty to provide explanation, the regulation was tightened to include more details on the prospectus for qualified retail investors (Financial Services Commission, April 27, 2020, FSC Finalizes Measures to Improve Regulatory Framework on Private Equity Funds, Press Release).

who is subject to the investment recommendation regulation. Accordingly, distributors should establish an extra process and a system so that they sell a private fund via an investment recommendation system and process for public offerings upon the request of their client. On top of that, when allocating assets as part of customized wealth management services, large-scale financial firms are required to add an extra process that helps them recommend their client suitable private funds. Hence, expanding the investment recommendation regulation to private funds is hardly likely to add extra burden.

Roles divided between existing and prime broker direct channels

On top of the investor classification and investment recommendation regulation, an improvement in sales channel is a must for the advancement of Korea's fund distribution market. For example, hybrid funds (hedge funds) of Korea's overall private funds are mostly sold through securities firms (78%), followed by banks (12%) and others (8%) as of end-August 2020. As production is separated from distribution, large-scale financial firms emerge as a key sales channel. Also notable is the high proportion of deposit-taking institutions. What about other markets? According to a CITCO survey (2017) on distribution channels, prime brokers' capital introduction accounts for 41%, followed by funds of funds and managed accounts (23%), third-party (17%), and private banks (11%). In another words, existing channels take up 52%, of which 35% are large-scale financial firms and 17% are small-scale third-party channels. Also, other methods such as via existing investors, etc. account for 8%. What's notable from the survey is a high proportion of direct sales via prime brokers with large-scale channels representing a smaller percentage. Compared to Korea, distribution channels are more diversified, and direct channels—that do not exist in Korea—account for a particularly high percentage.

A closer look shows the reasons. Large-scale channels in Korea and other countries are linked to wealth management, but the difference lies in how funds' track records matter in determining product lineups. In other words, large-scale channels try to choose a private fund whose manager shows proven investment strategies and performance. In Korea, it was after 2015 when large-scale distribution channels began recommending retail investors to purchase private funds established by private fund managers who got neither track records nor proven risk management performance. This, in part, became one of the reasons behind the wave of



redemption freezes.

In the private fund ecosystem in other countries, start-up private funds can hardly reach large-scale distribution channels before they achieve outcomes out of their investment strategies. They first try to establish an incubation fund by raising funds from either sources close to them or a limited pool of investors introduced by prime brokers. Based on that fund, they make every effort to test their investment strategies and accumulate their track records. During the process of such an incubation process, new private funds get much-needed support from prime brokers that function as a direct channel introducing investors. The linkage between the distribution channel and the growth ladder in the ecosystem suggests that there's more than mere competition behind the diversity in distribution channels in overseas markets. Rather, a better understanding of the ecosystem is that large-scale distribution channels become reluctant to sell start-up private funds because they put the best interest of their client ahead of others in their services. Also, the linkage between start-up private funds and direct channels should be interpreted as resulting from prime brokers actively supporting the incubation process via capital introduction, etc.

In sum, Korea's distribution channels need to head towards innovation in the following directions. First, existing large-scale channels should renew their strategies while keeping their private fund distribution as part of their wealth management services based on stability and confidence as an established sales channel. In line with their fiduciary duty, they need to refrain from selling start-up private funds that have neither industry history nor track records. This falls under the territory of strategies—rather than mandated regulation—that naturally result from the way they provide their services for clients' best interest. Second, under the circumstances, new private funds will use their own equity capital or turn to prime brokers' capital introduction, which helps them to accumulate track records. However, this is impossible under the current regulation: The FSCMA has no provision on prime brokers' capital introduction, and it's impossible to share client information within a financial firm due to the Chinese wall.

If the current regulation is revised to facilitate private funds to be sold directly via prime brokers, the private fund ecosystem is expected to evolve as follows. Start-up private fund managers could use their own equity capital, or raise money from sources close to themselves, and via prime brokers' capital introduction for establishing an incubation fund, via which to accumulate track records. Private funds with proven industry history and track records then



could solicit retail investors via institutional investors as well as wealth management channels of large-scale financial firms. Such a market structure helps the private fund market to advance further and regain confidence as start-up private funds test their innovative investment strategies via prime brokers while retail investors enjoy better access to private funds with proven performance.