

OPINION

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Revitalizing Foreign Investment in Korean Markets and Improving International Compatibility of Korea's Stock Market

Since the participation of foreigners in Korea's capital markets was permitted in 1992, a growing number of foreign investors have flocked to Korea's stock market and played a role in reining in the pursuit of private benefits by controlling shareholders or corporate management. Overall, they have made positive contributions to improving corporate governance in Korea. In addition, foreign investors who act as informed traders have helped alleviate a phenomenon where a company's shares show an excessive price hike without any change in intrinsic value and then turn into thematic stocks. Recently, the proportion of foreign investors' stock holding has plummeted to the 2000 level, raising concerns about shrinking foreign investment in Korean markets. In this respect, Korea's financial authorities have announced deregulatory measures for foreign investors in January 2023, such as the abolishment of the foreign investor registration system. But additional improvements are needed to upgrade Korea's stock market on par with international standards. Foreign investor regulations adopted by major economies aim at restricting strategically valuable enterprises from being controlled by foreigners. On the other hand, Korea's regulation places not only the individual foreign investor cap but also the combined foreign investment cap. In terms of over-the-counter (OTC) trading of listed stocks, foreign investors are subject to differential rules, which requires further examination. It is also necessary to expand the availability of the English version of disclosure and release an English translation of supervisory information to give foreign investors greater access to the Korean capital markets.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

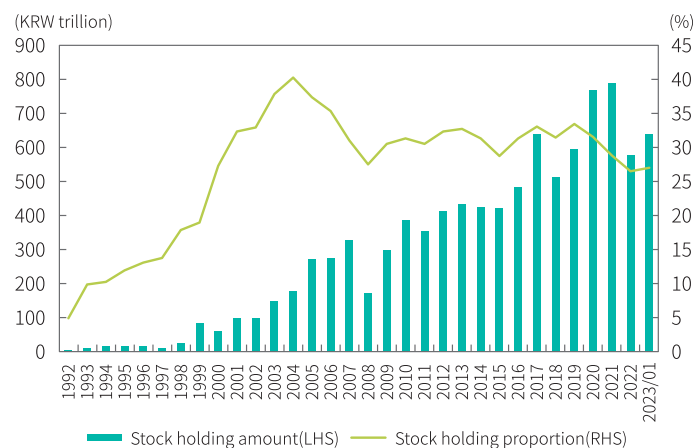
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Recently, Korea's stock market has gone through ups and downs on the back of soaring inflation and the US Fed's rate hikes while striving to break away from the Korea discount in the hope of joining the MSCI developed markets index. Foreign investors who have played a key role in shoring up Korean markets together with retail and institutional investors have lately continued to reduce their stock holdings, which raises serious concerns. Against this backdrop, this article intends to discuss how to improve market accessibility in an effort to give a boost to foreign investment.

Foreign investors' stock holding proportion fell to the 2000 level

According to the Financial Supervisory Service (FSS), foreign investors made net purchases of listed stocks worth KRW 6.1 trillion in January 2023 alone, driving up their holding amount to KRW 635.9 trillion. Despite the net buying trend in January, their stock holding proportion represents 26.9% in Korea's stock market, reaching the lowest level since 2000. The proportion of foreign investors' stock holding rose sharply from the 1992 opening of Korea's capital markets to foreigners until the early 2000s before experiencing a decline, and has shown a downward trend once again since 2019 (33.3% as the stock holding proportion) (Figure 1).

Figure 1. Listed stocks held by foreign investors: Stock holding amount and proportion



Source: Financial Supervisory Service

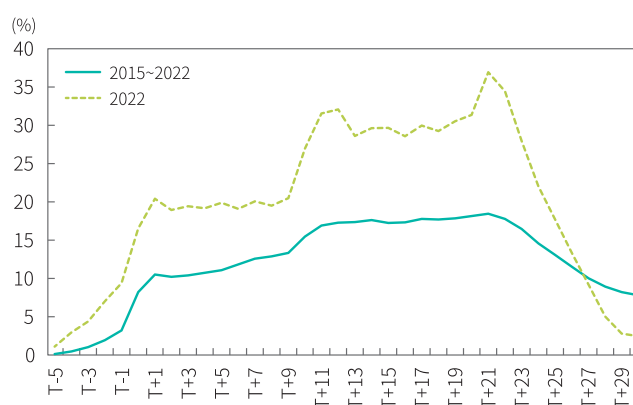
Investments made by foreigners do not necessarily have a positive influence on the domestic stock market. Corporate management has constantly complained that foreign investors' sudden threat to corporate control hinders management activities or that companies

cannot afford to make long-term investment due to foreign investors' excessive demand for dividend payment. On a positive note, a growing number of foreign investors who act as informed traders have helped rein in the pursuit of private benefits by controlling shareholders or management, which seems to have improved corporate governance as a whole. This suggests that the downward trend in foreign investors' stock holding proportion starting from 2020 would be a negative signal to Korea's stock market.

The role of foreign investors in thematic stocks

In Korea's stock market, foreign investors also play a role as informed traders in a phenomenon where a company's shares turn into thematic stocks after suffering an excessive price hike without any change in intrinsic value. More recently, the issuance of bonus shares by listed companies is a prime example of thematic stocks.¹⁾ Most bonus shares are issued as a one-time event to grab the attention of retail investors, which is well demonstrated by the fact that their prices that soared on the disclosure and ex-rights dates²⁾ declined to the original level in a short period of time (Figure 2).³⁾

Figure 2. Cumulative abnormal returns immediately after the disclosure day (T0) of bonus issues



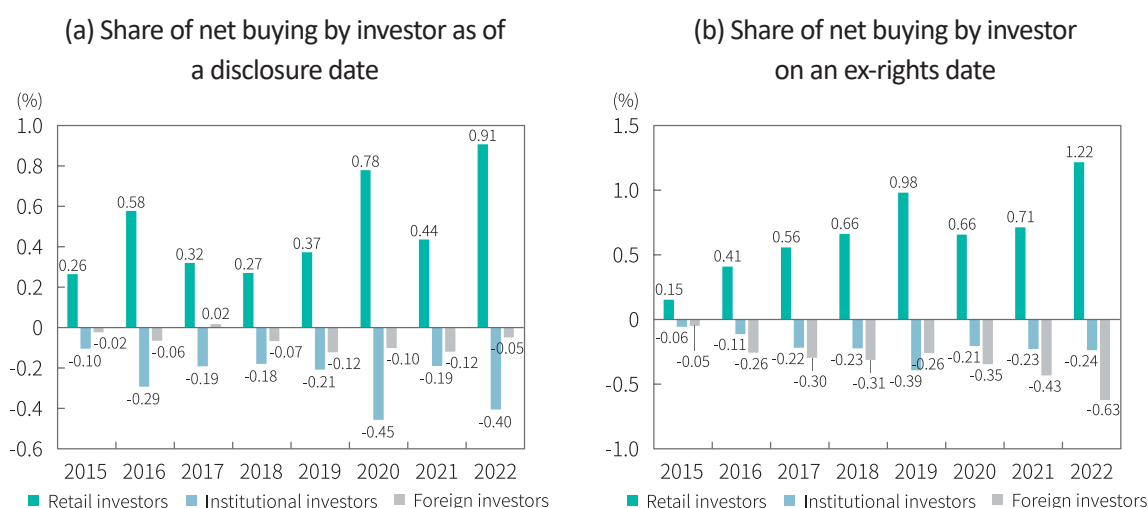
Note: Based on data compiled until July 2022

Source: The revised version of Nam (2022)

- 1) For more details about bonus issue-related thematic stock phenomenon, see Nam, G.N., 2022, *Bonus Issues Turning into Thematic Stocks and Role of Informed Traders*, Korea Capital Market Issue Paper 22-21.
- 2) On the ex-rights date of bonus issues (a trading day to come after an average of 11.1 days elapse following the disclosure date), the number of shares outstanding increases thanks to the issuance of bonus shares, leading to an automatic drop in the initial price. In this case, retail investors who mistakenly believe that stocks have become cheaper tend to buy a massive amount of such stocks, which then, pushes up the stock price.
- 3) It should be noted that in 2022 when newly listed and loss-making companies actively issued bonus shares, the difference between a sudden rise and a plunge in stock prices as of the disclosure and ex-rights dates became more obvious, compared to other periods.

In an analysis of the trading behaviors of foreign investors, they are found to have contributed to mitigating the effects arising from bonus shares turning into thematic stocks. On disclosure or ex-rights dates of bonus issues, foreign investors show a trading pattern that is in contrast to that of retail investors. In this respect, this article examines the proportion of net buying⁴⁾ on disclosure or ex-rights dates of bonus shares, depending on the type of investors. The examination finds that retail investors net bought bonus shares in large volume on both dates while foreign investors and institutional investors recorded a net selling on the dates. Compared to institutional investors, foreign investors adopted a strategy to actively use the ex-rights effect by increasing their net selling on the ex-rights date when net buying by retail investors was concentrated (Figure 3).

Figure 3. Characteristics of foreign investors' trading regarding disclosure and ex-rights of bonus issues



Note: Based on data compiled until July 2022

Source: Nam (2022)

Trading behaviors of foreign investors—opposite to massive buying by retail investors—are shown in not only bonus issues but also politically-themed stocks. In particular, it is presumed that foreign investors are taking advantage of even short selling, in addition to the selling of thematic stocks. This suggests that if the role of foreign investors is reduced in the stock market, it could add fuel to the phenomenon of thematic stocks irrelevant to intrinsic enterprise value.

4) The share of net buying is calculated as a percentage of the net buying quantity divided by the total shares outstanding.

Need to further improve foreign investors' access to the stock market

Amid a continuous drop in foreign investors' stock holding proportion, the Korean government announced a set of deregulatory measures for ensuring greater convenience and better market access for foreign investors on January 24, 2023. As part of the measures, Korea has decided to scrap the foreign investor registration system considered being far from international standards to provide a more convenient environment for foreign investors. It has been pointed out that the registration system causes inconvenience in administrative procedures, reveals the stock position of registrants, and makes it practically impossible to use an internationally accepted omnibus account, due to requirements for a separately assigned ID and real-time reporting. In this regard, abolishing the foreign investor registration system seems to give foreign investors greater access to Korea's stock market.

In terms of foreign investors' stock holding limits, major economies such as the US and Europe are found to restrictively apply such limits only for the purpose of prohibiting strategically valuable enterprises from being controlled by foreigners or foreign governments.⁵⁾ On the other hand, Korea has placed the combined foreign investment cap as well as the individual foreign investor cap. This requires a foreign investor to take into account the total volume of stocks acquired by other foreigners, which calls for further examination of regulatory benefits.⁶⁾

Also notable is the relaxation of another regulation that, in principle, allows foreign investors to trade listed stocks only within the exchange.⁷⁾ Governments with various forms of over-the-counter (OTC) trading permit foreign investors to participate in OTC trading of listed stocks without distinction. Considering that the launch of Korea's first alternative trading system (ATS) is on the horizon, it is necessary to bring how foreigners trade listed stocks to the international level.

5) In major economies including the US and EU, restrictions on foreign investors primarily apply to industries involving defense, advanced technology and core supply chains, and key allies are exempted from such restrictions. The US excludes Canada, the UK, Australia and New Zealand from foreign investment restrictions, while EU member states hardly place such restrictions on countries in the EU and the European Economic Area (EEA).

6) Currently, foreign investors' stock holding limit is placed on only 33 items. But if a company is a public corporation or subject to the limitations on stock acquisition by foreigners and foreign governments under the Telecommunications Business Act, the limit of combined stock acquisition by foreign investors (40%) is applicable and the per capita acquisition limit (3%) is also established by the articles of incorporation.

7) A foreign investor's OTC trading should go through a preliminary examination by the FSS.

Lastly, Korea plans to expand the availability of English disclosure in phases,⁸⁾ which would significantly improve market accessibility if an English translation of supervisory information is also released. In this respect, the financial authorities should prepare English versions of regulatory background and content and provide a relevant explanation to foreign investors and foreign financial institutions.

Conclusion: Lessons from Israel's promotion in the MSCI developed markets index

Looser regulation for foreign investors could be a plus for inclusion in the MSCI developed markets index. But joining the index does not necessarily bring about a surge in foreign investment. A case in point is Israel. Even after the country was promoted to the MSCI developed markets index in 2010, its Tel Aviv Stock Exchange has suffered a 37% decline in the average daily trading volume and major stock indexes have remained flat. The number of listed companies decreased by 28% from 613 in 2010 to 442 in 2019, resulting in an unexpected slowdown in the stock market. This demonstrates that inclusion in the MSCI developed markets index is not enough to invigorate the stock market. Hence, what is needed to promote foreign investment is the continuous effort to fundamentally upgrade market accessibility to meet international standards.

8) The financial authorities plan to adopt the mandatory submission of the English version of disclosure. This mandatory system would be expanded from KOSPI-listed companies with KRW 10 trillion or more in assets or those whose shares are held by foreigners by 30% or more (in this case, KRW 2 trillion or more in assets) in 2024, to those with KRW 2 trillion or more in assets starting from 2026.