

Understanding the '5 percent rule' for Korean equity holdings



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Under Article 147 of the Financial Investment Services and Capital Markets Act (FSCMA), an investor who acquires 5 percent or more of the total outstanding equity securities of a listed company must file a report regarding such acquisition (e.g., purpose and status of the holdings) with the Financial Supervisory Commission (FSC) and the Korea Exchange (KRX) (the '5 percent rule'). The 5 percent rule is provided to protect investors, promote market transparency and allow existing majority shareholders or management time to take defensive measures against hostile takeovers of the target company.

Definitions and scope

The equity securities subject to the 5 percent rule include shares, bonds with warrants, convertible bonds and equity-linked securities issued by any listed company. An investor required to report under the 5 percent rule is an individual or entity that 'holds' 5 percent or more of the total outstanding equity securities of a listed company. The 'holding' of the equity securities means either direct ownership or 'holdings equivalent to ownership' thereof (e.g., voting rights or rights to acquire or dispose of the equity securities), and all of the equity securities held by both the investor and its 'specially related parties' are aggregated to calculate the total 'holding' by the investor. The 'specially related parties' are 'persons in a special relationship with the investor' and joint holders. If the investor is an entity, the 'persons in a special relationship with the investor' include the following: (i) directors and/or auditors of the investor, (ii) the investor's affiliated companies and their directors and/or auditors, (iii) any individual or entity (including its directors and/or auditors) that holds 30 percent or more of the equity securities of the investor independently or in conjunction with other persons in a special relationship with the investor, or those who have the ability to effectively exert their influence on important management matters relating to the investor, such as the appointment or dismissal of officers, or (iv) any entity (including its directors and/or auditors), of which the investor holds 30 percent or more of the equity securities, independently or in conjunction with other persons in a special relationship with the investor or have the ability to effectively exert influence on its important management matters. The term 'joint holders' refers to persons who agree with the investor through any

contract or arrangement (i) to jointly acquire or dispose the equity securities, (ii) to receive or transfer the equity securities acquired solely or jointly from or to the investor, or (iii) to jointly exercise voting rights attached to the equity securities.

Penalties

An investor who violates the 5 percent rule may have its voting rights suspended with respect to its ownership of unreported equity securities exceeding 5 percent and may also be ordered to dispose of such equity securities. The investor may also be subject to criminal sanctions such as fines or imprisonment.

Comments

If a foreign investor alone acquires 5 percent or more of the equity securities of a listed company, there is no doubt that such foreign investor is subject to the 5 percent rule and must file a report regarding such acquisition with FSC and KRX. However, if a foreign investor acquires less than 5 percent of the total equity securities of a listed company, it is less clear whether such foreign investor is subject to the 5 percent rule because, as noted above, all of the equity securities held by the investor and its specially related parties (persons in a special relationship with the investor and joint holders) must be added to determine the total holdings by the investor. Whereas the persons in a special relationship with the investor can be easily identified upon review of the equity relationship, the joint holders can only be identified upon confirming the existence of, and the extent of, any agreement regarding the acquisition of equity securities between the investor and any other persons. Therefore, if a foreign investor makes an agreement in any form with another investor (foreign or domestic) in connection with the acquisition of equity securities, the foreign investor should confirm in advance whether they are likely to be deemed the joint holders of the equity securities under FSCMA based on that agreement.

Side Note: Any investor who has filed a report on its holding of equity securities pursuant to the 5 percent rule must file a report with FSC and KRX when there is any subsequent change to its holding by 1 percent or more.

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