

# KIM & CHANG

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## NETTING ANALYSER LIBRARY

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January 28, 2013

Dear Sirs,

You have asked us to give an opinion in respect of the laws of the Republic of Korea ("**this jurisdiction**") as to the effect of netting and set-off and collateral arrangements in relation to the Korea Exchange (the "**Clearing House**") as between the Clearing House and its clearing members (each a "**Member**").

We understand that your requirement is for the enforceability and validity of such netting and set-off and collateral arrangements to be substantiated by a written and reasoned opinion letter.

References herein to "**this opinion**" are to the opinion given in Section 3.

### 1. TERMS OF REFERENCE

- 1.1 Except where otherwise defined herein, terms defined in the Rules (to be defined below) of the Clearing House have the same meaning in this opinion letter.
- 1.2 There are no netting, set-off or collateral arrangements in relation to the insolvency or default of the Clearing House between the Clearing House and the Members and there are no provisions in the Rules (to be defined below) contemplating the insolvency or default of the Clearing House. Thus, our opinion herein is based on the remedies available under general laws of this jurisdiction.
- 1.3 The Contracts are governed by the Rules and thus governed by the laws of this jurisdiction.
- 1.4 The opinions given in Section 3.6 are given only in relation to Non-cash Collateral

comprising account-held securities. The “**account-held securities**” mean the securities recorded in fungible book-entry form in an account maintained with a financial intermediary.

## 1.5 Definitions

In this opinion, unless otherwise indicated:

- (a) “**Assessment Liability**” means a liability of a Member to pay an amount to the Clearing House (including a contribution to the assets or capital of the Clearing House, or to any default or similar fund maintained by the Clearing House); but excluding:
  - (i) any obligations to provide margin or collateral to the Clearing House, where calculated at any time by reference to Contracts open at that time;
  - (ii) membership fees, fines and charges;
  - (iii) reimbursement of costs incurred directly or indirectly on behalf of or for the Member or its own clients;
  - (iv) indemnification for any taxation liabilities;
  - (v) payment or delivery obligations under Contracts; or
  - (vi) any payment of damages awarded by a court or regulator for breach of contract, in respect of any tortious liability or for breach of statutory duty.
- (b) “**Contract**” means an exchange-traded derivative which is cleared through the Clearing House (excluding any spot transactions);
- (c) “**Individually Segregated Client Account**” means a legally segregated account with the Clearing House opened in the name of a Member on behalf of each client of such Member;
- (d) “**Netting**”<sup>1</sup> means a Member’s right to close-out all outstanding

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<sup>1</sup> Since there is no netting agreement between the Clearing House and the Members, the definition of “netting” herein is purely for the purpose of this opinion. In a broad sense, the “netting” as defined herein falls within the scope of “set-off” under the law of this jurisdiction.

Contracts, exercise set-off rights and calculate a single net amount of claims against the Clearing House including margin;

- (e) "**House Account**" means and account with the Clearing House opened in the name of a Member that is not an Individually Segregated Client Account;
- (f) "**Party**" means the Clearing House or the relevant Member;
- (g) "**Set-off**" means the Member's right to set off its claims against the Clearing House under the Contracts against its claims against the Clearing House under the transactions other than the Contracts and calculate a single net amount of claims or cross-claims;
- (h) "**Non-cash Collateral**" means the non-cash collateral consisting of account-held securities which are provided to the Clearing House as margin under the Rules by way of pledge or repledge;
- (i) references to the word "**enforceable**" and cognate terms are used to refer to the ability of a Party to exercise its rights in accordance with their terms and without risk of successful challenge. We do not opine on the availability of any judicial remedy;
- (j) "**Rules**" means the rules of the Clearing House in force as at the date of this opinion;
- (k) references to a "**section**" or to a "**paragraph**" are (except where the context otherwise requires) to a section or paragraph of this opinion (as the case may be).

## 2. ASSUMPTIONS

We assume the following:

- 2.1 That the Contracts are legally binding and enforceable against both Parties under the laws of this jurisdiction.
- 2.2 That each Party has the capacity, power and authority under all applicable law(s) to enter into the Contracts; to perform its obligations under the Contracts; and that each Party has taken all necessary steps to execute and perform the Contracts.
- 2.3 That each Party is duly incorporated and organized and validly existing and in good standing under the laws of the jurisdiction of its incorporation and of any jurisdiction

in which the conduct of its business or the ownership of its property makes such assumption necessary.

- 2.4 That each Party has obtained, complied with the terms of and maintained all authorisations, approvals, licences and consents required to enable it lawfully to enter into and perform its obligations under the Contracts.
- 2.5 That the Contracts have been entered into prior to the commencement of any insolvency procedure under the laws of any jurisdiction in respect of either Party.
- 2.6 That each Party acts in accordance with the powers conferred by the Rules of the Clearing House and the Contracts; and that each Party performs its obligations under each Contract in accordance with their respective terms.
- 2.7 That the Member is at all relevant times solvent and not subject to insolvency proceedings under the laws of any jurisdiction.
- 2.8 That in the case of Non-cash Collateral owned by clients, the Member has a first priority, perfected pledge interest (*Jil Kwon*) in the Non-cash Collateral provided by its clients, in which the Clearing House has a first priority, perfected re-pledge interest (*Jeon Jil Kwon*) and in the case of Non-cash Collateral owned by the Member, the Clearing House has a first priority, perfected pledge interest (*Jil Kwon*).
- 2.9 That the obligations assumed under the Contracts are mutual between the Parties, in the sense that the Parties are each personally and solely liable as regards obligations owing by it and is solely entitled to the benefit of obligations owed to it.

### 3. **OPINION**

On the basis of the foregoing terms of reference and assumptions and subject to the qualifications set out in Section 4 below, we are of the following opinions.

#### 3.1 **Insolvency Proceedings**

The only bankruptcy, composition, rehabilitation or other insolvency or reorganisation procedures to which the Clearing House could be subject under the laws of this jurisdiction, and which are relevant for the purposes of this opinion, are the procedures under the Debtor Rehabilitation and Bankruptcy Law (“**DRBL**”) and the Corporate Restructuring Promotion Law (“**CRPL**”).

##### 3.1.1 **Proceedings under the DRBL**

Chapter 2 of the DRBL provides for proceedings for rehabilitation of a legal

entity as well as an individual engaged in business (“**Rehabilitation Proceedings**”), Chapter 3 of the DRBL provides for proceedings for bankruptcy (i.e., liquidation) of a legal entity or an individual (“**Bankruptcy Proceedings**” and together with Rehabilitation Proceedings, “**DRBL Proceedings**”).

The formal requirement for the institution of DRBL Proceedings is the filing of a petition for a rehabilitation or bankruptcy, as applicable. The filing of the petition *per se* does not act as an automatic stay. However, upon the formal commencement of Rehabilitation Proceedings by a court order or declaration of bankruptcy by the court in Bankruptcy Proceedings, any actions to enforce claims against the insolvent party are stayed and the claims will be satisfied in accordance with the rehabilitation plan (in the case of Rehabilitation Proceedings) or the distribution table as approved by the creditors and court (in the case of Bankruptcy Proceedings). Upon the filing of a petition, the competent court will decide whether to commence the Rehabilitation Proceedings or the Bankruptcy Proceedings, as the case may be. Under the Rehabilitation Proceedings (but not the Bankruptcy Proceedings), the court is required to make its decision regarding the commencement of the proceeding within one month after the filing of the petition. DRBL Proceedings are deemed to have commenced on the date when the court issues a commencement order or an order declaring bankruptcy, as the case may be. The issuance of such an order is published in the government gazette.

### 3.1.2 Proceedings under the CRPL

The CRPL proceeding applies to a company (“**Company**”) which has received credit<sup>2</sup> from financial institutions licensed under the relevant Korean law or other entities as prescribed by the Presidential Decree of the CRPL (“**Financial Institution Creditors**”) if the total amount of the outstanding credit is not less than 50 Billion Korean Won and if such Company is determined by its prime bank (“**Prime Bank**”) or the Council (as defined below) to be unable to repay its debt without financial assistance from outside or special borrowings (excluding borrowings made in the ordinary course of its business) (such company referred to as a “**Failing Company**”). The Prime Bank which finds or is notified by one or more other banks that a Company

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<sup>2</sup> The term “credit” is defined to include, loans, promissory notes and claims, equipment lease, guarantee, payment of guarantee or any other transaction under which a financial institution may incur losses upon payment default of the counterparty and is to be further defined in the regulations to be promulgated by the Financial Supervisory Service.

falls under the definition of Failing Company must notify the Company that (i) it falls under the definition of Failing Company and (ii) it may apply to the Prime Bank for the commencement of a restructuring process under the CRPL. If the Company makes such an application (“**Application**”), the Prime Bank must send a notice (“**Notice**”) to call a meeting of the council of the Financial Institution Creditors (or, if applicable, creditor banks) (“**Council**”) within 7 calendar days from the date when it received the Application from the Company. All Financial Institution Creditors of a Failing Company will be bound by the resolutions of the Council except for those creditors that requested other members of the Council to purchase their claims. At the first meeting of the Council, the creditor financial institutions must determine whether to suspend the exercise of creditor’s rights (including exercise of security interest) and the period for such suspension. The suspension period may be up to one month (or three months if an investigation of the Failing Company’s financial status is necessary). This suspension period may be extended by the Council for an additional one month. The Council must approve a plan for normalization of the Failing Company and enter into an agreement with the Failing Company for implementation of the normalization plan.

### **3.2 Special provisions of law**

The Financial Investment Services and Capital Markets Act (“**FSCMA**”) applies to the Contracts by virtue of the fact that the Contracts are, or relate to, exchange-traded derivative products and are cleared through a central counterparty.

### **3.3 Recognition of choice of law**

The Rules do not contain any choice of law provisions.

### **3.4 Netting and Set-off: General**

**3.4.1 Event of Default:** Neither the FSCMA nor the Rules of the Clearing House contain any provisions that relate to default or insolvency of the Clearing House or any remedy for the Member upon occurrence of such an event. Accordingly, we discuss whether the Member may be entitled to Netting or Set-off as a remedy as a matter of general law and/or insolvency laws of Korea upon default, insolvency or liquidation of the Clearing House.

**3.4.2 Default other than Insolvency or Liquidation:** As a matter of contract law, a material default (i.e., default that constitutes a breach) by the Clearing House under the Contract would entitle the Member to terminate the Contract. Upon

such termination, the Member will have the statutory right of set-off under the Civil Code so that:

- (a) the Member would be entitled immediately to exercise its rights to Netting; and
- (b) the Member would be entitled to receive or be obligated to pay only the net sum of the positive and negative mark-to-market values of the included individual Contracts, together with other losses or gains referable to the Contracts.

Under the Civil Code, the statutory right of set-off is conditioned upon the satisfaction of the following:

- (1) *Mutuality*: The claim and cross-claim must be mutual obligations of the parties. The mutuality requirement will be satisfied if the claim and the cross-claim exist between the same parties. Accordingly, a creditor may not set off its claim against the debtor against a cross-claim that a third party holds against the creditor, even if such third party is an affiliate of the creditor or debtor. There is no requirement that the claim and the cross-claim arise out of the same transaction, nor is it required that the parties stand in the same capacity.
- (2) *Commensurability*: The claim and the cross-claim must be commensurable (i.e., they must be of the same type). So long as the claim and the cross-claim are both payment obligations, the commensurability requirement will be satisfied unless otherwise agreed. Claims for the delivery of assets will be commensurable if they relate to the same class and type of fungible assets. Where the claims to be netted are claims for payment, it may be argued that they will only be commensurable if the claim and the cross-claim are denominated in the same currency. Therefore, so long as the claim and the cross-claim are both payment obligations, the commensurability requirement will be satisfied unless otherwise agreed.
- (3) *Maturity*: The claim and the cross-claim must be due and payable at the time of the set-off. A claim or a cross-claim will be treated as due and payable whether as a result of having matured in accordance with its terms or as a result of acceleration or prepayment. Under Korean law, a debtor may generally prepay a debt, provided that the debtor pays damages to the creditor caused by the pre-payment. Set-off is

permitted even when the cross-claim is subject to preliminary attachment or attachment if the following conditions are satisfied: the claim has arisen (although it may not have matured) at the time the preliminary attachment or attachment order takes effect and the claim will mature prior to or at the same time as the maturity of the cross-claim.

(4) *No prohibition on set-off:* Neither the claim nor the cross-claim may be subject to any contractual or statutory prohibition on set-off. However, even if the cross-claim is subject to attachment by the counterparty's creditors, set-off would be permissible as long as the claim matures prior to or at the same time as the cross-claim.

It is not clear, however, what event will constitute a breach of the Contract that will entitle the Member to terminate the Contracts.

3.4.3 **Liquidation:** The Clearing House is a joint stock company and therefore, its liquidation (other than for reasons of insolvency) will be governed by the Commercial Code. The commencement of liquidation proceedings with respect to the Clearing House will clearly indicate that the Clearing House will cease to perform under the Contracts and therefore, this would constitute a material breach which will entitle the Member to terminate the Contracts and exercise its statutory rights of set-off as described above.

3.4.4 **Insolvency:** We discuss (1) Bankruptcy Proceedings under the DRBL; (2) the Rehabilitation Proceedings under the DRBL and (3) the proceedings under the CRPL, separately below.

#### 3.4.4.1 **Bankruptcy Proceedings:**

Article 338 of the DRBL (applicable to the Bankruptcy Proceedings) provides that any "fixed-term contract" will be automatically terminated upon declaration of bankruptcy with respect to a party to such a contract. A "fixed-term contract" is defined as "an agreement to deliver at a specified time or within a specified period of time the commodities that are traded at a market price on an exchange. In addition, Article 425 of the DRBL (applicable to Bankruptcy Proceedings) provides that any unmatured payment obligations will become immediately due and payable upon declaration of the Bankruptcy Proceedings. As a result, all Contracts will be automatically terminated upon declaration by the court of the Bankruptcy Proceedings for the Clearing House. Article 338 further provides that the damage for non-bankrupt party will be the

difference between the market price and the price agreed between the parties.

In the Bankruptcy Proceedings, the set-off right may be exercised without restriction (subject to our discussion in 3.4.5.3) and there is no requirement that the claim and the cross-claim be matured or accelerated at the time of set-off. Accordingly, we are of the opinion that upon declaration of bankruptcy for the Clearing House.

- (a) the Member would be entitled immediately to exercise its rights to Netting; and
- (b) the Member would be entitled to receive or be obligated to pay only the net sum of the positive and negative mark-to-market values of the included individual Contracts, together with other losses or gains referable to the Contracts.

#### **3.4.4.2 Rehabilitation Proceedings:**

Neither the filing of a petition for or commencement of, the Rehabilitation Proceedings by or with respect to the Clearing House will entitle the Member to terminate the Contracts, absent a material default by the Clearing House. Moreover, the DRBL provisions applicable to the Rehabilitation Proceedings do not include provisions similar to Article 338 or Article 425 (discussed above) applicable to the Bankruptcy Proceedings. Accordingly, we are unable to opine that the Netting or the Set-off would be available for the Member in the event of Rehabilitation Proceedings of the Clearing House.

#### **3.4.4.3 Corporate Restructuring Promotion Law:**

The application for or commencement of proceedings under the CRPL with respect to the Clearing House will not entitle the Member to terminate the Contracts, absent a material default by the Clearing House. Once the first meeting of institutional creditors adopts the stand still resolution, no Member may exercise any creditor's rights including the set-off right. Accordingly, we are unable to opine that the Netting or the Set-off would be available for the Member in the event of proceedings under the CRPL.

**3.4.5 Set-off:** For purposes of the discussion of Set-off, we assume that the Contracts are all closed-out and the Member successfully exercises its right to Netting. The issue is whether the Member may set-off the net amount ("Termination Amount") payable to or receivable from the Clearing House obtained as a result of the Netting against any other claim or cross-claim

against the Clearing House arising under transactions other than the Contracts.

Subject to the following discussions, the Set-off would be enforceable and (a) the Member would be immediately entitled to exercise its rights under the Set-off; and (b) any and all amounts owed by the Member to the Clearing House (including the Termination Amount once calculated would be set off against any such amounts owed by the Clearing House to the Member under transactions other than the Contracts:

**3.4.5.1        If the Triggering Event is Breach of Contract:**

To the extent that the conditions for the statutory set-off discussed above under 3.4.2 are satisfied, the Set-off will be enforceable.

**3.4.5.2        If the Triggering Event is Liquidation:**

To the extent that the conditions for the statutory set-off discussed above under 3.4.2 are satisfied, the Set-off will be enforceable.

**3.4.5.3        If the Triggering Event is Bankruptcy Proceedings:**

Set-off and Netting are permitted without restriction at any time in the Bankruptcy Proceedings. However, certain Set-off and Netting are not permitted if they fall under the following:

- (a) the creditor has assumed the obligation to the insolvent party after the commencement of the DRBL Proceedings;
- (b) the obligor has acquired a third party's claim against the insolvent party after the commencement of the DRBL Proceedings;
- (c) the creditor has assumed the obligation to the insolvent party knowing that there has been an insolvency event with respect to the insolvent party, except where the creditor assumes the obligation to the insolvent party (i) as a matter of law, (ii) due to a cause that arose prior to the creditor becoming aware of the insolvency event or (iii) due to a cause that arose one year or more prior to the commencement of the DRBL Proceedings; or
- (d) the obligor has acquired the claim against the insolvent party at a time when the obligor knew that an insolvency event has occurred, except where the obligor acquires the claim against the insolvent party (i) as a matter of law, (ii) due to a cause that arose prior to the obligor

becoming aware of the Insolvency Event or (iii) due to a cause that arose one year or more prior to the commencement of the DRBL Proceedings.

**3.4.5.4      If the Triggering Event is Rehabilitation Proceedings:**

Creditors may exercise the set-off rights only up to the expiry of claim filing period once the rehabilitation proceedings are commenced. In addition, the set-off right cannot be exercised if it falls under the prohibited set-offs discussed above under 3.4.5.3.

**3.4.5.5      If the Triggering Event is CRPL Proceedings:**

No set-off rights may be exercised once the first creditors' meeting adopts a resolution to suspend all creditors' rights.

**3.5      Netting and Set-Off: House Accounts and Client Accounts**

To the extent that the Member makes an appropriate settlement to the clients with respect to the Contracts held for the account of the clients, we are of the view where a Member has exercised its rights under the Netting, a Termination Amount payable on any of the types of accounts listed below would be aggregated with or netted against a Termination Amount payable on any of the other types of accounts listed below:

- (a)      House Account of the Member; and
- (b)      Individually Segregated Client Account of the Member.

**3.6      Netting and Set-Off: Cross-Product Netting**

The term "Contracts" is defined so that the Contracts are limited to the futures and options traded on the Clearing House. Therefore, we do not discuss the cross-product netting.

**3.7      Cash Collateral**

Payments made by a Member to the Clearing House as cash margin constitute an absolute transfer of cash, so that, in the event of Bankruptcy Proceedings or Rehabilitation Proceedings or the CRPL Proceedings relating to the Clearing House, such cash would be treated as the property of the Clearing House available to its creditors generally.

However, the amount of cash so provided would constitute a debt owed by the

Clearing House to the Member as principal.

### 3.8 Non-cash Collateral

Any securities provided to the Clearing House as cover for margin and constituting Non-cash Collateral would not be treated as the property of the Clearing House and would be returnable to the Member or the Client, as applicable, in the event of insolvency proceedings relating to the Clearing House, subject to the Member satisfying its obligations to the Clearing House.

This is because with respect to Contracts, the Non-cash Collateral is pledged by the Client to the Member which in turn may repledge them to the Clearing House. The Member also may pledge its own Non-cash Collateral to the Clearing House. Accordingly, the Clearing House has a security interest in the Non-cash Collateral.

If the Member is entitled to exercise its right to Netting (see the discussion above under 3.4), the Netting may apply to Non-cash Collateral in the following manner:

- (a) In the case of securities pledged by Client and repledged to the Clearing House, the Member will obtain consent from the Client so that the Member will be deemed to make “payment in kind” (*Daemul Byunjae*) to the Clearing House; if the Clearing House consents thereto, then the market value of the securities will be applied to the amount payable by the Member to the Clearing House and the net amount will constitute the Termination Amount; and/or
- (b) In the case of securities pledged directly by the Member to the Clearing House, with the consent of the Clearing House, the Member will be deemed to make “payment in kind” (*Daemul Byunjae*) to the Clearing House; the market value of the securities will be applied to the amount payable by the Member to the Clearing House and the net amount will constitute the Termination Amount.

### 3.9 Members' Assessment Liabilities

A Member's Assessment Liability is as follows:

Member's Assessment Liabilities will include: (i) contribution to the Joint Compensation Fund; and (ii) deposit of fidelity guarantee fee.

#### 3.9.1. Joint Compensation Fund

The amount that a Member contributes to the Joint Compensation Fund will be

calculated for each quarter as (the sum of (x) the one time “basic contribution” paid at the time of obtaining the membership (KRW 1 billion) and (y) the quarterly “variable contribution” reflecting either (i) the ratio of the average daily trading value of the relevant member to the average daily trading value of all members for one (1) year (for securities markets) or (ii) the ratio of the average daily margin of the relevant member to the average daily margin of all members for one (1) year (for the derivatives market)). In addition, each clearing member will pay to/receive from the Clearing House the difference between the amount calculated and the total contribution made as of the end of previous quarter.

Currently, total accumulation of the Joint Compensation Fund is capped at KRW 200 billion for each of the securities market and the derivatives market. However, if the Joint Compensation Fund is used to cover the loss caused by a Member’s default, the Clearing House may require the Members to make additional contribution pursuant to a board resolution.

In addition, the Clearing House may increase the amount of total accumulation of the Joint Compensation Fund for the derivatives market, if necessary, by amending the Membership Regulations. Accordingly, in theory, there will be no limit to Member’s potential liability.

### 3.9.2 Fidelity Guarantee Fee

Each Member must deposit the fidelity guarantee money of minimum KRW 1 million at the time of obtaining the membership. The amount of the fidelity guarantee money will be determined by the board of the Clearing House.

## 4. QUALIFICATIONS

The opinions in this opinion letter are subject to the following qualifications:

- 4.1.1 Our opinion hereof is only in relation to Korean law as it stands at the date of this opinion, and we have assumed that no law of a jurisdiction other than Korea adversely affects our opinion.
- 4.1.2 As used in this opinion letter, the term “enforceable” means that each obligation or document is of a type and form enforced by the Korean courts. However, the remedies of specific performance or injunction might not be necessarily available with respect to any particular provision in the documents. Also, the enforceability of provisions releasing or exculpating a party from, or requiring indemnification of a party for, liability for its own action or inaction

may be limited or affected where the action or inaction involves unlawful conduct, wilful misconduct or gross negligence. In addition, the obligations of the parties may also be affected or limited by the general principles of good morals and other social order and the general principles of good faith and fairness provided for in the Civil Code of Korea.

4.1.3 Korean courts may exercise judicial discretion in determining such matters as conclusiveness of certificates, amount of damages and entitlement to attorneys' fees and other costs.

There are no other material issues relevant to the issues addressed in this opinion which we wish to draw to your attention.

This opinion is given for the sole benefit of the Futures and Options Association and such of its members (excluding associate members) as subscribe to the Futures and Options Association's opinions library (and whose terms of subscription give them access to this opinion). This opinion may not be relied upon by any other person unless we otherwise specifically agree with that person in writing, although we consent to it being shown on a confidential basis to such Futures and Options Association members' affiliates (being members of such persons' groups, as defined by the UK Financial Services and Markets Act 2000) and to any competent authority supervising such member firms and their affiliates in connection with their compliance with their obligations under prudential regulation, *provided that*, such affiliates or any supervising authority may not rely on this opinion without our written consent.

Very truly yours,



Kim & Chang