

Improvement Plan for Internal Control System in Financial Companies

On June 22, 2023, the Financial Services Commission, in collaboration with the Financial Supervisory Service presented an improvement plan for internal control systems in financial companies. This newsletter provides an insight into the cruxes of the plan from the perspective of financial regulators and key takeaways for financial companies.

I. Background to the Improvement of Internal Control Systems in the Financial Sector

- Problems with the current discipline and operation of internal control systems

Despite most financial companies having established internal control standards in line with standard guidelines based on the requirements under Article 24 of the Act on Corporate Governance of Financial Companies (hereinafter “Financial Governance Law”), continuous occurrence of financial incidents of various scales have raised questions about the effectiveness of the current system and its operation. The financial regulators have assessed that despite the mandatory establishment of internal control standards, the system falls short in several ways: (i) many employees found to have violated the obligation to establish internal control standards were unaware they were in charge of such duties, and (ii) current laws merely impose a formal obligation to establish internal control standards without effectively regulating the actual operation, failing to induce changes in employees’ awareness and behavior.

The financial regulators set up a Task Force to review the new regulations to hold the management liable for internal control obligations under a new approach to restructure internal control regulations by introducing a substantive responsibilities map rather than relying on sanctions based largely on the failure to establish internal control standards under the Financial Governance Law.

II. The Gist of the Improvement Measures for the Financial Sector's Internal Control System

1. Introduction of the Responsibilities Map

A Responsibilities Map is a document listing the **allocated responsibilities** carried out by each of the **executives** of a financial company. In this context, '**executive**' refers to executive officers as defined in the Financial Governance Law, '**responsibilities**' refer to internal control responsibilities for each operational area (to be specified in the enforcement decree) that could impact compliance, sound management, consumer protection, and '**allocation**' refers to assigning the responsibility to each of the executives shown in the responsibility structure table.

The Responsibilities Map will introduce new responsibilities of the executives to proactively perform their duties, in addition to the current disqualification criteria. Consequently, financial companies will have to confirm the executive's qualification not only at the time of new appointment, but also when there are changes in the positions of existing executives according to the Responsibilities Map. Moreover, the representative director shall be in charge of compiling the Responsibilities Map thereby bearing the responsibility for any inadequacy or falsification in the Responsibilities Map.

Bearing the "overall" responsibility for internal control, the representative director shall bear its own responsibility to establish an effective internal control system considering each company's business characteristics and management environment, and eventually be held accountable in the event of a systemic failure of internal control (e.g., recurrence of systemic and widespread problems).

The Responsibilities Map will be finalized with the resolution of the board of directors and submitted to the financial regulators (the same applies when major changes are made). Although the financial regulators will not have the power to approve the adequacy of the Responsibilities Map, they may request corrections if needed.

The board of directors will bear the ultimate responsibility for checking the adequacy of the overall internal control system and operations within the company. Individual executives on the Responsibility Map will take specific management measures in their respective areas, while the board will oversight the internal control system. In order to ensure that the board fulfills its role, an internal control subcommittee will be established within the board. The internal control subcommittee can be integrated and operated with existing subcommittees such as the risk management committee, audit committee, etc.

2. Sanctions and reduction standards for violation of internal control management obligation

If the internal control management measures are not fully executed and result in the management obligation, the executive in question will be subject to disciplinary action due to the executive's own responsibility for violating the management obligation.

However, if it is acknowledged that a **reasonable care** was taken to execute relevant **management measures** (Reasonable Steps), the responsibility can be reduced or exempted. Whether a 'reasonable care' was taken will be determined by whether relevant **management measures** were taken proactively to such level that is objectively and reasonably expected, which shall be subject first to self-regulation of the industry and the company.

The financial regulators plan to enhance the transparency and consistency of their law enforcement by predefining and publicly disclosing certain situations where the executives are held accountable for violations of internal control management obligations, in the form of the guidelines of the Financial Services Commission.

Further, it intends to establish criteria for triggering the "the procedure for clarifying internal control responsibility", which will determine whether to address violations of managerial duties of internal control in the event of an incident.

III. Items to Prepare in Accordance with the New Internal Control System

1. Future schedules

The financial regulators plan to carry out prompt legislation after collecting opinions through public hearings and explanatory meetings for each industry following the announcement of this internal control improvement plan. Expected timeline for legislation and enforcement is as shown below.

- End of 2023: amendment of the Financial Governance Law;
- End of 2024: other amendments such as enforcement decrees and ordinances;
- Starting from 2025 (i.e., 1 year after promulgation of the amended law): enforced against banks and financial holding companies;
- Starting from July 2025: enforced against large financial investment companies, comprehensive financial investment companies, and large insurance companies; and
- As determined by the enforcement decree (no later than the end of 2028): enforced against small and medium-sized financial companies that are not subject to certain governance regulations.

2. Considerations and precautions for the introduction and implementation of the reformed internal control system

First of all, financial companies need to actively express their opinions by participating in public hearings during the legislative process, to ensure that a reasonable and content-rich internal control system can be established. Since the Responsibilities Map is not a universal norm in developed countries and is implemented in a handful of jurisdictions that adopt principle-centric approach for financial regulations, there are issues and circumstances to consider for its consistency with existing regulations in Korea.

If the law is amended as planned, the introduction of the Responsibilities Map and the provision of obligations for internal control management based on it would be the gist of the reformation. Therefore, it is necessary to accurately compile the Responsibilities Map based on facts, and clearly assign and reflect the actual responsibilities of each senior executive. Each executive must be fully aware of one's responsibilities.

In addition, financial companies need to take reasonable measures to ensure that individual senior executives can clearly comprehend the code of conduct that applies to them. They need to ensure that each executive exercises reasonable care in performing internal control management and clearly records and organizes each executive's history of management actions, for the exercise of a reasonable care in management actions is an important factor in assessing the responsibilities.

Special care is required regarding the representative director's responsibilities. For example, simple defect in explicit responsibility relationship among the executive on the Responsibilities Map may lead to the representative director's liabilities for inadequacies in compiling the Responsibilities Map. The representative director bears responsibility for structuring a company-wide internal control system and checking the appropriateness of overall executive control activities, if not for every single control action. Therefore, it is important to design the internal control system clearly from the construction stage to avoid any internal control-related issues from being assessed as a "systemic failure" rather than an individual violation.

IV. Experience of YOON & YANG LLC

1. The expertise of YOON & YANG in financial sector internal control

YOON & YANG LLC has had the opportunity to deeply contemplate the position and limits of the financial regulators, and the direction of improvement for internal controls within the financial

sector, through our experience representing banks in administrative litigation related to DLF sanctions due to violations of the obligation to establish internal control standards under the Financial Governance Law.

We are currently playing a leading role in developing core arguments and persuading the financial regulators in a majority of sanction cases concerning Korean private equity funds' violations of the obligation to establish internal control standards.

We have also conducted research tasks to specify principal issues of internal control standards' that are common to financial companies subject to the Financial Governance Law, together with the Korean Federation of Banks, Korean Financial Investment Association, Life Insurance Association, General Insurance Association, Credit Finance Association, and Mutual Savings Banks Association.

Furthermore, we are continuously conducting proactive research and review related to the compilation and inspection of the Responsibilities Map following the scheduled reform of the internal control system, and provide advice to major financial companies.

The financial regulation team at YOON & YANG LLC possesses expertise optimized for advising and responding to regulations concerning internal control in the financial sector., and provides optimal legal advisory services for clients, based on the experience and know-how accumulated through various advisories for financial companies across all domains. If you have any inquiries related to this, please feel free to contact us at any time.

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