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KOREAN SHORT-SELLING ENFORCEMENT (PART II): MITIGATING PENALTIES FOR INADVERTENT VIOLATIONS

I. OVERVIEW

This client alert is the second installment in a two-part series addressing practical considerations arising in Korean short-selling investigations and enforcement proceedings. Part I examined the methodology for calculating the short-sale order amount that serves as the basis for administrative monetary penalties. This installment addresses strategies available to market participants seeking to mitigate penalties where the underlying violation cannot reasonably be contested.

Approximately 18 months have elapsed since the Korea Exchange ("**KRX**") implemented its Naked Short-Selling Detection System ("**NSDS**") in connection with the resumption of short selling on March 31, 2025. A growing number of matters identified through NSDS are now advancing through the investigative and enforcement stages.

II. DISPUTING THE VIOLATION OR SEEKING MITIGATION

Certain matters flagged by NSDS present substantive questions as to whether a naked short-selling violation occurred at all. Most notably, whether the relevant sell orders in fact exceeded the trader's sellable balance. Recurring examples include whether a securities borrowing had been validly confirmed prior to order submission and the timing of recalls where loaned shares are sold. BKL continues to engage actively with the regulators on these issues in a number of pending matters.

In our experience, however, the majority of matters stem from operational errors, including deficiencies in balance-management systems, timing discrepancies between systems, IT disruptions, and human error in the recording of positions. Such errors may result in the submission of sell orders in excess of the shares available for sale at the time of submission.

Notably, the imposition of administrative monetary penalties for naked short selling does not require a showing of intent; negligent conduct is likewise sanctionable. Accordingly, where an error has in fact resulted in an excess sell order, the assertion that the order was inadvertent does not, in and of itself, constitute a defense to liability. Regulators have imposed penalties in such circumstances.

Where the underlying violation cannot reasonably be contested, the focus should therefore shift to identifying and substantiating mitigating factors. While the optimal strategy will necessarily depend on the specific facts and circumstances, four considerations warrant particular attention.

III. KEY MITIGATING FACTORS

A. Degree of Negligence

Evidence demonstrating that an error was not reasonably foreseeable or readily detectable may support a finding of a lesser degree of negligence and, correspondingly, a reduced penalty.

By way of example, a trader may rely on account-management software licensed from a third-party vendor, and an unforeseen defect in that software may cause an inaccurate position to be reflected in the trader's sellable balance. In such circumstances, the trader should articulate with specificity the nature of the failure and why the error could not reasonably have been anticipated or detected prior to order submission. A generic characterization of the incident as a "system error" is unlikely to convey these circumstances adequately.

B. Voluntary Self-Reporting

Voluntary self-reporting merits particular consideration in light of a recent development in enforcement practice.

Historically, there was no independent basis for an additional reduction on account of voluntary self-reporting where another mitigating factor, such as a low degree of negligence, had already been credited. In a matter resolved in 2026, we challenged this practice on the ground that self-reporting should be afforded separate credit. We understand that the regulators have since adopted criteria permitting an additional reduction for voluntary self-reporting, notwithstanding the application of other mitigating factors.

Accordingly, depending on the facts and circumstances, a trader that identifies a potential violation should evaluate whether to self-report prior to receiving a notice or inquiry from KRX or the Financial Supervisory Service ("**FSS**").

C. Prompt Steps to Ensure Settlement

Whether an order constitutes a naked short sale is determined as of the time of order submission, rather than at settlement. Accordingly, timely settlement does not retroactively cure a violation, and penalties have been imposed in numerous matters in which settlement occurred on schedule and without incident.

Nevertheless, prompt remedial action following discovery of the violation may be relevant to mitigation. Such action includes purchasing the requisite shares or otherwise securing shares for settlement, and successfully completing settlement as a result of those efforts.

Submissions should draw a clear distinction between (i) arguing that successful settlement negates the violation, a position the regulators have consistently rejected, and (ii) demonstrating that the trader acted promptly to remediate the consequences of the error. Contemporaneous records reflecting when the issue was identified, the actions taken in response, and when settlement was completed can substantiate the latter position.

D. Remediation

In our experience, the FSS and the commissioners of the Financial Services Commission ("**FSC**") who review proposed sanctions place significant weight on whether the root cause of an operational error has been remediated.

Traders should be prepared to demonstrate, with supporting documentation, that enhancements to systems, procedures, or internal controls have addressed the specific root cause of the incident and are reasonably designed to prevent recurrence.

This requires a clear articulation of the nexus between the original failure and the corrective measure: what caused the error, what was changed, and how that change addresses the root cause. Rather than relying on a generalized assertion that controls have been strengthened, the trader should present a clear and accessible explanation supported, where available, by system documentation, revised procedures, and testing results.

IV. PRACTICAL CONSIDERATIONS

Korean regulators continue to adopt a rigorous approach to short-selling enforcement. Where there is no viable basis for contesting the underlying violation, a response premised solely on the absence of intent or the completion of settlement is unlikely to suffice.

Traders should instead identify all available mitigating factors, including those discussed above and any other circumstances particular to the matter, and substantiate them with contemporaneous records and a clear explanation of both how the error occurred and what was done in response.

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