

NEWSLETTER

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Digital Finance Team

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Digital Finance: Current Issues and Laws

••• NFTs: Key Korean Legal Considerations

NFTs, or non-fungible tokens, have exploded in popularity recently in line with the surge in interest in the metaverse among companies like Meta (former Facebook) as well as investors and consumers. We discuss the characteristics of NFTs and the legal and regulatory issues relating to them.

1. Overview of NFT

Put simply, NFTs are digital tokens that encrypt and represent rights to digital images, videos, game items, or other digital form of assets, based on computer code and recorded on distributed ledger technology such as blockchain. Unlike traditional virtual currencies like bitcoin which are fungible in nature, the non-fungible nature of NFTs distinguishes them from other digital assets, and NFTs are used to prove the ownership and authenticity of the underlying digital assets.

NFTs are created, traded and exist on a blockchain that has an NFT standard, such as Ethereum, Flow chain, and Wax. Among NFT standards, Ethereum's ERC-721 standard is the most widely used. NFTs may be comprised of a unique identifier, metadata (the details of the digital asset in the case of the NFT), code (also known as a smart contract), and more.

NFTs have become immensely popular lately for their use in creating new assets and markets. Through NFTs, underlying assets are digitized, thereby becoming tokenized and commercialized assets, or new digital assets are created and given value, which in turn enables their trading and distribution. The marketability of the NFT is evidenced by the sale of an NFT representing the source code of the World Wide Web for about USD 5.4 million (approximately KRW 6.3 billion), or the sale of the first-ever published tweet by Twitter CEO Jack Dorsey for USD 2.9 million (approximately KRW 3.4 billion). Companies are becoming more and more interested in NFTs as they can create new business models and revenue streams by tokenizing their own physical or digital assets or those of third parties they have partnered with into NFTs.

2. Key Legal Considerations Related to the NFT

The following are some key legal issues to consider for clients who wish to use or issue NFTs.

■ The legal nature of NFTs and the uncertainty of the relevant regulations

- Due to the novelty of the NFT technology and the various characteristics embedded in NFTs from a commercial, legal, and regulatory perspective, it has been difficult to classify and regulate NFTs under the existing regulatory and legal environments across the globe. With no clear, official interpretation, many countries are reviewing the legal nature of NFTs and responding to issues as they emerge. By their nature, NFTs are linked to various different assets and represent numerous rights and obligations, making them challenging to classify based on their legal nature. There are a variety of issues, such as whether they should be regulated under existing securities laws, whether they should be classified as commodities or separate virtual assets, and how various relevant regulations should be applied according to such classification. Furthermore, given their use in cross-border transactions, NFT transactions often require the consideration of not only Korean laws and regulations, but those of foreign jurisdictions as well.
- In the United States, while the Commodity Futures Trading Commission (CFTC) has interpreted the definition of commodity under the Commodity Exchange Act ('all other goods and articles') to include cryptocurrencies such as bitcoin (https://www.cftc.gov/sites/default/files/2019-12/oceo_bitcoinbasics0218.pdf), the CFTC has yet to provide official guidance about whether NFTs should be considered commodities. Furthermore, it is also unclear whether NFTs should be treated as securities under the Securities Act of 1933 and the Securities Exchange Act of 1934, and the SEC and US courts, which apply the Howey Test to determine whether various assets should be considered investment contracts (a type of security), also apply the Howey Test to NFTs.

* In *SEC v. W.J. Howey Co.*, the U.S. Supreme Court used a test to determine whether a leaseback agreement was an investment contract and therefore a security. Since then, the Howey test has been applied to various financial transactions to determine whether they constitute investment contracts under U.S. law.

In the European Union, the 'Markets in crypto-assets Regulation' (MiCA) was announced on September 24, 2020 and is expected to enter into force around 2024. Under MiCA, crypto asset issuers will have to publish white papers on virtual assets and comply with certain other obligations. The definition of crypto-assets under MiCA includes NFTs, but the obligation to issue white papers does not apply to NFT issuers.

In the U.K., guidance published by the Financial Conduct Authority in 2019 suggests that in many cases, NFTs are likely to be 'unregulated tokens,' provided that some NFTs will potentially be classified as financial instruments depending on their structure and nature.

Singapore's regulatory structure does not separately regulate NFTs. Instead, NFTs are categorized under existing laws and regulations depending on their characteristics, although utility tokens are not regulated. That is, after

reviewing whether the relevant NFT falls under the definition of security token, payment token, or utility token, the applicable laws and regulations are applied.

* Security token: A token similar in nature to securities.

Payment token: A token that functions as a means of payment for goods or services.

Utility token: A token that does not constitute a security token or payment token, which allows access to goods or services.

- In Korea, the crux of NFT regulation turns on whether it is a 'virtual asset' under the Act on Reporting and Using Specified Financial Transaction Information (**the Specified Financial Information Act**). The Specified Financial Information Act defines 'virtual assets' as 'electronic certificates (including all rights related thereto) which have economic value and which can be traded or transferred electronically', provided that certain instruments are exempt from this definition, including 'electronic certificates that cannot be exchanged for money, goods, or services, or information about such certificates, for which the issuer has limited the place of use and purpose thereof.' Whether NFTs fall under such exempted category is unsettled.

On the other hand, in October of 2021, the Financial Action Task Force (FATF), an international anti-money laundering organization, updated its Risk-Based Approach for virtual assets and virtual asset providers (VASP) for 2019. In general, according to the FATF's definition of virtual assets, NFTs are not interchangeable, but unique, and are used as collectibles rather than as means of payment or investment instruments. Thus, they are not considered virtual assets under the FATF interpretation. However, the FATF approach contemplates that where certain NFTs are actually used as a means of payment or investment based on their characteristics, they could be deemed virtual assets, implying that there is a need to review the characteristics of NFTs case by case.

Also, the securities nature of physical asset tokens, such as NFTs, can create issues under the Korean regulatory scheme. For example, the launch of SOTWO, a joint purchase service for artworks operated by Seoul Auction Blue, was suspended after the Korean financial regulator determined that the tokens to be issued by SOTWO were likely to be construed as 'investment contract securities' under the Financial Investment Services and Capital Markets Act.

- As described above, specific conditions may be imposed on NFTs through smart contracts, and there are various NFT use cases related to DeFi, such as NFT-based mortgage loans, asset management and evaluation, and fund creation. Thus, it is necessary to closely analyze the structure of NFTs and examine their legal nature and classification to determine which regulations should govern.

* DeFi refers to decentralized finance using virtual assets based on blockchain technology without the involvement of intermediaries.

■ Money laundering risks, regulations and security-related risks

If an NFT is considered a virtual asset, apart from the reporting obligations of

VASPs under the Specified Financial Information Act, there is a risk that the NFT will be used as a means of money laundering. NFTs have a high risk of being used for money laundering due to their opacity, anonymity and confidentiality, mobility, and representation of the value of underlying assets. As regulators in each jurisdiction may apply their own measures to control money laundering risks relating to NFTs, it is important to keep track of relevant regulatory trends in a timely manner and endeavor to comply with such regulations. For example, the Office of Foreign Assets Control (OFAC), the financial intelligence and enforcement arm of the U.S. Treasury Department, issued a notice on October 30, 2020 regarding money laundering risks arising from the transaction of expensive art works.

In addition, NFTs are often targeted for cybercrimes, and centralized NFT exchanges are especially vulnerable because they store private keys. In light of these risks, any individual or enterprise intending to participate in NFT transactions needs to inspect the security of NFT-related platforms such as NFT exchanges, and the NFT platforms also need to strengthen their technical, physical, and administrative security measures.

■ Other issues - the transfer of intellectual property rights in NFT sales

Before purchasing NFTs, it is necessary to ascertain the content and scope of the rights represented by them. In particular, it is important to note that the sale of an NFT does not automatically equate to transfer of copyrights with respect to the underlying asset. In the case of an NFT with a smart contract attached, it will be necessary to examine whether there is any condition on the transfer of copyrights or the right of the NFT publisher to receive the copyright royalties, etc. For NFT sellers, special care should be taken to clearly indicate the terms and conditions of the NFTs to be sold so as not to be liable to purchasers for any misrepresentations. In many cases, in addition to issuing NFTs that represent their own assets, companies also issue NFTs by entering into contracts with creators or copyright holders. In the latter scenario, the issuer should discuss the core licensing terms and conditions to be included in the sale and minimize legal risks by specifying them in the agreements to be executed with creators as well as the relevant NFT.

3. Implications

As a means of representing the ownership and property value of underlying assets, such as various works of art and game items in the digital realm, NFTs have pioneered the creation of new asset domains and functions and expanded asset distribution channels. In addition to individuals interested in capitalizing and monetizing NFTs, companies can use NFTs to establish new types of business models and diversify revenue streams by digitizing their assets or creating new digital assets. Companies and consumers may also consider NFTs as investments. In spite of these positive functions, the legal and regulatory environment for NFTs is still uncharted, and risks relating to money laundering and security issues remain. For these reasons, when dealing with NFTs, it is crucial to have external experts review the relevant NFT and its structure carefully from various perspectives.

In addition to providing legal advice regarding various issues relating to blockchain, virtual assets, and NFTs, Lee & Ko's Digital Finance Team actively participates in academic research on these topics with members of the National Assembly and

government agencies. If you need legal assistance in connection with NFTs, please contact our Digital Finance Team at any time.



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