

NEWSLETTER

March 2023

Digital Finance Team

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Korea - The FSC's Announcement of the Guidelines on Security Tokens

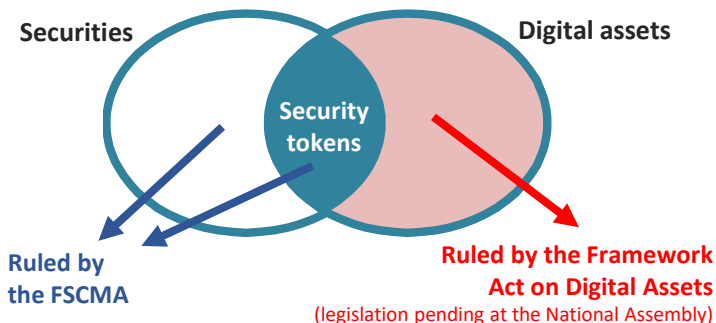
On February 6, 2023, the Financial Services Commission (the **FSC**) announced the "Measures to Overhaul Regulations to Permit Issuance and Circulation of Security Tokens" and the "Guidelines on Security Tokens" (the **Guidelines**).

The Guidelines present the basic principles for determining whether a certain digital asset utilizing distributed ledger technology qualifies as a security, clarify that "Security Tokens", which correspond to securities are subject to securities regulations under the Financial Investment Services and Capital Markets Act (the **FSCMA**), and unveil the plan to improve the relevant system to the effect of procuring security tokens to be issued and distributed in accordance with the FSCMA and the Act on Electronic Registration of Stocks and Bonds (the **Electronic Securities Act**).

1. Details of the Guidelines

■ Background and Purpose

The Guidelines define digitalized securities utilizing distributed ledger technology under the FSCMA as "security tokens". As securities are subject to the regulations of the FSCMA regardless of the type or form of their issuance, it reaffirms that the regulations on securities under the FSCMA apply to security tokens in their entirety.



The FSC, Press Release dated February 6, 2023, the "Measures to Overhaul Regulations to Permit Issuance and Circulation of Security Tokens", pg. 2



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■ Principles for Determining Digital Assets as Securities

In order to reduce market uncertainty and protect investors, the Guidelines present the principles determining whether a certain digital asset utilizing distributed ledger technology qualifies as a security, and the following basic directions, such as the criteria for determining whether a digital asset qualifies as an investment contract security, are almost identical to the guidelines on fractional investment announced in April last year.

Among the different types of securities, debt securities, equity securities, beneficiary certificates, derivatives-linked securities, and depositary receipts are standardized and the application cases related thereto have been generally established, while investment contract securities can be widely recognized and open to interpretation due to their broad definition and the negative regulatory system of the FSCMA, which accordingly are often applied complementally in case that they do not fall under the other five (5) types of securities.

Therefore, digital asset business operators must closely examine whether digital assets they issue, distribute and/or handle fall under investment contract securities by meeting the following requirements:

- ① **Common enterprise:** It shall amount to common enterprise if there is horizontal commonality (if there is relevance of earnings between two or more investors) or vertical commonality (if there is relevance of earnings between the investor and the issuer).
- ② **Investment of money and others:** Invested money and others do not necessarily have to be legal tender (i.e., money), and it is subject to a combination of factors such as the exchangeability with legal tender and the presence or absence of property value.
- ③ **Mainly carried out by others:** The efforts of others (issuer) must be undeniably material and amount to essential management efforts that determine the success or failure of the business. Even in case that the investor operates a part of the business, it can still be considered as being mainly carried out by others if there is information asymmetry on the majority of the business matters.
- ④ **Contractual rights in which gains and losses resulting from the common enterprise vest:** The right to claim profits under the contract entered into between the investor and the issuer must be recognized, such as the issuer explicitly or implicitly promising to distribute business profits directly to the investor, or the issuer promising to procure a third party to distribute business profits to the investor based on a contract with such third party.
 - Investors' rights are carried out through a smart contract, but if there is an issuer who promised to implement the smart contract as a contract, it can be interpreted as a contractual right in and to the issuer.
 - This may include a contract under which gains or losses resulting from the business outcome are attributed in the event that a certain point of time is reached at a later stage or certain objective conditions (e.g., sales targets) are met.
- ⑤ **Purpose of profit acquisition:** Investors should have invested money and others for the purpose of acquiring investment profits.

Accordingly, the Guidelines also provide specific examples with respect to determination of digital assets as securities.

■ **Current Regulation Status on Issuance and Distribution of Security Tokens and Financial Regulatory Sandbox**

The Guidelines clarify that security tokens are securities under the FSCMA, and they should be issued, distributed, and handled in compliance with the current statutory regulations on securities (such as regulatory licenses for financial investment businesses, regulations on public disclosure, and/or regulations on entry of an exchange, provided that investment contract securities shall be exempted from certain regulations).

In addition, as the current system under the Electronic Securities Act does not permit ‘dematerialization’ which utilizes distributed ledger technology without an account management institution managing all information on the books, only securities issued in real form or electronic securities by way of electronic registration can be issued until the Electronic Securities Act is revised.

If the issuance and distribution is not feasible within the current legal system due to the nature of the securities at issue but if business innovation is present and specially recognized, it can be designated as an innovative financial service under the Special Act on Support for Financial Innovation as an exception, subject to temporary benefits granted under the regulatory exceptions under the Special Act on Support for Financial Innovation with an opportunity to test the business for up to four (4) years. However, since the regulatory exceptions would not be applied to make security tokens effective under the current Electronic Securities Act, measures which are feasible under the existing Electronic Securities Act such as issuing electronic securities that match tokens one-to-one should be taken.

On the other hand, concurrent issuance and distribution are restricted in principle, but concurrent issuance and distribution may be permitted temporarily to the extent that a separate distribution market is a must considering the nature of the securities to be issued and it is recognized that innovative services can be provided only through concurrent issuance and distribution.

Furthermore, in light of the possibility that the business may have to be suspended in the end after four (4) years at maximum if the regulatory exceptions are not institutionalized through revision of relevant statutes even after business opportunities are granted through designation as innovative financial services, it is recommended for the business operator to have the contents of the business reflecting the “Measures to Overhaul Regulations to Permit Issuance and Circulation of Security Tokens” below to the extent possible and then apply for designation as an innovative financial service.

■ **The Measures to Overhaul Regulations to Permit Issuance and Circulation of Security Tokens**

■ **Issuance : Legalization of security tokens**

By amending the Electronic Securities Act, the distributed ledger will be recognized as a public book, and security tokens will be defined as a type of electronic securities to which effects* under the Electronic Securities Act are granted.

* Granting the power of presumption of rights and the power to assert against a third party to the right holder of the securities listed in the account book (Article 35 under the Electronic Securities Act).

Distributed ledger must meet certain requirements for prevention of manipulation and change, and securities issuance review and total volume management* of the Korea Securities Depository will be applied equally (prior to the revision of the Electronic Securities Act, conventional issuance of electronic securities will be used by linking to token transfer for electronic securities transactions, and “mirroring” based on electronic securities will be utilized as to presumption of rights in ownership).

* In case that there is a change in the total volume of securities issued, submit the relevant information to the Korea Securities Depository, and the Korea Securities Depository to verify if necessary.

Requirements for Distributed Ledger (Proposal)

1. Information on the right holder and transaction shall be recorded in chronological order, and ex-post manipulation and change shall be prevented.
2. The identity between the right holder information and transaction information recorded in the distributed ledger and the actual transaction details can be proved at the responsibility of the account management institution.
3. Information on the right holder and transaction shall be recorded equally in multiple distributed books.
4. Electronic registry, financial institutions, or account management institutions that do not correspond to the affiliated person(s) with the issuer shall be entitled to participate and verify the distributed ledger.
5. No separate virtual assets shall be required to record information on the right holder and transaction.
6. Rights suitable for recording by means of distributed ledger shall be registered (excluding listed securities, listed DR or derivatives-linked securities).
7. It shall not violate laws and regulations such as the Personal Information Protection Act and the Credit Information Use and Protection Act.

At the present stage, partnership with a securities firm functioning as an account management institution is essential to issue electronic securities, but it is expected that the issuer satisfying certain required conditions will be allowed to become an account management institution for self-issued security tokens (or in case of a brokerage transaction by a securities firm, the securities firm’s trading system will be linked to the distributed ledger of the account management institution).

Requirements for Account Management Institution of Issuer (Proposal)

1. (Distributed Ledger) The requirements for distributed ledger shall be met.
2. (Requirements for equity capital, physical facilities, major shareholder, and executive officer) Will be finalized later based on the opinions collected.
3. (Requirements for human resources) Two (2) individuals for each of the following positions: Legal professionals, professionals in charge of the affairs related to securities, and IT professionals.
4. (Compensation for damages) Fund accumulation proportional to the volume of investment contract securities issues.
5. (Total volume management) Notify the electronic registry (KSD) of the encrypted details at the time of the initial issuance, a change in the issuance quantity, or an arrival of a certain cycle → KSD compares and verifies if necessary.

In addition, the plan is to ease the burden of public disclosure at the time of issuing securities that are less likely to undermine investors' interests, such as introducing private placement for professional investors, expanding the limit on small public offerings (KRW 1 billion → KRW 3 billion), and establishing a new small public offering II (KRW 10 billion, strengthening investor protection) system - all for the purpose of allowing the securities that are less likely to undermine investors' interests to be issued without the burden of public disclosure.

■ Distribution : Establishment of a distribution market for investment contract securities and beneficiary certificates with high demand for security tokens

Under the current FSCMA, investment contract securities are neither subject to nor bounded by distribution-related systems (such as investment brokerage/trading business license, exchange permission, and business report submission), but distribution-related systems are expected to be fully applied to investment contract securities.

In addition, regulatory license for over-the-counter trading brokerage business is expected to be put in place under which multilateral transactions involving investment contract securities and beneficiary certificates (non-monetary trust, which applies the same hereinafter) can be carried out.

It is expected that a KRX digital securities listing market through which investment contract securities and beneficiary certificates are traded will be opened. The issuer can choose whether to list the digital securities, and the plan is to set up an initial market with listing requirements (such as audit opinions, issuance size, public disclosure regulations, and designated advisors in case of investment contract securities) a bit more alleviated compared to the same under the current securities market.

2. Direction of System Improvement in Coming Years

Follow-up work such as revision of the Electronic Securities Act and revision of the FSCMA and subordinate regulations is expected to be carried out in stages in accordance with the "Measures to Overhaul Regulations to Permit Issuance and

Circulation of Security Tokens” in the Guidelines. The FSC unveiled its plan to proceed with the revision of laws and regulations, including submitting amendments to the Electronic Securities Act, from the first half of the year 2023 and that it intends to test, even prior to the revision of laws and regulations but to the extent that innovation is recognized, the distribution of investment contract securities and the issuance and distribution of beneficiary certificates through financial regulatory sandbox.

In addition, in regards to the judgement principles and cases of application in determining digital assets as securities as presented in the Guidelines, the FSC announced its plan to continue to reflect in the Guidelines relevant cases of judgment as applied by financial authorities or judiciary and accumulated to a certain degree.

3. Implications and Takeaways

The Guidelines, for the purpose of lessening market confusion over so-called “Security Tokens” and protecting investors’ interests, are of significance in that the Guidelines have (i) clarified that so-called “Security Tokens”, despite being in the form of digital assets, fall under securities under the FSCMA, and therefore are subject to related regulations, and provided criteria for determining the scope of security tokens, and (ii) introduced and presented in detail a system improvement plan that reflects market demands to issue and distribute various rights in the form of security tokens.

The basic directions as presented in the Guidelines, such as the principle of determining whether digital assets qualify as securities and the criteria for determining whether to qualify as investment contract securities, seem to be an extension of the guidelines on fractional investment announced in April last year. Currently, digital assets are issued and distributed in various contents and forms, and if a digital asset is deemed to fall under securities, a related business operator that issues, distributes, and handles the same may be exposed to the risk of violating public disclosure/market regulations and others under the Securities and Exchange Act. Therefore, it is recommended that such business operator goes through a careful review of whether such digital asset falls under securities such as investment contract securities and/or beneficiary certificates (non-monetary trusts) under the FSCMA.

If it is considered to qualify as securities, it is necessary for such business operator to review and determine whether measures in compliance with regulations under the FSCMA, such as submission of a registration statement or public disclosure documents for small public offering (Part 3, Chapter 1), or measures to apply for designation as an innovative financial service would be better suited for the business at issue.

The FSC has explicitly stated its intention to test the distribution plan of investment contract securities and the issuance and distribution plan of beneficiary certificates as an innovative financial service to the extent that innovation is recognized. In this regard, it may also be an option for a business operator to consider applying for designation as an innovative financial service in accordance with the “Measures to Overhaul Regulations to Permit Issuance and Circulation of Security Tokens” announced, along with the Guidelines.

We, the Digital Finance Team at Lee & Ko, will be on full alert in monitoring changes in the regulatory environment in the digital finance sector, analyze in-depth the foreseeable impact on related industries, and provide you with insightful information as swiftly as possible. If you need any assistance in relation to the above, please feel free to contact the Digital Finance Team at Lee & Ko.

For more information pertaining to this newsletter, please contact the attorneys identified on the left.

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