SHIN & KIM
법무법인(유) 세종

Regulatory Roadmap for Security Tokens Issuance and Trading in Korea

Febuary 27, 2023

In February 2023, the Financial Services Commission ("**FSC**") published a "Security Token Issuance and Distribution Regulation System Improvement Plan and Security Token Policy Tasks" (collectively referred to as the "**Policy Tasks**"). A security token is a security as defined under the Financial Investment Services and Capital Markets Act (the "**FSCMA**") that is in a digitalized form and based on the distributed ledger technology. FSC replaced the term "security-type token" with "security token" to clarify that the FSCMA regulations on public disclosure, sales, and market order will apply. FSC unveiled its plan to overhaul the system that had previously caused difficulties in issuing and circulating security tokens.

The key policy tasks include (i) providing principles for determining whether a digital asset would be deemed to be a security ("**Security Token Criteria**") and (ii) establishing a regulatory foundation to ensure an appropriate market for issuing and circulating security tokens. Security tokens issued overseas would may also be deemed to be a security under certain circumstances. An over-the-counter ("**OTC**") market and a dedicated exchange at the Korea Exchange ("**KRX**") will be introduced for trading security tokens. These measures are designed to mitigate regulatory uncertainties on security-type digital assets (including tokenization), to protect investors and to create a robust market for security tokens. By the way, non-security-type digital assets will be regulated by a separate statute, tentatively named the framework act on digital assets, etc., that is currently under deliberation at the National Assembly.

1. Security Token Criteria

The same criteria for "security" as defined under the FSCMA will apply in determining whether a digital asset is a security. In the Policy Tasks, FSC provided more detail on criteria for determining whether a given asset should be categorized as an investment contract security, which is a type of security under the FSCMA. As a general rule, whether a digital asset is categorized as a security will be determined on a case-by-case basis with emphasis on substance over form.

FSCMA defines security as ”financial investment instrument issued by a Korean national or a foreigner, for which an investor does not owe any obligation to make any payment other than the consideration that the investor paid at the time he acquires such instrument” (Article 4(1) of the FSCMA) and further categorize it into seven types: (1) debt securities, (2) equity securities, (3) beneficiary certificates, (4) investment contract securities, (5) derivative-linked securities, and (6) depositary receipts, and additionally (7) collective investment securities for collective investment schemes and investment trusts.

FSC provided the following examples for reference on applying the Security Token Criteria. These examples are expected to be supplemented over time by court rulings and FSC’s practice.

< Examples of Security Tokens >

Likely Cases of Security Tokens
– A right holder gains a stake in business management, or is entitled to dividends from the performance of business or its remaining assets. (e.g.: equity securities) - A right holder is paid back the investment amount after the elapse of a certain period of time. (e.g.: debt securities) - A right holder gains a beneficiary right to a trust. (e.g.: beneficiary certificate) - A right holder receives money according to a predetermined formula linked to price fluctuation of any underlying asset as per the FSCMA. (e.g.: derivatives-linked securities) - A right holder is granted a right to subscribe, acquire new issues of securities - A right holder has a contractual right to other securities deposited. (e.g.: depositary receipts) - A right holder receives from the issuer profits generated by the business performance using the right holder’s money and especially when the issuer’s efforts, experience and capability were represented as the key to business performance in the offering. (e.g.: investment contract securities) - A right holder receives money in the form of compensation for investor activities which is from the profit generated by the issuer and such compensation is proportionate to the business outcome instead of the investors’ activities and especially when the nature of profit distribution based on business outcome was represented in the offering. (e.g.: investment contract securities)

Unlikely Cases of Security Tokens
- There is no issuer or other entity that is obligated to implement the duties corresponding to investors' rights. - There are neither rights on the digital asset nor investors' rights to profits. - A right is issued and used for the purpose of consuming and using goods and services at present or in the future. - A right is issued for the purpose of maintaining a fixed value to be used in payment or exchange and does not promise refund. - Investors are participating in the day-to-day management and operation of the business leading to little information asymmetry. - Investors provide material goods and services that determines the success or failure of the business and are paid consideration. - There is only an indication of joint ownership of real asset and no undertaking is made on the issuer's role and contribution to increase the value of the jointly owned object or share any value appreciation.

The investment contract securities are the most pertinent type of security relating to security-type digital assets. Under the FSCMA, investment contract security is defined as "an instrument bearing the indication of a contractual right under which an investor invests money in a joint endeavor with another party and share any profit/loss from such endeavor mainly carried out by such other party (Article 4(6) of the FSCMA). This is quite conceptual and is thought to supplement the other more specifically defined ones. Nevertheless, this type of security has been recognized in limited circumstances, mainly in the context where the special rules on online small-sum retail brokerage or the rules on disclosure and unfair trading activity is applicable.
In the Policy Tasks, FSC set forth detailed requirements of investment contract securities as follows:

< Requirements for Investment Contract Securities>

① Joint endeavor
- Qualifies as joint endeavor if there exists horizontal commonality or vertical commonality. * Horizontal commonality: two or more investors depend upon the profitability of the endeavor. * Vertical commonality: the investor and the issuer depend upon the profitability of the endeavor.
② Investment of money or other evaluable
- The money or other valuable being invested does not have to be legal currency, and the exchangeability with legal currency and the presence/absence of property value are comprehensively considered.

③ **Performed mainly by third party.**
- The efforts of the third party (issuer) must be an undeniable, material and essential key determining factor for the endeavor's success. - Even though the issuer does not directly manage all aspects of the endeavor, this requirement would be met if common and collective efforts are made by parties other than the investors. - If the issuing entity and the business entity are different entities only in form, they may be deemed as one and the same issuer. - If the investors perform any part of the endeavor but there still exists information symmetry in most aspects of such endeavor, it would be deemed that the endeavor is performed mainly by a third party.
④ **Right to share in profit/loss generated by the performance of the joint endeavor.**
* FSC introduced a 'Guideline on Securities Businesses Dealing with Fractional Investment' on April 28, 2022, assuming that fractional investment fits this requirement. - The contract should promise a right to share in profit or loss generated by the performance of the endeavor upon attaining a certain objective goal (e.g.: sales target) or reaching a certain point in time. - Where the investors' rights are exercised through smart contracts and the issuer promised by a contract to deliver such smart contracts, the investors can be interpreted as having a contractual right to the issuer. - The issuer or some other third party should carry out the endeavor using investors' money or other valuables and promise to distribute profits generated from the endeavor. Especially when the promised profit is proportionate to the operating profit generated from the endeavor, or when the issuer promises to convert and distribute the operating profits generated, this shall be deemed as sharing in profit/loss from the joint endeavor. - The right to claim profits under the contract between the investors and the issuer must be acknowledged by way of the issuer explicitly or implicitly promising to directly distribute profits to thee investors or a third party promising to distribute profits to the investors based on a contract between the issuer and the third party.
⑤ **For profit**
- The investors must have invested money and other valuables for the purpose of gaining investment profits.

In light of the foregoing, anyone who issued and distributed or is to issue and distribute a digital asset must check whether such digital asset would be deemed a security under the FSCMA and adjust its characteristics according to its desired outcome or take appropriate compliance measures.

2. Security Token Market

FSC plans to permit the issuance and circulation of security tokens by amending the Act on Electronic Registration of Stocks and Bonds ("**ERSBA**") and the FSCMA as follows:

Revision of ERSBA	① Permit security tokens as a form of security issuance.
	② Introduce issuer-account managers that will register and manage security tokens on their own instead of the Korea Securities Depository ("**KSD**").
Revision of FSCMA	③ Introduce the OTC brokerage business for investment contract securities and beneficiary certificates

Security tokens will be treated similarly to the existing electronic securities. Therefore, KSD will check the characteristic requirements (transferability, substitutability, standardization and such) of each security token before it is issued in the form of electronic security. KSD will monitor and manage the total issuance quantity for such security token. Those issuers who meet certain requirements will be allowed to issue security tokens directly. The other issuers will need to issue security tokens through a securities company as intermediary.

Once relevant listing and other rules of KRX are revised, public offering of security tokens would be possible. In the meantime, an OTC brokerage business would be introduced to allow transactions involving security tokens that are investment contract securities or beneficiary certificates.

After the ERSBA is revised, the distributed ledger technology will be recognized as a valid method of recording occurrence, change and extinction of any right relating to a security. There will be certain requirements to ensure security, stability and investor protection. Currently, proposed requirements are as follows:

< Distributed Ledger Requirements (Draft) >

1. Information on right holders and/or transactions is recorded sequentially with any ex-post alteration blocked.
2. The account manager is able to authenticate the consistency between the information recorded in the distributed ledger and the actual transaction information.
3. Information on right holders and/or transactions is identically recorded in multiple distributed ledgers.
4. Multiple electronic registration institutions, account managers not specially related to the issuer, and/or financial institution should be able to check the distributed ledger (at least 51% of the node should be comprised of third-party financial institutions and others)

4. Multiple electronic registration institutions, account managers not specially related to the issuer, and/or financial institution should be able to check the distributed ledger (at least 51% of the node should be comprised of third-party financial institutions and others)
5. No additional digital asset should be required to record information.
6. The rights to be recorded should be appropriate for the distributed ledger technology.
   * Excluding listed securities, listed depositary receipts and derivative-linked securities.
7. It should not violate the Personal Information Protection Act, the Credit Information Act and other relevant laws.

For security tokens issued on qualified distributed ledgers, investors' rights will be afforded the same protection as electronic securities, namely the benefit of presumed valid ownership and defense against competing third-party claims.

An issuer meeting certain qualifications can be an issuer-account manager and would be able to issue security tokens independently without a securities company. The issuer account manager is made available due to the distributed ledger technology's key characteristics—multiple nodes verifying records and prevention of ex-post alteration. Existing securities companies are already recognized as account managers/electronic registration institutions under the ERSBA and will be able to issue security tokens without additional licensing or registration if they meet the distributed ledger requirements.

< Issuer Account Managers (Draft) >

1. (Distributed ledger) The distributed ledger requirements must be met.
2. (Equity capital/physical facilities/largest shareholder/executive officers requirements) To be determined later after consultation.
3. (Human resources requirement) Two personnel for each of the following: lawyers, securities administrators and IT experts.
4. (Indemnification) Reserve to be set aside in proportion to the quantity of investment contract securities issued.
5. (Control of total issuance) Encrypted details to be reported to KSD upon initial offering, additional issuance, reduction and also periodically, specifications should be notified to the electronic registration entity (KSD) → KSD will review and verify as necessary.

A. OTC Brokerage Business

The FSCMA will be revised to introduce a regulated line of business for OTC brokerage for investment contract securities and beneficiary certificates. A licensed OTC broker will collect bids and asks from multiple parties (as currently done at K-OTC market operated by the Korea Financial Investment Association) where transactions are made for matching bids and asks. Licensed securities brokers will be able to engage in OTC brokerage by registering such service as per the procedure under Article 16-2 of the FSCMA. There will be a cap on investment amount for retail investors. However, an exception to sales disclosure will be given for OTC broker-matched transactions of those investment contract securities and beneficiary certificates transactions for which a registration statement or small public offering disclosure was filed previously.. This measure is expected to increase liquidity for these types of securities.

Meanwhile, a public listed market for investment contract securities and beneficiary certificates can be established and operated only by someone approved by KRX as per Article 373-2 of the FSCMA. It is expected that KRX will directly establish and operate a digital securities market. For listing a security in such market, such security will need to be converted to electronics securities (if not in such form already) and use the existing trading, settlement and clearing infrastructure.

3. Implications

The Policy Tasks show a pathway for establishing a regulatory scheme to facilitate security tokens to be issued and circulated and form , and forming markets for them, especially an OTC market in the beginning.

Even before the ERSBA and FSCMA are revised to allow for such, it is to be noted that the authorities may permit a security token in the form of investment contract security through the existing financial regulatory sandbox program. If it is done electronically, it will be necessary to implement mirroring – i.e., 1-to-1 matching between a security token and an electronic security. Or, it can be done by way of a physical certificate and a registration statement.

For Questions or Comments

- **Sang Yeon Eom** | Partner T. 02-316-4677 E. syeom@shinkim.com
- **Hyun-il Hwang** | Partner T. 02-316-4453 E. hihwang@shinkim.com
- **Jong Ki Kim** | Partner T. 02-316-4271 E. jkkim@shinkim.com
- **Jaecheong Oh** | Associate T. 02-316-1782 E. jcoh@shinkim.com
- **Bryan Shin** | Senior Foreign Attorney T. 84-28-3827-4614 E. khshin@shinkim.com

SHIN & KIM
법무법인(유) 세종