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FSC's ANNOUNCEMENT OF THE GUIDELINE FOR NEW SECURITIES BUSINESS AND ITS IMPLICATION

I. The New Development

On April 20, 2022, the Securities and Futures Commission ("SFC") published a circular which states that the 'music copyright fee participation claim' which *Musicow Inc.* ("Musicow") offers constitute 'investment contract securities' under the Financial Investment Services and Capital Markets Act of Korea ("Capital Markets Act"). On April 28, 2022, the Financial Services Commission ("FSC") published the Guideline for New Securities Business including Fractional Investment ("Guideline").

II. The Main Takeaways

The SFC's decision to recognize the music copyright fee participation claim as an investment contract security and the publication of the FSC Guideline reflect the Korean regulators' will to regulate new markets which have been forming in Korea but not yet formally recognized or regulated. Business operators are permitted to offer, in accordance with the Guideline, and investors are permitted to make fractional investments in rights to various assets without actually acquiring the asset itself. Although not explicitly stated in the Guideline, there is hope in the market that such implication may expand to other products such as non-fungible tokens ("NFT") and other virtual assets.

Previously, the Korean regulators have taken the position that security token offerings ("STO") are not permitted. However, if virtual assets are classified as investment contract securities, then the Guideline may apply to STOs provided that it meets the requirements under the Capital Markets Act, such as the submission of securities registration statement. In addition, STOs may further qualify for the regulatory sandbox (as described below) procedure if it meets such relevant requirements.

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III. The Expected Developments

The FSC has announced its plans to improve regulations relating to the circulation

of investment contract securities. In addition, the incoming administration is conducting a comprehensive review of the virtual market as a whole. Korea should be closely monitored for further developments in respect to these regulations.

IV. The Details

Musicow purchases claims to music copyright fees from copyright owners, fractionalizes the claims and sells the fractions to investors. Such fractions are called 'music copyright fee participation claims' and refer to the rights to claim a fraction of copyright royalties. The SFC has recently resolved that such fractions should be considered investment contract securities under the Capital Markets Act.

Based on the announcement, Musicow must have had submitted a securities registration statement and should be subject to a penalty for failing to do so. However, considering that it is the first application of the recent resolution, the SFC decided to suspend punishment on the condition that Musicow implements certain investor protection measures in the next six months.

FSC Guideline

Fractional investment refers to investors purchasing a fraction of claims in certain assets or rights of value. According to the Guideline, fractional investments are investment contract securities if it has certain characteristics such as:

- (i) the right to repayment of the principal investment amount after a set period of time;
- (ii) the right to receive profit-loss distribution drawn from the business operator's business;
- (iii) the right to profits and loss from the valuation of the investment target;
- (iv) the right to profits and loss from the valuation of the asset;
- (v) the right to subscribe and acquire newly issued securities;
- (vi) the contractual rights or interest in other securities; and
- (vii) business operator's performance is a major factor in its profit and losses. Examples are:
 - without the business operator, the receipt of profits and minimization of the losses are not practical;
 - the business operator created an active secondary market which has a significant impact on the profit; and
 - the business operator's effort and ability related to such business is expected to reasonably impact the profit of the investors.

In principle, a company must file a securities registration statement and meet all the requirements in the Capital Markets Act to offer products of fractional investment which are investment contract securities. However, if filing such statement is impractical due to the nature of the fractional investment, a business

operator may consider applying for the regulatory sandbox (as described below) leniency.

Regulatory Sandbox

Key factors which the Korean regulators consider when examining the regulatory sandbox eligibility include:

- (i) whether securitization of the asset is required for the fractional investment;
- (ii) whether the fractional investment products are innovative and can contribute to the advancement of the financial market; and
- (iii) whether the company has implemented adequate investor protection and risk management measures such as:
 - provision of informative materials that sufficiently explain the major terms and conditions of the product;
 - separation of the investors' assets from proprietary assets in separate financial accounts;
 - investor protection from business operator's bankruptcy;
 - keeping registry of investment records;
 - maintaining a technical system to efficiently and systematically prevent and handle technical failures;
 - separation of the securities issuance function and the secondary market operation function; and
 - dispute mediation and loss reimbursement mechanism.

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