

## FSC UNVEILS GUIDELINE ON SECURITIES BUSINESSES DEALING WITH FRACTIONAL INVESTMENT

The FSC introduced a guideline on the recently expanding form of securities business dealing with fractional investment on April 28 in order to make available information about the applicability of the Financial Investment Services and Capital Markets Act (FSCMA) and things needed to be considered for business activities.<sup>1</sup>

Decisions regarding whether a fractional investment product qualifies as a financial security are determined on a case-by-case basis, taking into account various factors related to investments and transactions such as the contents of the contract and the terms of use in a comprehensive manner. Regardless of the method, formality or technicality in indicating the rights, decisions will be based on the actual contents of the indicated rights and the authorities will interpret and apply the rules in line with the purpose of the financial securities regulations.

Business entities with a plan to issue and distribute fractional investment products that are considered as securities should abide by the FSCMA and all other relevant laws. However, a provisional regulatory exemption can be granted through the financial regulatory sandbox program when their innovativeness and necessity (utility) are particularly recognized and when they have established an investor protection system as well as a system for operating separate markets for the issuance and distribution of fractional investment products.

### **BACKGROUND**

Fractional investment is generally known as investing in a share of the ownership right for real-life assets, etc., and most investors perceive that they actually own a piece (fraction) of the ownership right through their investments. When investors have direct ownership,<sup>2</sup> they can earn profits generated from the asset in possession and can exercise their rights including property rights regardless of the success or failure of the fractional investment business. The trading of real-life assets in this regard is not subject to financial regulations in principle.

Recently, however, as opposed to the general awareness of investors, there has been a growing trend of fractional investment businesses engaged in issuing and distributing the right to claim profits generated from assets—not the ownership right

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<sup>1</sup> Fractional investment is a new form of investment that allows two or more investors to invest and trade fractional shares of the royalty or ownership right for real-life assets and other rights that are deemed valuable as property.

<sup>2</sup> When multiple individuals jointly invest and possess an apartment unit and divide up profits made by monthly rent and sale, there exists no correlation between the success or failure of the realtor that helped them purchase that apartment and the value of the apartment as a property.

to assets. Even though some of these fractional investment products may be qualified as a financial security depending on the characteristics of individual products such as the rights structure, contract details and so on, it appears that some fractional investment businesses have been operating their business without closely reviewing whether their products qualify as a financial security or not and without complying with the relevant rule on the issuance and distribution of financial securities under the FSCMA that aims to protect investors. In many cases, investors are also unaware of the precise rights structure while mistakenly thinking that they have direct ownership of the real-life underlying assets in which they have made fractional investment. As such, this great variety in the shape and form of fractional investment businesses and their products depending on individual cases has raised concerns about the potential illegality and the possibility of damages to investors.

Therefore, the government has prepared a guideline on the recently expanding form of securities businesses dealing with fractional investment (“the guideline” hereinafter)<sup>3</sup> to inform and notify about the applicability of the FSCMA on fractional investment business and the things to consider for investor protection. The authorities expect that this guideline will help make application of laws more predictable on fractional investment so as to prevent illegitimate activities and promote development of a sound market based on investor protections.

<Types of Fractional Investment>

Investment by purchasing in a share of the ownership right of a real asset (Exercising the ownership right is possible via proof of official registration, notarization documents, etc.)	Application of the Civil Act and the Commercial Act (Ordinary commercial transaction)
Investing in the right to claim a share of profits generated by an asset (Need to check the characteristics of security, regulations on issuance and disclosure, the need for authorization, approval or registration, etc.)	Application of the FSCMA ( <b><i>Subject to the Guideline</i></b> )

**GUIDELINE DETAILS**

The guideline largely consists of (a) the standards for deciding whether a fractional investment product qualifies as a financial security and (b) the issues to consider for fractional investment business in dealing with fractional investment products that are considered as securities (“fractional investment securities” hereinafter).

**I. DETERMINING A FINANCIAL SECURITY**

A security, where investors carry no additional burden of payment duties whatsoever apart from the money paid at the time of acquiring that security, is classified into debt security, equity security, beneficiary certificate, derivative-linked security and investment contract security. The characteristics of a security are determined on a case-by-case basis, taking into account various factors,<sup>4</sup> and regardless of the

<sup>3</sup> The guideline takes into account wide-ranging opinions from experts and has been presented to the FSC at its regular meeting held on April 27 after being presented to the Securities and Futures Commission and getting an approval from the Financial Development Review Committee’s subcommittee on capital markets.

<sup>4</sup> Aside from the terms of use, consideration is given to the management and operating method of fractional investment products, details of cost changes on various services including fees and payments, details on profit allocation, contents of advertisement, other agreements, etc.

method, formality or technicality in indicating the rights, they are determined based on the actual contents of the indicated rights. When there are attempts to evade the existing regulations, the authorities will seek active interpretation and application of the current regulations in pursuit of the goal of investor protection in regulating securities specified under the FSCMA.

Business entities that are currently operating a fractional investment business or have a plan to do so (“fractional investment business” hereinafter) should comply with the disclosure regulation by filing a security registration report when they plan to issue a fractional investment product that falls under the classifications of a security. Moreover, fractional investment businesses need to check the applicability of laws depending on their business practice as they may be required to get an authorization, approval or registration for investment brokerage business, collective investment business, etc.<sup>5</sup>

In particular, fractional investment businesses need to closely review the applicability of investment contract securities among different types of securities as there is a wide-ranging applicability for this type of security with not many applicable cases so far.<sup>6</sup> When the expertise and operational activities of the business entity plays an important role on the level of profit returned to the investor, there is a high probability of being considered to be under the category of investment contract security. More specifically, examples include (a) when allocating profit for fractional investment or avoiding loss is difficult without the presence of the fractional investment business, (b) when the distribution market operated by the fractional investment business has a significant impact on profits and (c) when the fractional investment business offers a reasonable expectation at the time of recruiting investors for the potential of price increases in fractional investment products linked to its business based on its own efforts or capabilities.

On the other hand, when the business entity directly handles allocation of ownership rights or is able to individually make use of, make profit from or get rid of the fractional investment product, there is a relatively low probability of being considered as a security.

## **II. GUIDING PRINCIPLES ON FRACTIONAL INVESTMENT SECURITIES**

Business entities planning to issue and distribute “fractional investment securities” should comply with the FSCMA and all other relevant laws,<sup>7</sup> a violation of which may be subject to sanctions.

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<sup>5</sup> (a) Management of securities (buying, selling, etc.) and allocation of shares without taking routine directions → Need an authorization to operate a collective investment business

(b) Subscription recommendation, subscription and subscription approval on securities issued by other entities → Need an authorization to operate an investment broker business

(c) Launching or operating a market for trading of securities → Need an approval to operate an exchange

<sup>6</sup> The Securities and Futures Commission has applied the investment contract security classification for the first time on fractional investment products offered by Musicow Inc. on April 20, 2022.

<sup>7</sup> For example, filing a security registration report, prohibition on unauthorized business operation, prohibition on opening an unauthorized market, prohibition on unlawful trading activities, etc.

## <Checklist for Legitimacy of Fractional Investment Business>

A. Whether a fractional investment product qualifies as a security	
Security types	Equity security, debt security, beneficiary certificate, derivative-linked security and investment contract security → Need to comply with disclosure rules when issuing a security by filing security registration reports, etc. (e.g. Musicow Inc.)
<p>&lt;Low probability of being considered as a security&gt;</p> <ul style="list-style-type: none"> <li>- Direct allocation of ownership rights → real estate registration (e.g. apartment unit), official proof of the ownership (e.g. notarization)</li> <li>- Able to make use of, make profit from and get rid of the ownership right → for direct use (e.g. condo membership)</li> </ul>	
B. Whether a service intended to provide qualifies as a financial investment business	
Investment broker business	Subscription recommendation, subscription and subscription approval on securities issued by other entities (aside from investment contract securities) → Need an authorization to operate an investment broker business
Collective investment business	Management of securities (buying and selling) and allocation of shares without taking routine operational directions → Need an authorization to operate a collective investment business
Exchange	Launching or operating a market for trading of securities (aside from investment contract securities) → Need an approval to operate an exchange
C. Whether there are other laws applicable aside from the FSCMA	

Fractional investment businesses can apply for a provisional exemption on certain rules (via financial regulatory sandbox) pursuant to the Special Act on Support for Financial Innovation which went into effect from 2019 when they need to get an exemption on the application of certain financial regulations for operating their businesses. The financial regulatory sandbox is a program offering a special and provisional regulatory exemption for financial services that have been recognized for their innovativeness. After reviewing the effects of designated innovative financial services on investors and markets, the authorities consider regulatory improvements on a medium to long term basis. If there are applications for the financial regulatory sandbox program from the fractional investment security sector, the financial authorities will rigorously review the innovativeness, necessity for designation and issues for ensuring investor protection and market order according to the assessment standards specified under the Special Act on Support for Financial Innovation.

### III. ISSUES TO CONSIDER BEFORE APPLYING FOR FINANCIAL REGULATORY SANDBOX

#### a) Need to be recognized for innovativeness and necessity

The innovativeness and the necessity factors for fractional investment securities should be given strong consideration in order to prevent regulatory arbitrage resulting from the designation of such services under the financial regulatory sandbox program.

**(INNOVATIVENESS)** The issuance and distribution of fractional investment securities should contribute to the development of financial markets, investor benefits and the development of underlying assets and royalties markets. It is difficult to say that the innovativeness requirement has been fulfilled simply because the business entity has insufficient conditions and capacities for complying with the securities regulations.

**(NECESSITY)** The issuance of securities should be essential due to the impossibility of commercializing under the relevant laws governing underlying assets and royalties. In the case that business commercialization is possible through a regulatory sandbox program managed by a relevant ministry that has jurisdiction over underlying assets and royalties, or if the purpose of applying for the financial regulatory sandbox program is to evade the relevant laws overseen by another ministry, there will be no designation of innovative financial service.<sup>8</sup>

b) Need to establish adequate investor protection mechanisms

Even when an exemption is granted on certain regulations, key safeguards should be put in place for investor protection. In particular, it is most important to have the actual rights structure of fractional investment aligned with the characteristics of that particular fractional investment and investors' awareness and to provide accurate information to ensure that investors do not misunderstand the rights structure of the fractional investment security. In this regard, fractional investment businesses should carry out the following.

- (a) Prepare standards and procedures for investor information documents and advertisement to help investors not to misunderstand about key factors crucial for making investment decisions and issue terms of agreement and contracts
- (b) Manage deposits from investors separately with a third-party financial institution and work to return investor deposits in case of bankruptcy<sup>9</sup>
- (c) Insulate investors' rights from the risk of bankruptcy of fractional investment business as the purpose of investing in fractional investment securities is to make investment in underlying assets and royalties—not in the fractional investment business—thus the rights structure with no insulation from the risk of bankruptcy is inappropriate for fractional investment<sup>10</sup>
- (d) Prepare a system for managing and checking the rights relationship on a par with that for securities deposit or akin to that level<sup>11</sup>
- (e) Have material facilities and professional personnel
- (f) Draw up a conflict resolution process and a damage compensation system for investors

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<sup>8</sup> The FSC and FSS will maintain close cooperation and discussion with the relevant ministries that have jurisdiction over underlying assets and royalties when determining the innovativeness and necessity of granting regulatory exemption on fractional investment services.

<sup>9</sup> Without this investor safeguard, if investors deposit money directly with the fractional investment business, investor damages can result from the business going bankrupt.

<sup>10</sup> Without this investor safeguard, the value of fractional investment security can collapse upon the business going bankrupt even though the underlying assets and royalties continue to remain.

<sup>11</sup> Without this investor safeguard, it may result in cases similar to buying an apartment unit but not registering thereafter in which case the buyer cannot exercise the ownership right on that property.

### c) Need to separate the issuance market and the distribution market

In principle, fractional investment businesses are not permitted to operate a distribution market while issuing fractional investment securities due to concerns about damages to investors.<sup>12</sup> However, there may be situations where it is critical to have a distribution market<sup>13</sup> for certain types of fractional investment securities for protecting investors but there exists no such distribution market. In this case, it may be possible to exceptionally and temporarily allow the operation of the issuance and distribution markets by the same business entity after assessing the establishment of a conflict of interest prevention system<sup>14</sup> and the relevant market operating mechanisms.<sup>15</sup> However, in the future, when there emerges a distribution market where a variety of fractional investment securities get traded backed by appropriate operational system and rules, the operation of the issuance and distribution markets by the same entity will no longer be permitted.

### **FURTHER PLAN**

The enforcement of laws on fractional investment and the application review for designating innovative financial services will be carried out according to the guideline announced today. When necessary, the authorities plan to make revisions and improvements to the guideline in the future and work on regulatory improvements needed for investor protection.

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<sup>12</sup> This is akin to a business issuing stocks and operating a stock exchange at the same time. There are concerns over unfair activities such as generating a profit by spiking stock distribution prices and then issuing prices later, or by issuing stocks excessively to jack up on transaction fees.

<sup>13</sup> For example, when investors need opportunities to liquidate because of the extremely long period of investment depending on the characteristics of the underlying asset.

<sup>14</sup> Draw up standards for market distribution and liquidation, prepare an independent review system, information exchange prevention mechanism

<sup>15</sup> Set up a market monitoring system, provide information to investors, etc.