

FSC UNVEILS MEASURES TO OVERHAUL REGULATIONS TO PERMIT ISSUANCE AND CIRCULATION OF SECURITY TOKENS

The FSC introduced a set of policy tasks to overhaul regulatory system on the issuance and circulation of security tokens in order to allow security token offerings (STOs) within the regulatory scope of the Financial Investment Services and Capital Markets Act (FSCMA).¹ The key policy tasks include (i) providing principles for determining whether a digital asset qualifies as a security as well as examples for applying these principles in order to prevent potential violation of laws and protect investors, and (ii) establishing a regulatory foundation to ensure that security tokens are appropriately issued and circulated by improving regulatory system in the following three areas and making the government’s policy direction publicly known in advance.

- a) Accept security tokens as a new form of securities issued under the Act on Electronic Registration of Stocks and Bonds.
- b) Create “issuer” account managers that will directly register and manage security tokens.
- c) Introduce over-the-counter (OTC) trading brokers for investment contract securities and beneficiary certificates.

These measures permit the issuance and circulation of security tokens with the investor protection mechanism that is supported by the framework of capital market regulations. Authorities expect that these measures will (a) facilitate the issuance and circulation of a variety of rights, such as fractional shares, in the form of a security, (b) facilitate the formation of small-scale OTC markets where atypical types of securities can be circulated, and (c) ensure the application of current rules and regulations on securities, which are designed to protect investors, equally.

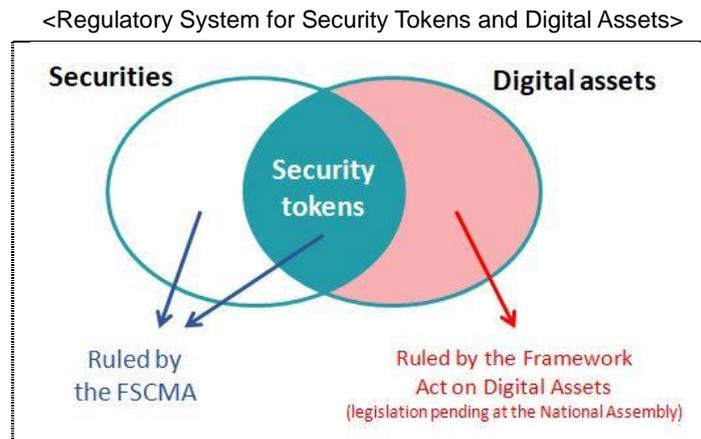
SECURITY TOKEN: REGULATORY SYSTEM AND CONCEPT

A security token (or tokenized security) is a digitalized form of the security that is legally defined in the FSCMA and is based on the distributed ledger technology. Among various types of digital assets, security tokens are—contrary to the “non-security-type digital assets” (a.k.a. virtual assets)—“security-type digital assets.”

Securities fall under the regulatory purview of the FSCMA, irrespective of their forms of issuance. If a right gained by an investor is deemed to fit the definition of a security under the law, regardless of its shape or form, all securities-related regulations apply equally, such as mandatory disclosure, authorization and permission, prohibition of

¹ It is one of the government’s policy agendas aimed at boosting innovation in digital finance.

unfair trading activities, etc., for protecting investors and maintaining market order. Therefore, by nature, security tokens come under the regulatory purview of the FSCMA as they are securities that are just issued in the form of digital assets. On the contrary, non-security-type digital assets will not be regulated by the FSCMA and a separate regulatory system will be established based on new bills such as the framework act on digital assets, etc., that are currently under deliberation by the National Assembly.



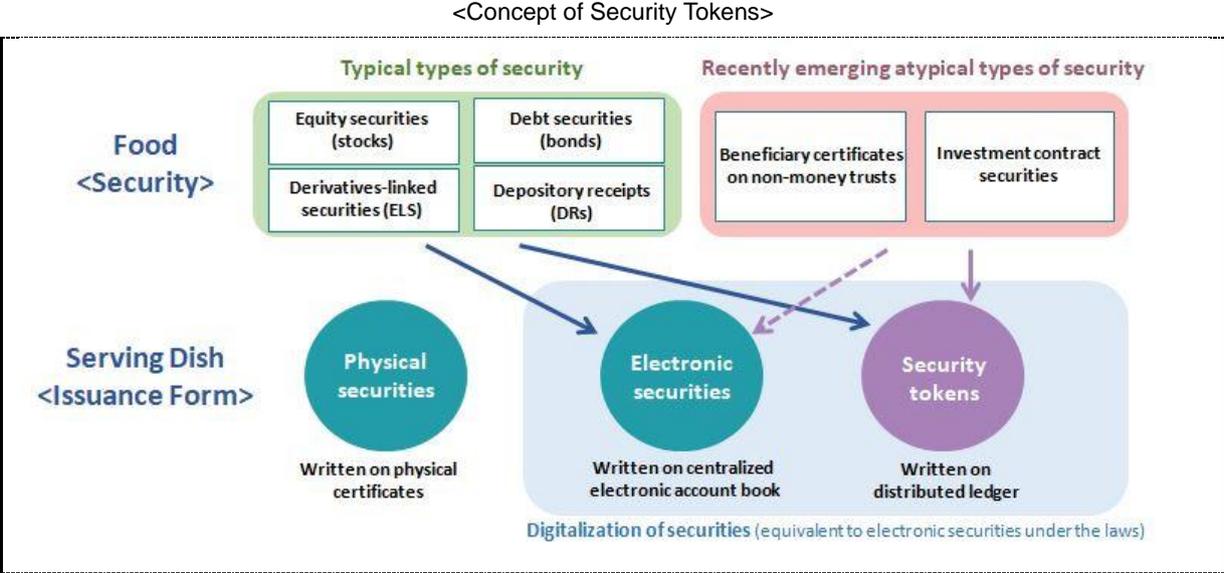
Present laws, especially the Commercial Act and the Act on Electronic Registration of Stocks and Bonds, permit the issuance of securities in the form of (a) physical paper certificates and that of (b) electronic securities which register rights on the electronic register. For physical security certificates and electronically registered securities, presumption of rights² is legally recognized, so that it is possible to protect the property rights of investors and ensure stable transactions of securities. In addition to physical security certificates and electronically registered securities, security tokens represent a new form (or method) of security issuance.

The relationship between the concept of securities under the FSCMA and the form (or method) of issuance under the Commercial Act and the Act on Electronic Registration of Stocks and Bonds can be metaphorically compared to a food-and-a-serving dish relationship, where securities represent a food and the method of issuance a serving dish.

- a) The food remains the same regardless of the type of a serving dish that holds it. In other words, different forms (or methods) of issuance do not affect the nature of a security.
- b) It is not possible to use any object as a serving dish to place the food. To protect investors, the method of issuing a security should carry certain legal force and be subject to certain requirements.
- c) Depending on the type of food, the appropriate type of serving dish may be different. Especially, for the issuance of atypical securities in small amounts, the current form of electronic securities which securities firms centrally register and manage is inappropriate, thus a new form (or method) of issuance is required.

² A holder of a physical security certificate is assumed to be in legal possession of that security and the right to that security is transferred through delivery of the physical security certificate. An entity registered on the electronic registration account book is assumed to hold the legal right to the security and the right to that security is transferred through electronic registration of transfer between accounts of electronically registered securities.

In this regard, by permitting security token offerings (STOs)—that is, the issuance and circulation of security tokens—authorities will support the newly emerging trend of securitizing various types of rights and also improve the efficiency and convenience³ in the issuance and transaction of securities that already exist by utilizing the distributed ledger technology.



BACKGROUND

Under the current system, issuance of digital securities is only possible through a particular mode, and the availability of circulation market where multiple parties participate in transactions is limited. The Act on Electronic Registration of Stocks and Bonds restricts ways to digitalize securities, so that it is only possible through a securities firm, etc., and an issuance of security tokens is not permitted under the current laws. Either investment contract securities or beneficiary certificates on non-money trusts, for which the demand on issuance of fractional shares, etc. has shown recently, remain difficult to be traded within the current regulatory system, because currently there is no circulation system established under the FSCMA.

However, market’s desire for issuing and circulating various rights in the form of security tokens has emerged from various fronts. From the securities market front, there have been requests for issuing, investing and trading various types of atypical securities in small amounts that are not adequately accommodated under the current system centered on both typical securities such as traditional stocks and exchange-listed markets. On the digital asset market front, relevant businesses have grown up rapidly, on the back of regulatory vacuum and convenience of new technology, and they are making attempts to expand into the traditional securities market.

Meanwhile, the issuance and circulation of digital assets that are qualified as securities should be carried out in compliance with all the securities-related regulations under the FSCMA. Thus, as a step toward establishing order in the digital

³ Ease of checking shareholders of unlisted stocks, convenience of issuance and sale of unlisted bonds in small amounts, etc.

asset market, it is necessary to prevent potential violation of the law and protect investors by minimizing uncertainty in deciding whether certain assets qualify as securities.

⇒ *As one of the government's policy agendas⁴ to promote innovation in digital financial services, authorities will revamp the regulatory system on the issuance and circulation of security tokens to permit STOs within under the current system created by the FSCMA.*

KEY DETAILS

POLICY TASK #1: PROVIDE PRINCIPLES FOR DETERMINING WHETHER A DIGITAL ASSET QUALIFIES AS A SECURITY BY INTRODUCING GUIDELINES ON SECURITY TOKENS

The same basic principles for determining what is a security previously introduced in the guidelines for fractional shares investing⁵ will be equally applied to security tokens.

- a) Determining what is a security should be carried out after considering specific related facts and all relevant circumstances⁶ comprehensively and based on the substantial content of the right that matters on a case-by-case basis.
- b) The responsibility of reviewing and determining whether a right that matters is a security, as well as that of complying with the securities regulations in the case that right qualifies as a security token falls on the party who attempts to issue, circulate and handle the security token. In essence, this is equivalent to cases of stocks where a company makes a judgment independently on whether what it issues is a stock and complies with the duties under the FSCMA including the disclosure requirement, etc.
- c) Even when a security token is issued overseas, if it has domestic consequences through an activity such as making offers to domestic investors to make offers, etc., it will be subject to the application of the FSCMA.
- d) For activities attempting to intentionally circumvent the FSCMA, authorities will actively interpret and apply the FSCMA, taking into account the purpose of securities regulations and the need for investor protections.

Therefore, if a digital asset that was currently issued through a public offering or that is being traded in the market is proven to be a security, the issuer is deemed to be in violation of the FSCMA and, in principle, subject to sanctions.

In order to prevent the potential violation of the FSCMA and protect investors, authorities are also providing additional explanations on investment contract

⁴ (Policy task #35-2) Create market conditions and establish a regulatory system to enable the issuance of security tokens with investor protection mechanisms established under the FSCMA.

⁵ For details, please see the [press release](#) dated May 2, 2022.

⁶ Apart from explicit contracts, agreements and white papers, these include conclusion and execution of implicit contracts and smart contracts, details of distribution of profit, content of advertisement and solicitation intended to receive investment, other contracts, etc.

securities, for which there has been no case of applying the basic principles for determining what is a security since the introduction of guidelines on fractional shares investing in April 2022.

Meanwhile, as a reference for making a judgment on whether a digital asset qualifies as a security, authorities have added examples for both the likely and unlikely cases of a right being qualified as a security.

<Examples of Likely Cases of a Right Being Qualified as a Security>

- a) A case when a right holder gains a stake in business management, or gains dividends based on the performance of business management from remaining assets.
 - b) A case when an issuer returns profits generated by the performance of business management to investors (= right holders).
 - When payment of money, etc. to investors actually qualifies as a circulation of generated profits, even though it takes the form of compensation for investor activities.
- * For fractional shares investing, the right to receive profit or loss generated by the performance of a joint enterprise is assumed under the contract. However, for digital assets, a separate judgment is required in this regard.

<Examples of Unlikely Cases of a Right Being Qualified as a Security>

- a) A case when there is no issuer, or exists no entity that is obligated to implement the duties corresponding to investors' rights.
- b) A case when a certificate of right is issued for the purpose of maintaining a stable value to be used in payment and settlement or as a means for mediation of exchange, and does not promise refund.
- c) A case when there is only an indication of the joint ownership to real assets and no pledge is made on the issuer's role and contribution to increase the price and value of the jointly shared object.

When the number of cases applying the principles and relevant judicial precedents accumulate in the future, authorities will reflect them in the guidelines on security tokens to make improvements continuously.

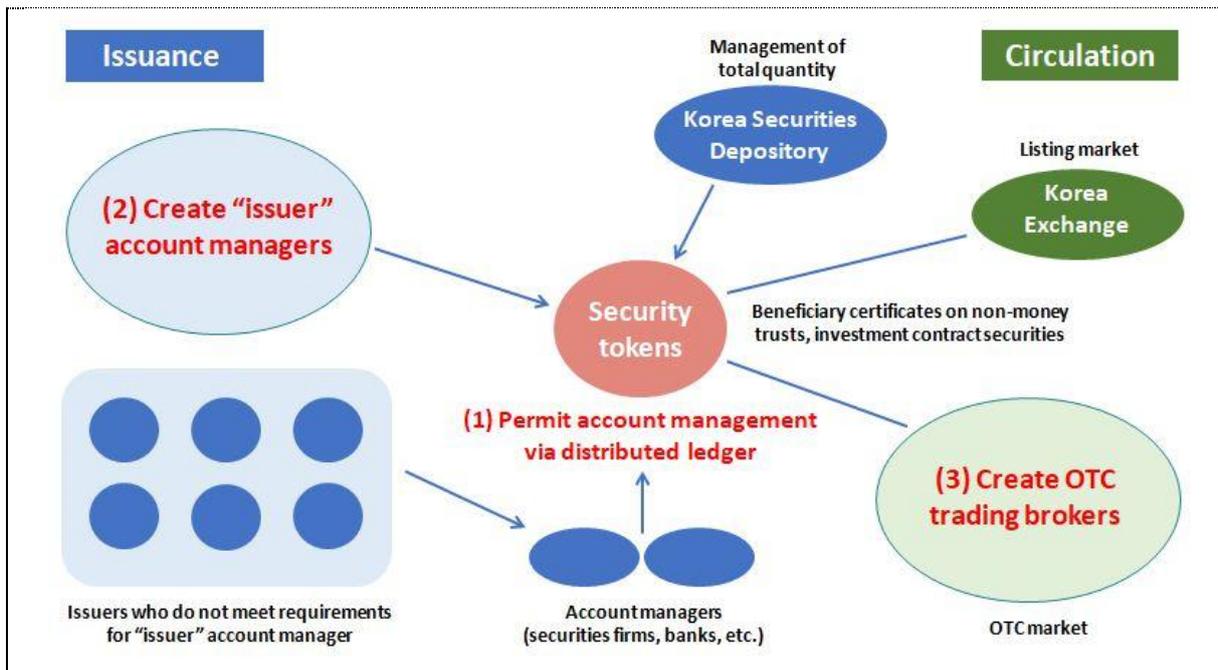
POLICY TASK #2: OVERHAUL REGULATORY SYSTEM ON THE ISSUANCE AND CIRCULATION OF SECURITY TOKENS

<BASIC DIRECTION>

Embrace security tokens' innovativeness and pursue the investor protection aim of the FSCMA in a balanced way

The innovativeness of security tokens can be summarized as their potential for securitizing a variety of rights that has remained difficult to securitize under the current electronic securities system centered on traditional financial institutions such as securities companies as well as enhancing convenience in transaction of these atypical securities, as they become digitalized. While embracing these advantages, authorities plan to build an institutional foundation on which security tokens can be issued and circulated appropriately. This foundation will alleviate the problem of information asymmetry and ensure market order, which will contribute to attain the purpose of securities regulations to protect investors.

<Regulatory System for the Issuance and Circulation of Security Tokens>



I. PERMIT SECURITY TOKEN OFFERINGS (STOs)⁷

Embrace security tokens as a form of security issuance under the Act on Electronic Registration of Stocks and Bonds.

Security tokens that meet the qualification of distributed ledger will be admitted as digitalized (electronically registered) form of securities in the Act on Electronic Registration of Stocks and Bonds. In other words, the distributed ledger technology will be legally recognized as a method of entering in official records information about occurrence, change and extinction of rights pertaining to a security. Certain requirements to secure stability of distributed ledger and protect rights of investors will be needed. These requirements will include, for example, (a) checking and verifying transaction records by multiple participants, preventing ex post manipulation and alteration, requiring no additional virtual asset for issuing or transacting security tokens, etc.

For security tokens issued based on the distributed ledger technology that satisfies these requirements, the same investor protection measures as those applied to electronic securities under the Act on Electronic Registration of Stocks and Bonds will be applied equally.

- a) Investors' property rights will be protected with the presumption of rights and assertion of right against a third-party under the Act on Electronic Registration of Stocks and Bonds.
- b) The Korea Securities Depository (KSD) will check whether a security token qualifies for a security. The KSD will look into whether a security token meets the

⁷ Through a revision of the Act on Electronic Registration of Stocks and Bonds

form of a security as a standardized right by scrutinizing whether the right can be transferred (transferability), whether each right holder has the same right (substitutability), whether the issuance is in violation of any law, etc.

- c) The KSD will manage the total issuance quantity. Upon finding an error after comparing the total quantity of securities allocated to investors and the total issuance quantity, the KSD will request a correction to be made or dispose of the excess quantity according to the procedure prescribed by the Act on Electronic Registration of Stocks and Bonds.

II. INTRODUCE “ISSUER” ACCOUNT MANAGERS⁸

Permit issuers with certain qualifications to issue security tokens directly on their own without having a securities company as an intermediary.

An issuer of security tokens who meets certain requirements will be allowed to directly enter the information on detailed rights, right holders, etc. of securities it issued in the distributed ledger. That is, an issuer equipped with certain qualifications will become an “issuer” account manager to be able to issue security tokens independently⁹ without having a securities company as an intermediary. The requirements for “issuer” account managers will be determined after consideration of the credibility, expertise and stability required for such entities who record and manage official records under the laws. Issuance of security tokens by the entities who do not meet the qualifications will not be restricted, but only their issuance should be made via a securities company, as the issuance of electronically registered securities currently is.

In addition, authorities will also pursue the measures to overhaul rules on private offering and small-sum public offering (already introduced in October 2019) in tandem with the current measures in order to facilitate the use of small-sum public offering when issuing various rights in the form of security tokens.

<Key Details of Measures to Overhaul Rules on Private Offering and Small-sum Public Offering>

- a) When all subscribers are professional investors, it will be recognized as a private offering (professional investor-only private offering).
- b) Small-sum public offering (Tier 1) upper limit is raised from KRW1 billion to KRW3 billion.
- c) Small-sum public offering (Tier 2) with upper investment limit of KRW10 billion is introduced with stronger investor protection measures.

III. INTRODUCE OTC TRADING BROKERS¹⁰

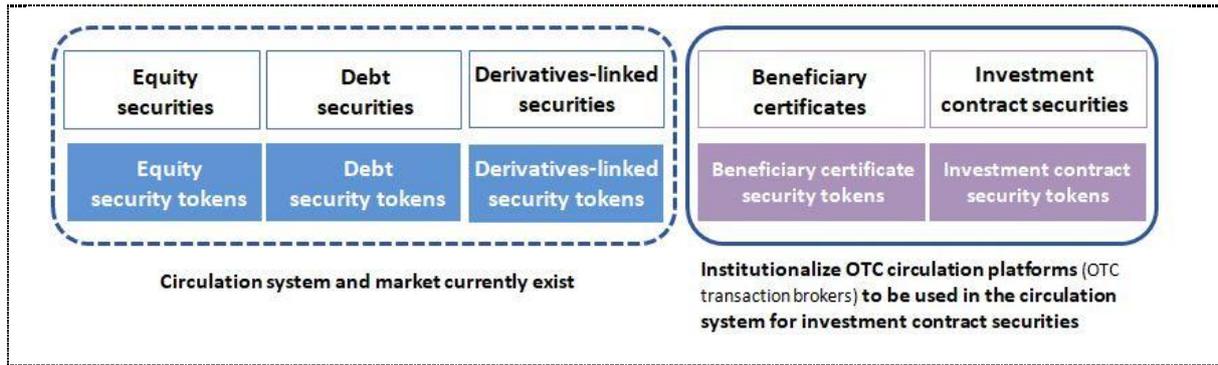
Institutionalize small OTC circulation platforms for investment contract securities and beneficiary certificates on non-money trusts.

⁸ Through a revision of the Act on Electronic Registration of Stocks and Bonds

⁹ Subject to the same investor protection measures for issuing electronically registered securities under the Act on Registration of Electronic Stocks and Bonds and the FSCMA.

¹⁰ Through a revision of the FSCMA

<Revamping the Distribution System for Atypical Securities>



A new business license will be created for OTC trading brokers, which will enable execution of multi-party transactions involving investment contract securities and beneficiary certificates.

- a) **(DUTIES)** An OTC trading broker can intermediate transactions between its own customers via negotiated transactions (transactions executed when bid and ask prices exactly match).
- b) **(LICENSE)** An OTC trading broker will be required to have above a certain level of own capital and be subject to the specific physical, human resources, large shareholder and executive officers requirements. In addition, it will need to prepare internal standards regarding entries and exits of trading items, provision of information to investors, penalties on bad members, extracting abnormal transactions, etc.
- c) **(REGULATION)** The principle of separation between the role of issuer and the role of circulation market intermediary will be applied to prevent a conflict of interest in the business operation of OTC trading platforms. That is, a security issued, undertaken or underwritten by an OTC trading broker cannot be circulated at the platform by the same broker, and the act of self-contracting will also be prohibited.
- d) **(EXEMPTION OF DISCLOSURE)** An exemption of sales disclosure¹¹ will be recognized when transactions of investment contract securities or beneficiary certificates, for which securities registrations or disclosure documents for small-sum public offering have been already filed, are made via OTC trading brokers.
- e) **(INVESTMENT LIMIT)** As it is a small-scale circulation market with an exemption for disclosure, there will be investment limits for retail investors in order to protect them.¹²

The listing market of investment contract securities and beneficiary certificates can only be operated by the entities who obtained permission for an exchange under the FSCMA, as with other types of securities. To protect investors, they will apply the listing requirements and mandatory disclosure of material information, etc., but these

¹¹ A disclosure duty requiring a submission of a securities registration each time a sales subscription is offered or a purchase subscription is solicited for a security already issued to 50 or more investors.

¹² Investment limit for investment contract securities will be set lower than that for beneficiary certificates, given higher level of investment risk associated with the former regarding insolvency insulation, atypical characteristics, etc.

rules will be applied at an eased level under the consideration of the characteristics of this particular market. The listing market is participated by many investors with a large transaction volume. As there are limitations on the processing speed of distributed ledgers, security tokens will be transformed into the form of electronically registered securities, after listed, and will utilize the existing transaction, payment and settlement infrastructure.

ANTICIPATED EFFECT

- a) A variety of rights previously regarded as difficult to be issued in the form of electronic securities, such as fractional shares investment items, can be easily issued and circulated as security tokens. Security tokens are based on distributed ledgers with the characteristics of decentralization, so that it is possible to allow issuers that are non-financial institutions to independently register and manage securities electronically as well as to issue and circulate diverse types of rights in the form of securities with the technologies like smart contract.
- b) The current securities circulation system mainly centered on listed stock markets will be expanded to create versatile small-scale OTC markets suitable for atypical security types (investment contract securities and beneficiary certificates on non-money trusts). With the creation of OTC markets, which have been unpermitted before, circulation of a variety of securities will be made possible in different ways that correspond to the characteristics of different securities, and it will help to satisfy the diversified demand for trading securities.
- c) All investor protection measures, which have been introduced and improved within the capital market system throughout the history, will be equally applied to the issuance and distribution of security tokens. The history of capital market can be seen as a history of the development of investor protection mechanisms. By providing security token investors the same level of protections applied to the investors of traditional securities, authorities will make efforts to ensure that the securities token market can bring about responsible innovation without hollowing out investor protections.

FURTHER PLAN

Authorities will work to revise relevant rules and regulations in phases. Revision bills for the Act on Electronic Registration of Stocks and Bonds and the FSCMA are planned to be submitted to the National Assembly in the first half of 2023. Even before the revision of the laws, authorities will permit the circulation of investment contract securities as well as the issuance and circulation of beneficiary certificates to be tested¹³ through the financial regulatory sandbox program, if the proposed solutions meet the innovativeness requirement. Moreover, authorities will finalize the detailed requirement relating to the authorization for newly introduced businesses, etc. during revising subordinate statutes after collecting opinions once more from relevant stakeholders.

¹³ However, before revising the Act on Electronic Registration of Stocks and Bonds, electronic securitization, such as matching (one-to-one) a security token to an electronically registered security, etc., will be needed.

In addition, the government will actively participate in relevant discussions taking place at the National Assembly on the establishment of a regulatory system on digital assets to establish rules on the comprehensive digital asset market.

Type	Policy task	Required action	Schedule
Security Token Issuance	Embrace security tokens in the current legal system	Revise the Act on Electronic Registration of Stocks and Bonds	Submission of revision bill in H1 2023
	Create "issuer" account manager	Revise the Act on Electronic Registration of Stocks and Bonds	Submission of revision bill in H1 2023
Security Token Circulation	Apply the circulation system for investment contract securities	Revise the FSCMA	Submission of revision bill in H1 2023
	Introduce a new authorization for OTC trading brokers	Revise the Enforcement Decree of the FSCMA	Follow-up action to FSCMA revision
	Exempt sales disclosures for small-sum investors	Revise the Enforcement Decree of the FSCMA	Follow-up action to FSCMA revision
	Introduce a digital securities market	Revise the Enforcement Decree of the FSCMA	Follow-up action to FSCMA revision

#

For press inquiry, please contact Foreign Media Relations at fsc_media@korea.kr.