Main Issue is whether NFT should fall under the definition of virtual asset under the Act on Reporting and Using Specified Financial Transaction Information (“AML Act”) or securities under the Financial Investment Services and Capital Markets Act (“FSCMA”).

1. NFTs as virtual assets

The AML Act broadly defines virtual assets as “electronic certificates of economic value which can be traded or transferred electronically.” Therefore, unless it falls under one of the exceptions prescribed by law, NFTs may be considered as virtual assets (Article 2, Item 3 of the AML Act). On this issue, the Financial Action Task Force (“FATF”) revised its Guidance for a Risk-Based-Approach to Virtual Assets and Virtual Asset Service Providers (“VASP”) on October 28, 2021, suggesting that while NFTs generally do not fall under virtual assets, they may be classified differently if they are used for payment or investment purposes and noting that the actual functions of individual NFTs need to be considered. The Financial Services Commission (“FSC”) seems to agree that whether a particular NFT is a virtual asset should be determined on a case-by-case basis (refer to Press Release dated November 23, 2021).

In order to determine whether a particular NFT constitutes a virtual asset under the AML Act, it is necessary to comprehensively consider the purpose and specific provisions of the AML Act, the rights,
contracts, and use inherent in the NFT, the commercial purpose or marketing of the NFT, the purpose of acquiring the NFT, and the applicability of other finance-related laws to the NFT.

2. NFTs as securities

The FSCMA provides for six categories to define different types of financial investment products. Among the six categories, the category of investment contract security may be the most relevant to NFTs, and therefore, the key question would be whether an NFT may be deemed as an investment contract security under the FSCMA. The term “investment contract security” refers to a contractual right whereby an investor invests money in a joint business together with a third party (which could be another investor) and receives gains or losses from the performance of the joint business which is mainly conducted by the third party. In the case of a fractional NFT (i.e., f-NFT), which breaks down the ownership rights and other incidental rights with respect to the underlying asset, there is a question as to whether it could qualify as a joint business.

When reviewing the investment contract security issue under the FSCMA, it may be helpful to refer to the Howey Test that served as the basis for determining the investment contracts issue in the SEC v. W.J. Howey Co., 328 U.S. 293 (1946) decision of the U.S. Federal Supreme Court and the “Framework for ‘Investment Contract’ Analysis of Digital Assets” published by the US SEC (the “SEC Framework”), from a comparative legal analysis perspective. Under the FSCMA, one of the requirements for an investment contract security is the “contractual right to receive profits or losses,” while under the Howey Test and the SEC Framework, an investment contract exists if “there is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.” Therefore, it is necessary to closely examine the differences between the two requirements for investment contract securities under the FSCMA and the Howey Test. If the Howey Test is applied in determining whether NFT is a security, the likelihood would increase depending not only on the legal nature of the NFT, but also on the issuer’s involvement in the marketing, sales, and distribution process, and the existence of the secondary market.

According to the media reports, the FSC is reviewing whether to apply the FSCMA to securities-type tokens since around June 2021. The report submitted to the National Policy Committee of the National Assembly on November 23, 2021 also included potential regulations on NFTs as part of virtual asset regulations. Therefore, it is necessary to monitor whether Korean regulators would present standards or criteria to determine the legal nature of NFTs in due course.

If NFTs are determined to be securities, virtual assets or financial instruments and the likes under the relevant laws and regulations, it may give rise to unforeseen challenges depending on the requirements under the relevant laws and regulations that must be complied with. Therefore, it is necessary to check the potential legal risks in advance and structure the NFT project accordingly.

3. Regulation of NFT in foreign countries

Major foreign countries are also reviewing how NFTs should be classified under their existing finance related laws. For example, in the U.S., the regulators are discussing and determining whether an NFT is a
commodity or security under the relevant federal regulations and virtual asset or money transmission under individual state laws, and it is likely that f-NFT would be considered as security. In Singapore, where virtual assets related businesses are most active, the main debate is about whether NFTs should be considered as security token, payment token or utility token.

Under the European Commission’s Regulation on Markets in Cryptoassets (MiCA), issuers of NFTs that are unique and not-fungible do not have to issue white papers. However, for the issuance of f-NFT that are not unique, it may be subject to MiCA. In the U.K., there is an ongoing debate on whether NFT falls under a security or a financial instrument. In Japan, the Japanese Cryptocurrency Business Association (JICBA) published the NFT guideline on April 26, 2021 to provide a standard for determining whether a certain NFT is a crypto asset, a security, or a prepaid payment instrument, etc. In case of China, the centralized NFT exchange allows purchases of NFTs only in RMB, which is China’s legal currency, and thus it seems that NFTs are not regulated as virtual assets. However, it is necessary to review whether the Chinese regulatory authorities will strengthen regulations for NFTs in consideration of AML/CFT risks.

II. Issues related to NFT life cycle

We set forth below major legal issues under Korean law for each stage of the issuance (minting), distribution, and storage of the NFT, limited to the financial regulatory perspective. In addition to the issues below, if an NFT project involves multiple jurisdictions, the project should comply with the Foreign Exchange Transactions Act of Korea, as well as the relevant laws and regulations of other jurisdictions involved. Also, it is necessary to check whether the project is subject to the reporting obligation for value-added telecommunications business.

- **(Issuance)** From the perspective of an NFT issuer, the main issue would be whether NFT would be considered as securities under the FSCMA and thus be subject to regulations on securities issuance. If an NFT is issued in Korea, it is necessary to review the specific details so that the issuance would not go against the government’s position that does not allow ICOs. It is also necessary to regularly check to see whether the proposed laws relating to virtual asset industry would introduce regulations on virtual assets issuers.

- **(Sales and distribution)** In case an NFT exchange or sales platform acts as a broker or seller of NFTs that are considered as virtual assets or securities, without filing a report as VASP or obtaining the requisite license for investment dealing or brokerage, or in case such acts are viewed as establishment of an unlicensed market under the FSCMA, it may be subject to criminal punishment. Also, in case an NFT exchange or a seller does not file a report as a virtual asset business on the assumption that it does not deal in virtual assets, it can still be deemed as an online retailer (or online sales broker). In case a person provides payment or settlement services in relation to sale and brokerage of NFT, the person may be required to register as an electronic payment agency (PG) business under the Electronic Financial Transactions Act, or as other specialized foreign exchange business under the Foreign Exchange Transaction Act, depending on the business model.

- **(Storage, custody and management)** An NFT storage, custody or management service providers needs to review the FATF’s October 2021 Guidance and VASP Report Manual issued by Financial Supervisory Service and Korea Financial Intelligence Unit, in order to determine whether it has an
obligation to report as VASP. Even if an NFT wallet is deemed a decentralized wallet, it is necessary to examine the specific facts to determine whether a VASP report would be required.

New financial services relating to NFT are introduced, such as NFT-backed virtual asset loan services, NFT valuation, and investment advisory services using NFTs. In order to provide NFT-related financial services in Korea, it would be necessary to check the issues under the relevant financial laws and policy trends of regulatory authorities, in addition to the AML Act that regulates virtual assets.

III. Conclusion

NFT has the potential to create new businesses in various fields and areas including games, entertainment, finance, fashion, and metaverse. Investments in various domestic and global projects involving NFTs are expected to actively take place. Although the laws and regulations applicable to NFTs are yet unclear, it is necessary to closely review key legal issues and review the regulatory authorities’ position in advance to mitigate potential risks. (In Part 2 of the newsletter series, we will discuss the legal issues related to intellectual property rights for NFT.)
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