

# Fragmented Investment and Investment Contract Securities – The Critical Analysis of the South Korean Regulatory Body’s Attempt to Correlate the Two\*

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## Abstract

*In South Korea, the advent of fragmented investment has attracted many young adults who were looking for new investment opportunities with limited capitals. Musicow's business model has been the epitome of the new phenomenon, as it introduced an idea of royalty participation right and offered it to the public instead of copyright itself. However, some started to complain about the lack of or the insufficiency in investor protection. As a response, the Korean regulatory body labeled the royalty participation right as an investment contract security and ordered Musicow and other service providers of similar fragmented investment products to establish systems for bankruptcy remoteness and other means of investor protections.*

*During the process, however, the regulatory body erred in labeling royalty participation right as an investment contract security as such a decision conflicted with the existing law. While restrictions on the issuance of investment contract security could be no more than the submission of registration statement and avoidance of unfair tradings, the demands to Musicow and other service providers were above such a limitation. In theory, it seems to be more fit to consider such products as derivatives-linked securities rather than investment contract securities. In addition, such an inconsistency could have been avoided if the regulatory body had i) waited for an appropriate amendment of the related law or ii) guided Musicow and other service providers in restructuring their products as entrusted beneficiary certificates.*

KEYWORDS: fragmented, investment, contract, security, FSC, SFC, derivative, linked, beneficiary, certificates, sandbox, innovative, financial, service, Musicow, RPR

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## I. Introduction

With the success of its native idol groups such as BTS, BLACKPINK, and many others, South Korea has garnered much attention in recent years. Many have been focusing on what is going on in the country's music scene. Aside from what is happening onstage, however, some in backstage have been experimenting with "fragmented investment" in both the music industry and other sectors. This new business is now one of the freshest attractions in South Korea, luring a significant number of new users and drawing much attention not only from musicians, but also from the big names of the financial industry. As the fad grew, however, those enforcing regulations also began their attempts to prepare countermeasures to this new experiment.

On April 20, 2022, the Financial Services Commission of Korea ("FSC," hereafter), which is the regulatory body of South Korea that performs duties concerning financial policy, supervision of the soundness of foreign exchange business management institutions, and financial supervision under the jurisdiction of the Prime Minister,<sup>1)</sup> released the statement that the fragmented investment product Musicow was offering at the time was determined as an investment contract security ("ICS," hereafter) under the Financial Investment Services and Capital Markets Act of Korea ("FSCMA," hereafter). This was an attempt by FSC to include fragmented investment within its domain of regulation as outcries for investor protection were arising. Thereafter, FSC began to label similar fragmented investment products of different industries as ICS, requiring them to submit a registration statement and meeting other related requirements set forth within FSCMA. In addition, FSC also required the service providers to build investor protection systems as pursuant to FSC's orders.

Such decisions by FSC to correlate fragmented investment and ICS, however, contained significant errors of not considering the nature of ICS thoroughly. Under the rules regarding ICS within FSCMA, FSC could not have asked the service providers for more than the submission of registration

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1) Geumyungwiwonhoeui seolchi deunge gwanhan beoblyul [Act on the Establishment of Financial Services Commission] art. 3 para.1 (S. Kor.).

statement and avoidance of unfair tradings. Ordering Musicow to establish systems for bankruptcy remoteness and other means of investor protections, therefore, was inconsistent with the current law.

FSC might have forced to make a rash decision due to the lack of time to wait for an appropriate legislation. Such an inconsistency with the existing law, however, shall only worsen the confusion within the industry and the disbelief towards the legal system. In theory, Musicow's investment product seems more to be a derivatives-linked security than an investment contract security; however, labelling its product as such would have caused an unbearable burden to the industry as a whole. Instead, FSC should have called for the immediate amendment of the Article 4(1) or guided Musicow to issue RPR in the form of beneficiary certificates and, if necessary, apply for the recognition as an "innovative financial service" rather than making a statement based on a flawed logic.

In order to critically assess FSC's decisions over fragmented investments and ICS, this paper will i) define ICS under FSCMA and fragmented investments, using the case of Musicow and other similar services, and ii) discuss in detail FSC's decisions over Musicow products and other fragmented investment products by reviewing its press releases, before iii) illustrating the flaws made by FSC regarding its decisions over fragmented investment products and discussing about why these flaws mattered.

## **II. Investment Contract Security**

### *A. Definition*

ICS in the Article 4(6) of FSCMA mean instruments bearing the indication of a contractual right under which a specific investor is entitled to the profits earned, or liable for losses sustained, as a result of a common enterprise in which a specific investor invests money, etc. jointly with a third person (including other investors) and which is to be run mainly by the third person.

In short, ICS requires (i) an investment of money in a common enterprise with a third person (including other investors), (ii) that the venture be run mainly by the third person, and (iii) that the investor be

entitled to the profits earned or liable for the losses sustained.

The idea of ICS is derived from that of “investment contract,” listed as an example of per se securities in the Section 2(a)(1) Securities Act of 1933 of the United States. A rule determining whether an instrument is an investment contract was adopted by the U.S. Supreme Court in *SEC v. W. J. Howey Co.*<sup>2)</sup> The rule, which is now commonly called the *Howey Test*, requires an instrument to meet the following four prongs:

“Investment contract’ exists when (i) there is the investment of money (ii) in a common enterprise (iii) with a reasonable expectation of profits (iv) to be derived solely from the efforts of others.”<sup>3)</sup>

#### *B. Difference Between ICS and “Investment Contract”*

The most noticeable difference between ICS within FSCMA and the Investment Contract of the *Howey Test* is the wording. Unlike an investment contract as defined in the *Howey Test*, ICS does not require that the profit be generated “solely” from the efforts of the promoter or a third party. Instead, the profit is to be generated from a common enterprise which is to be run “mainly” by a third party.

The “solely” component of the *Howey Test* has recently been interpreted not as strictly as before. In *SEC v. Glenn W. Turner Enterprises, Inc.*,<sup>4)</sup> the U.S. Court of Appeals of the 9th Circuit ruled that the “solely” component of the *Howey Test* could be satisfied if “the efforts made by those other than the investor are the undeniably significant ones” and “those essential managerial efforts affect the failure or success of the enterprise.”

The definition of ICS presented in the FSCMA shows that the lawmakers intended to take the “softened” version of the *Howey Test* in order to explicitly include the idea of “vertical commonality” as well as that of

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2) Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293, 66 S. Ct. 1100 (1946).

3) *Id.* at 301.

4) Securities and Exchange Commission v. Glenn W. Turner Ent., 474 F. 2d 476 (9th Cir. 1973).

“horizontal commonality.”<sup>5)</sup> While criticism exists,<sup>6)</sup> it is commonly understood that the notion of “common enterprise” of the *Howey Test* requires only the horizontal commonality; the courts have ruled that “uniform trading for separate discretionary accounts absent (i) some pooling of funds or (ii) other evidence of a distinct contractual tie between the separate accounts or customers did not constitute horizontal commonality and lacked the “common enterprise” element.<sup>7)</sup> Unlike the case of investment contract under the Securities Act, the Korean lawmakers’ intended to make the range of “common enterprise” larger than what is provided in the *Howey Test* by specifically including the vertical commonality for ICS.<sup>8)</sup>

Unlike investment contracts under the *Howey Test*, FSCMA does not state a reasonable expectation of profits as a requirement for ICS; it is, however, required in Article 3(1) of FSCMA to meet the definition of “financial investment instrument,” which is the term that includes ICS as one of its types.<sup>9)</sup> Therefore, it can be logically assumed that ICS requires a reasonable expectation of profits as does any other financial investment instrument.

### C. The Related Responsibilities

The Article 119(1) of FSCMA stipulates that no securities shall be publicly offered or sold, unless and until the registration statement filed by the issuer in connection with the public offering or sale of the securities with FSC is accepted by the Commission, with the further requirement that the total amount of securities publicly offered or sold is not less than the amount specified by the Article 120(1) of the Presidential Decree Regarding FSCMA, which is KRW 1 Billion.

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5) RESEARCH COUNCIL FOR THE UNIFIED CAPITAL MARKETS ACT, JABONSIJANG TONGHAPBEOP HAISEOLSEO [THE GUIDE FOR THE UNIFIED CAPITAL MARKETS ACT] 21 (2007), [https://www.kofia.or.kr/brd/m\\_117/view.do?seq=177&srchFr=&srchTo=&srchWord=&srchTp=&multi\\_itm\\_seq=0&itm\\_seq\\_1=0&itm\\_seq\\_2=0&company\\_cd=&company\\_nm=&page=18](https://www.kofia.or.kr/brd/m_117/view.do?seq=177&srchFr=&srchTo=&srchWord=&srchTp=&multi_itm_seq=0&itm_seq_1=0&itm_seq_2=0&company_cd=&company_nm=&page=18) (In Korean).

6) *Brodt v. Bache & Co. Inc.*, 595 F. 2d 459 (9th Cir., 1978).

7) *Deckebach v. La Vida Charters, Inc.*, 867 F.2d 278 (6th Cir. 1989) at 283. *See also Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir. 1972) at 278.

8) RESEARCH COUNCIL FOR THE UNIFIED CAPITAL MARKETS ACT, *supra* note 5, at 21.

9) *Id.*

In addition, under Article 429(1) of the same law, if the registration statement is not submitted or contains falsehood or omission of material fact, FSC may impose on the issuer a penalty surcharge not exceeding 3% of the amount of public offering or sale written on the relevant registration statement.

In short, selling securities under FSCMA, of which the sum of the value exceeds KRW 1 Billion (Approx. USD 0.788 Million) requires the submission of a registration statement filled by the issuer. In addition, if this duty is not fulfilled, the issuers are to be liable for unlawful activity and be charged with penalties. Therefore, the issuer of ICS would face penalty if it issued the security without submitting the registration statement in certain situations. The goal of such a registration is to promote investor protection by mandating the issuers to provide both hard and soft information regarding the issued securities to the public.<sup>10)</sup>

### III. Fragmented Investment

#### A. Definition

In South Korea, “Fragmented investment” is widely understood as an investment where i) an operator collects monies from multiple investors, ii) purchases a high-value asset with the collected monies, iii) manages the asset and raises revenues and thus profits, and iv) splits and returns the profits to individual investors.<sup>11)</sup> This type of investments allows individual investor to participate in a venture involving a high-value asset with a comparably small amount of capital. Fragmented investment has been drawing much attention from the younger generations of Koreans who, unlike their parents and grandparents, do not yet have enough savings for large investments.

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10) Soohyun Ahn & Jae-eun Jeong, *Onju: Article 119 of Financial Investment Services And Capital Markets Act*, LAWNB (March 10, 2016), [https://lawnb.com/Info/ContentView?sid=J001010513\\_93231\\_0](https://lawnb.com/Info/ContentView?sid=J001010513_93231_0) (subscription required).

11) Sehee Baek, *Kontencheu 'Jogagtuja'wa Beoblyul Isyu: Jeunggwonseongeul jungsimeulo [Fragmented Investment for Contents and Legal Issue – Focusing on the Securitization]*, LAWTIMES, (April 29, 2022, 15:31), <https://www.lawtimes.co.kr/news/178367> (In Korean).

Many Koreans are already familiar with the mechanism of fragmented investments. Through businesses involving artworks, Korean cows, real estates, etc., service providers have already offered numerous fragmented investment opportunities to individual investors. However, the phenomenon of Musicow, a company that allowed the general public to participate in the royalty distribution of music copyrights, provided a decisive impetus to legal scholars in South Korea as they began to reflect seriously on the legality of fragmented investment.

### *B. Musicow and the Royalty Participation Right*

#### *1. The Business Model*

Musicow, Inc. was founded on April 25, 2016 by Jisoo Kim and Hyunkyung Jeong. Since 2019, Musicow grew rapidly after receiving series of investments from some of South Korea's biggest financial institutions and venture capital companies—Kiwoom Investment, STIC Investment, Korea Development Bank, LB Investment, Korea Growth Investment Corp., etc.

Musicow, Inc. introduced a “royalty participation right (“RPR,” hereafter)” in the market where anyone can buy a share of the right to participate in the distribution process of royalty fees and profits. Such a unique “right” is the residue of much dedicated brainchild of Musicow, which wished to stave off the regulations regarding finance and intellectual property in South Korea.<sup>12)</sup>

Musicow's business process begins when Musicow Asset, Inc., a subsidiary to Musicow Inc., makes an agreement to purchase copyrights and other related rights from the right-holder(s).<sup>13)</sup> The purchased copyrights are then entrusted to the Korea Music Copyright Association (“KOMCA,” hereafter), a Korean performance-rights organization that collectively manages the intellectual property rights of registered musical works. Through this process, Musicow will earn the royalty right from KOMCA,

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12) *Investment Guide*, Musicow, <https://www.musicow.com/about/guide>.

13) FINANCIAL SERVICES COMMISSION, JEJAGGWONLYO CHAMYEOCHEONGGUGWONUI JEUNGGWONSEONG YEObU PANDAN MICH (JU)MYUJIGKAUE DAEHAN JOCHI [CONSIDERATION ON WHETHER THE ROYALTY PARTICIPATION RIGHT IS A SECURITY AND MEASURES ON MUSICOW] 7 (2022) (In Korean).

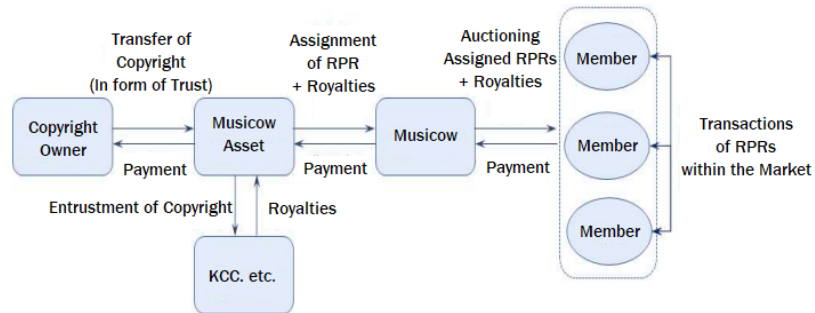


Figure 1. The Business Process Diagram of Musicow<sup>14)</sup>

from which it will receive royalty fees distributed by KOMCA upon use of related musical works.<sup>15)</sup>

Based on the royalty right from KOMCA, Musicow Asset will issue an RPR and entrust it to Musicow. The RPR here serves as a receivable that allows the holder to request the distribution of royalty fee Musicow Asset has collected from KOMCA. Musicow will sell the RPR to its investors in parts or in its entirety.<sup>16)</sup> An investor with an RPR may, therefore, (i) receive royalty fees collected by KOMCA and transferred to Musicow Asset, OR (ii) sell his/her RPR to other investor(s) and enjoy the profit generated as a result.

The reason why Musicow adopted such a complicated business mechanism lies in the complexity of copyright transactions in South Korea. Any transfer of copyrights in South Korea requires registration with Korea Copyright Commission.<sup>17)</sup> In addition, if the ownership of a copyright is in the form of sharing, such a transfer also requires the agreement of all shareholders. If hundreds and thousands of people share a single copyright, the transfer or the exercise of the copyright will necessitate an extremely complicated procedure.<sup>18)</sup> For these reasons, Musicow chose to take a

14) *Id.*

15) *Id.*

16) *Id.*

17) Jaewook Jeong, *Jogagtujuwa Myujigkau 'Jejae Bolyu' Gyeoljeongi Namgin Geosdeul [Fragmented Investment and Musicow – What Remained After the Reservation of Sanctions]*, 67(6) *GOSHIGYE*, 143,144 (2022) (In Korean).

18) *Id.*



roundabout by introducing RPR, which shall be construed as a kind of bonds and do not require to go through a complicated procedure like a copyright itself.<sup>19)</sup>

Musicow's business model has been robust. According to a report from), Musicow has gathered 915,000 members by 2021. The total amount of money exchange has increased from KRW 1,000,000,000 (Approx. USD 700,000) in 2018 to KRW 274,200,000,000 (Approx. USD 191,696,620) in 2021.<sup>20)</sup> At least 169,000 members had acquired an RPR at least once by April 2022.<sup>21)</sup>

## 2. Concerns Regarding Investor Protection

Regulations against such an investment, however, have long been anticipated since its inception. Since the Global Financial Crisis in 2007 and 2008, the South Korean government and related financial agencies have displayed a rather clear propensity when dealing with the financial industry; they have long demanded financial service providers to endeavor to address the issue of information asymmetry and build a system for investor protection that is as sturdy as possible.<sup>22)</sup> In addition, the regulatory body has since been eager to expand the range of its rein towards financial services – especially those involved in B2C (business-to-consumer) commerce – that have received much attention from the public.<sup>23)</sup>

Until 2022, the Financial Services Commission of Korea ("FSC," hereafter received numerous civil complaints from the investors of Musicow and other interested parties. The common issues raised in those complaints included the following<sup>24)</sup>:

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19) *Id.*

20) Dawoon Jeong, "Myujigkau Eumag Jeojaggwondo Jeunggwon" ... NFT·Misul·Budongsan Deung 'Jogag Tuja' Jedogwoneulo ["Musicow Music Rights are Securities" ... Fragmented Investments Like NFT, Arts, and Real Estates Now under the Regulation], MAEL BUSINESS NEWS KOREA (April 22, 2022, 11:51), <https://www.mk.co.kr/economy/view.php?sc=50000001&year=2022&no=359644> (In Korean).

21) *Id.*

22) KONSIK KIM & SUNSEOP JUNG, SAELO SSEUN JABONSIJANGBEOB [THE NEWLY WRITTEN CAPITAL MARKET ACT], 4-6 (4<sup>th</sup> ed. 2023) (In Korean).

23) *Id.*, at 6.

24) FINANCIAL SERVICES COMMISSION, *supra* note 13, at 2.

- 1) Whereas the public believed that investors are investing their money in music copyrights directly, the right investors received through their investments on Musicow was simply a right of claim toward Musicow but not copyright owners; this might lapse in the event of Musicow's bankruptcy.
- 2) The third-party observance system was absent, and it was difficult to check whether investors' rights and deposits were safely managed.
- 3) Information related to the financial statement of the company, RPR's structure, the process of issuing RPR and determining their process, etc. had never been disclosed to public.
- 4) The market observance system for RPR markets was absent, and the danger of unfair trading such as price manipulation existed without restriction.

After receiving and reviewing these complaints, the Securities and Futures Commission of South Korea ("SFC," hereafter), an interagency of FSC, began its research on whether Musicow's business with RPR constituted an improper issuance and circulation of a security under the FSCMA to the extent that the company failed to fulfill its legal duty to submit a registration statement. SFC collected expert opinions from February to March 2022 on whether they should make an attempt to forestall the malicious events towards investors at will and, thereafter, held the Deliberative Committee for Legal Interpretation on March 2022.<sup>25)</sup>

### *C. Other Fragmented Investment Products*

Stockeeper, established in October 2020, began its platform service called "Bankcow" on January 5, 2021, and offered shares for public subscription for three times and gathered hundreds of investors.<sup>26)</sup> Bankcow

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25) *Id.*, at 3.

26) Jinho Yoon, *4manwoneulo Hanu Kiunda ... MZsedae 'Jogag Tuja' [Raising Korean Cows with Just 30 Dollars – Fragmented Investment by the MZ Generation]*, THE CHOSUN DAILY (Sept. 7, 2021, 03:00), <https://www.chosun.com/economy/stock-finance/2021/09/07/ZZTV7XMG55F6FMJJC6JS7D7R7W4/> (In Korean).

connects stockbreeders and investors by allowing investors to participate in a fund to own Korean cows, of which the auction bid had raised 66.6% from 2011 to 2021.<sup>27)</sup> Stockkeeper claimed that investors would be able to enjoy the average profit of 19.7% within 2 years while stockbreeders would have an opportunity to raise money for breeding costs without worrying about interests.<sup>28)</sup>

Kasa Korea, acquired by Daishin Financial Group in March 2023, has introduced a platform service where an investor can join a fund to own a real estate in Seoul in the form of acquiring beneficiary certificates, receiving dividends from leases or sales.<sup>29)</sup> From 2019 Kasa has listed 6 types of beneficiary certificates regarding an office, a lodging facility, a distribution center, etc., and successfully raised profits of above 10% during the sales of the Korea Technology Center building (10.16%) and the Yeoksam Londonville building (14.76%).<sup>30)</sup>

Tessa, Together Art, Seoul Auction Blue, and Yeolmae Company have introduced similar fragmented investment products regarding artworks; their products ultimately garnered FSC's attention and became their target of consideration for expanding the range of regulation.<sup>31)</sup>

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27) *Id.*

28) *Id.*

29) Jaegeun Hong, *Hong Jaegeun Daepyo "Kasaga Budongsan Jogagtujauui Joheun Mento Doel Geos" [the CEO: "Kasa Will Become a Good Mentor for Fragmented Investments on Real Estates]*, ENERGY KYUNGJE NEWSPAPER (August 21, 2023, 06:30), <https://m.ekn.kr/view.php?key=20230820010004925%20> (In Korean).

30) Minwook Baek, *Kasa, 'Yeogsam Leondeonbil' 117eogwon Maegag ... Baedang Suiklyul 14.76% [Kasa sold Yeaoksam Londonville for 11.7B Won, raising the dividend profit of 14.76%]*, NEWSIS (June 21, 2022, 09:23), [https://www.newsis.com/view/?id=NISX20220621\\_0001914361](https://www.newsis.com/view/?id=NISX20220621_0001914361) (In Korean).

31) Seongwook Jeong, *Hanu Misulpum Jogagtuja Sijang Yeollyeossda ... Tesa Deung 5gae Eobche Choejong Jejaemyoenje [Markets for Fragmented Investments for Cows and Artworks Have Opened – Tessa and Five Other Businesses Were Exempt from Sanctions]*, ETODAY (July 14, 2023, 15:56), <https://www.etoday.co.kr/news/view/2266175> (In Korean).

## IV. FSC's Decisions over Fragmented Investment

### A. FSC's Decision on RPR

On April 20, 2022, FSC released a statement that a RPR was determined as an ICS under FSCMA. FSC added that, as a result, Musicow was responsible for selling securities without submitting a registration statement and meeting other related requirements set forth in FSCMA.<sup>32)</sup>

### B. SFC's Decision on ICS

On April 20, 2022, SFC ruled that RPR fulfilled every requirement for being recognized as an ICS, and that Musicow was liable for the public offering and the public sale of securities without submitting the required registration statement to FSC.<sup>33)</sup>

The reasons SFC cited for its determination are as the following<sup>34)</sup>:

#### 1. *The Existence of a Joint Venture*

Investors who shared the same RPR should enjoy the same amount of royalty distribution and the price fluctuation of the RPR.

#### 2. *The Venture to Be Run Mainly by the Third Person*

Musicow and Musicow Asset solely undertook the i) investment, utilization, and management of copyrights, ii) calculation of the issuing price, iii) calculation and distribution of royalties, and (iv) operation of circulating markets. In addition, RPR and its circulating markets were newly created by Musicow Asset, and to realize and receive profits from an investment would not have been possible without the operations of Musicow Asset, it was impossible to realize and receive profits from investments.

The membership agreement stipulated that investors could not receive

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32) *Id.*, at 1.

33) *Id.*, at 3.

34) *Id.*, at 8.

royalty distributions without Musicow, as each member was required to entrust every right related to the calculation and distribution of profit shares to Musicow. Members were not allowed to demand the distribution of royalties directly to the copyright owners.

### *3. Investors' Entitlement to the Profits Earned or Liability for Losses Sustained*

Members who acquired shares of RPR were entitled to the profits realized by the related copyrights, including royalties.

### *4. A Reasonable Expectation of Profits*

Members invested their capitals on RPR with the expectation of receiving royalty distribution or realizing trading profits, rather than using the related actual songs for their own goals.

SFC added that such a restriction was necessary because, while Musicow was growing rapidly in the number of members and the volume of business, the means of investor protection were not adequate to the level of growth in business. SFC reasoned that, starting from the late 2021, many civil complaints had been submitted to FSC for (i) the possible violation of FSCMA and (ii) the structural insecurity of Musicow's business model. SFC also claimed that these were all because Musicow was outside of the financial regulation under FSCMA for investment protection, whereas RPR was issued and sold in the similar ways as securities.

## *C. The Conditional Reservation of Sanctions*

### *1. FSC's Decision to Reserve Sanctions Conditionally<sup>35)</sup>*

Meanwhile, FSC also allowed a conditional exception for Musicow. FSC stated that Musicow would not receive sanctions and/or punishments for violating FSCMA if it should satisfy the conditions set forth by the SFC. FSC added the following reasons for the exception:

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35) FINANCIAL SERVICES COMMISSION, JEJAGGWONLYO CHAMYEOCHEONGGUGWONUI JEUNGGWONSEONG YEObU PANDAN MICH (JU)MYUJIGKAUE DAEGHAN JOCHI [DECISION ON WHETHER THE RIGHT TO CLAIM PARTICIPATION IN COPYRIGHT ROYALTIES IS A SECURITY AND MEASURES AGAINST MUSICOW, INC.], 3-4 (2022), <https://www.fsc.go.kr/comm/getFile?srvcId=BBSTY1&upperNo=77698&fileTy=ATTACH&fileNo=2> (In Korean).

- 1) The RPR case was the first occasion on which FSC recognized a financial product as an “investment contract security”; therefore, Musicow could not have foreseen that the issuance and the sale of RPR would constitute an unlawful activity under FSCMA.
- 2) The continuance of business for five years would have caused ~170,000 investors to reasonably anticipate that Musicow would continue to be in business in the future.
- 3) This type of new business would introduce a new way to diversify the means of raising profits for content creators and invigorate the industry related to intellectual property rights.

## 2. *The Conditions*<sup>36)</sup>

The SFC ordered Musicow to transform the business structure in such a way that its investor protection system could be enforced. It required that this be done until October 19, 2022, and stipulated that Musicow had until this date to report to the Financial Supervisory Service of Korea (“FSS,” hereafter), which is an organization established in order to conduct the inspection and supervision on financial institutions under the guidance and supervision of FSC or SFC.<sup>37)</sup> The transformation of the business structure, the SFC added, was to entail the introduction of a new system that would better help the investors predict the amount of profit and better protect their bonds, deposits, and other properties.

The SFC added specific requirements as below:

- 1) Investors’ rights and properties must be remote from bankruptcy of the entity.
- 2) An investor's deposit must be kept in an account under his or her name and opened with a financial institution other than the entity.
- 3) Sufficient facilities and expert personnel must be provided for investor protection, information security, etc.

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36) *Id.*, at 4.

37) Geumyungwiwonhoeui seolchi deunge gwanhan beoblyul [Act on the Establishment of Financial Services Commission] art. 24 para. 1 (S. Kor.).

- 4) Appropriate materials and advertisements and clauses in membership agreements for explaining the structure of RPR must be prepared.
- 5) Simultaneous operation of markets for issuance and transactions shall not be allowed, unless i) in the bond transaction market as may be required for investor protection and ii) the system for the prevention of conflicts of interest and for market observance is prepared as effectively as market severance itself.
- 6) A reasonable procedure for dispute resolution and a compensation system for damages caused by the entity's negligence must be prepared.
- 7) The issuance of new RPR and advertisements is not allowed until the FSS confirms and the SFC approves that the conditions listed above are met.

The SFC also added that, if i) the FSS should undertake the transformation of business structure as described above and acknowledge the legality of the required changes, and if ii) the SFC should approve the FSS's report on the implementation of these changes, Musicow would be protected from all sanctions for violating FSCMA.

#### *D. Responses from Musicow*

After receiving the statement from FSC, Musicow successfully reinforced its investor protection schemes by changing its business structure as advised by FSC. The details of the change include i) the introduction of a system for preventing conflicts of interest between the company and investors, ii) the development of special human resources and additional facilities that would ensure investor protection, iii) the establishment of a trust fund that would serve to protect the investors' deposits and other assets away from a possible bankruptcy, etc.

FSC seemed to be satisfied with Musicow's efforts as it accepted Musicow's application for the recognition as an "innovative financial service" under the Special Act on Support for Financial Innovation of Korea ("SAOSFFI," hereafter) on September 7, 2022. Such a recognition will

enable Musicow to evade much of the governmental regulations for as long as five and a half years during its issuance of beneficiary certificates with the aid of Kiwoom Securities as a trust company.<sup>38)</sup>

On November 29, 2022, the SFC confirmed that Musicow would be exempt from all sanctions for violating FSCMA due to the company satisfying all conditions related to the transformation of business structure as instructed.<sup>39)</sup> In addition, Musicow submitted its registration statement to FSC after reorganizing RPR as a beneficiary certificate.<sup>40)</sup> Had it been accepted by FSC, RPR would have made the first case of a security based on an underlying asset other than traditional investment instruments or currencies.<sup>41)</sup> FSC, however, refused to accept the submission and rather requested for amendments by demanding more enforcements in explanation about how the investor protection would be secured.<sup>42)</sup>

#### *E. FSC's Guideline for Fragmented Investments, etc.*

On April 28, 2022, FSC publicly released a guideline for fragmented investments as requested from the industry for clarification.<sup>43)</sup> It stated that, by offering an official guide on how the FSCMA would be applied to these

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38) Myeonghwan Kim, *Myujigkau, 'Heogsingemyungseobiseu' Lo Jijeong [Musicow Being Appointed as a "Revolutionary Finance Service"]*, MAEL BUSINESS NEWS KOREA (September 7, 2022, 16:37), <https://www.mk.co.kr/news/stock/10449063> (In Korean).

39) Yeseul Hyun, "Misul Hanu Jogagtujado Jeunggwontuja" ... Myujigkaunen Jejae Myeonje [*"Fragmented Investments on Artworks and Korean Beef Are Investments on Securities" ... Musicow to Evade Sanctions*], THE JOONGANG (November 29, 2022, 21:48), <https://www.joongang.co.kr/article/25121674> (In Korean).

40) Soohyun Park, *Myujigkau, Geumgamwone Jeunggwonsingoseo Jechul ... Bijeonghyeong Jasan Choecho Nolinda [Musicow Submitted Registration Statement to FSC, Aiming for the First Case of An Atypical Underlying Asset]*, MONEYTODAY (November 15, 2023, 17:31), <https://news.mt.co.kr/mtview.php?no=2023111514462434088> (In Korean).

41) *Id.*

42) Da-eun Jeong, *Myujigkau, Geumgamwon 'Tujaja Boho Ganghwa' Yogue Singyu Jeunggwon Balhaeng Yeongi [Musicow To Delay The Issuance Of The New Security Due To FSC's Demand To Provide More For Investor Protection]*, ETNEWS (December 7, 2023, 13:51), <https://www.etnews.com/20231207000189> (In Korean).

43) FINANCIAL SERVICES COMMISSION, JOGAGTUJA DEUNG SINJONGJEUNGWON SAEOB GWANLYEON GAIDEULAIN [GUIDELINE FOR FRAGMENTED INVESTMENTS AND NEW TYPES OF SECURITY-RELATED BUSINESSES] (2022), <https://www.fsc.go.kr/no010101/77728> (In Korean).



new kinds of securities, FSC hoped to minimize the possibility of unlawful business-related activities involving ICS while promoting investor protection.

Regarding the question of whether fragmented investments constitute securities, FSC stated that, instead of methods and formalities, it would focus only on the rights and responsibilities that investors would come to assume as a result of their investments. FSC added that one who wished to issue or circulate securities under the FSCMA was subject to regulations under the FSCMA including the duty of registration, the prevention of unfair trading, etc. FSC also stated that they would check i) use agreements, ii) methods of managing investment targets, iii) methods of collecting fees, payments and other expenses, and distributing profits, iv) advertisements, v) other related agreements, and vi) other related matters per cases individually when determining the legality of activities regarding ICS.

FSC also provided examples of what would be and would not be deemed as securities under FSCMA. According to FSC, i) a case where an ownership and/or other property rights of an investment target is actually divided and distributed directly to the investors accordingly with their shares and ii) a case where the investors are allowed to directly and individually use, raise profits, and/or dispose an investment target would not be considered as securities under FSCMA.

Since the failure to fulfill the duties above can result in criminal consequences and other restrictions, service providers who wish to offer services related to fragmented investments must check whether their products are to be deemed as securities under the FSCMA individually in advance. FSC stated that this guide would help service providers determine that.

In the meantime, FSC offered a roundabout to service providers offering fragmented investment services wished to provide services related to fragmented investment and, thus, were likely to be subject to regulations under the FSCMA and other related laws. If the regulatory body acknowledges that a fragmented investment service is sufficiently 'innovative' and, due to its unique nature, cannot be easily promoted and sold under existing laws, upon the application of the service providers, they may recognize the service as an "innovative financial service" under the SAOSFFI. When service providers receive such a recognition, they will be exempt from regulations for a limited period of time and will be allowed to issue and circulate the securities as they wish within that period. FSC has been

advertising this program as the Financial Regulatory Sandbox.<sup>44)</sup>

Such a “sandbox” system was first adopted in the United Kingdom by the Financial Conduct Authority in October 2015 in order to aid “innovative firms” that are well prepared to provide new financial services that would contribute to the innovation of the industry.<sup>45)</sup> Likewise, SAOSFFI aims to “contribute to the national economy by accelerating the development of financial services with the goal of benefitting financial consumers and creating more jobs,” as stated in the Article 1 as its purpose.

#### *F. FSC’s Decisions on Other Fragmented Investment Products*

On November 29, 2022, FSC released a statement that i) Musicow will be exempt from all sanctions for violating FSCMA due to the company satisfying all conditions related to the transformation of business structure as instructed, ii) fragmented investment products offered by Stockeeper, Tessa, Seoul Auction Blue, Together Art, and Yeolmae Company were all determined as ICS under FSCMA, and iii) the divided ownership where the profits of investment heavily rely on the expertise and/or activities of business operators.<sup>46)</sup>

FSC claimed that the fragmented investment product of Stockeeper regarding Korean cows requires the business operator’s sole efforts to breed and sell cows and calculate and distribute dividends therefrom while the ownership of cows is shared among investors, thus meeting the requirements of ICS under FSCMA.<sup>47)</sup> Similarly, FSC pointed out that the fragmented investment product regarding artworks were also ICS under FSCMA

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44) Fintech Center Korea, *Overview: Financial Regulatory Sandbox*, SANDBOX KOREA, <https://sandbox.fintech.or.kr/financial/overview.do?lang=en> (last visited Feb. 19, 2024).

45) Seokyeong Kim, *The British Regulatory Sandbox and Its Implications*, 435 KOREA INS. RSCH. INSTITUTE REP. 10, 11 (2018), <https://kiri.or.kr/report/downloadFile.do?docId=2169> (In Korean).

46) FINANCIAL SERVICES COMMISSION, JOGAGTUJA SIJANGUI GYUYULEUL JISOGJEOGEULO HWAGLIBHAE NAGAGESSEUBNIDA. -(JU)MYUJIGKAU JEJAEMYEONJE UIGYEOL MICH HANU MISULPUM JOGAGTUJAIU JEUNGGWONSEONG PANDAN- [RULES FOR FRAGMENTED INVESTMENTS SHALL BE ESTABLISHED STEADILY – MUSICOW’S EXEMPTION OF SANCTIONS AND SECURITIZATION OF FRAGMENTED INVESTMENTS REGARDING COWS AND ARTWORKS], 1 (2022), <https://www.fsc.go.kr/comm/getFile?srvcId=BBSTY1&upperNo=79010&fileTy=ATTACH&fileNo=2> (In Korean).

47) *Id.*, at 3.

for necessitating the business operator's sole efforts to store, manage and sell artworks and calculate and distribute dividends therefrom.<sup>48)</sup>

As they did to Musicow for the same reason, FSC also granted conditional reservation of sanctions to the above companies and required them to i) reorganize the company structure and the business process and ii) establish schemes for the better investor protection.<sup>49)</sup>

## V. Critical Analysis of FSC's Decisions

### A. Overview

The two documents released by FSC clearly show its intention to treat RPR as an ICS and bring fragmented investment within its purview. However, while hastily acting upon this intention, FSC and the SFC seem to have erroneously interpreted the relevant law and failed to consider the unique characteristic of ICS as stated within FSCMA.

### B. The Unique Characteristic of ICS

ICS itself is a fairly new term in the finance industry of South Korea. The enactment of the FSCMA in February 2009 was the result of unifying the then-existing Securities Exchange Act, Futures Trading Act, Trust Act, etc.; they had all been the object of the criticism that they were inadequate to the realities of a rapidly growing finance industry.<sup>50)</sup> Lawmakers responded to this criticism by adopting a more inclusive system embodied by the FSCMA, which only specified what was not allowed and implicitly allowed everything else.<sup>51)</sup>

The concept of ICS epitomizes this new system. While the other types of securities listed in the Article 4(2) of FSCMA were mostly legacies from the old laws, ICS is a category that is the result of an unprecedented addition,

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48) *Id.*

49) *Id.*, at 4.

50) KIM & JUNG, *supra* note 22, at 6.

51) *Id.*, at 58.

one designed to include all securities not considered to be under regulation but still met the listed requirements within the regulatory system.<sup>52)</sup>

The FSCMA treats ICS quite differently from those of other securities, as if to emphasize its unique nature. The provisory clause of Article 4(1) of the FSCMA states that ICS shall be deemed to be securities only for the purposes of i) requiring the submission of a registration statement, ii) preventing unfair tradings, iii) compensation for damages, etc.<sup>53)</sup> ICS served as a tool to apply FSCMA regulation to what had not been recognized as securities at the time of lawmaking; by granting such an exception, lawmakers seemed to have an intention to exempt ICS from general regulation under FSCMA.<sup>54), 55)</sup> One of the core reasons for such an exclusion was the expectation that ICS would not be circulated like other securities due to its supplementary nature and, therefore, would not necessitate such a strict regulation.<sup>56)</sup>

In the press release dated April 20, 2022, however, FSC indicated that it wanted more from the service providers. Instead of merely requiring Musicow to submit a registration statement and/or endeavor to prevent unfair tradings, FSC ordered Musicow to build a system for bankruptcy remoteness and many other schemes to promote investor protection. Since the mere duty of submitting a registration statement does not make it necessary for issuers to provide plans for bankruptcy remoteness, etc., it is clear that FSC ignored the nature of ICS under FSCMA either willfully or neglectfully. Had it better understood the unique nature of ICS, it would not have forced Musicow to go through such a drastic change of its business structure. For this reason, FSC's decisions on RPR seemed rather arbitrary and even capricious.

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52) Min Han, *Onju: Article 4 of Financial Investment Services And Capital Markets Act*, LAWNB (March 10, 2016), [https://lawnb.com/Info/ContentView?sid=J001010513\\_0\\_0](https://lawnb.com/Info/ContentView?sid=J001010513_0_0) (subscription required).

53) This clause was newly added to FSCMA by the Amendment on August 29, 2013.

54) KIM & JUNG, *supra* note 22, at 65.

55) This clause has been a target of continuous criticism for not considering the possible advent of a market where mass transactions of ICS may occur; in response, on July 28, 2023, lawmakers submitted a bill for amendment (#2123531) that included the deletion of the clause. The bill is now under the review of the related committee.

56) KIM & JUNG, *supra* note 22, at 69.

Such decisions might have been made due to the lack of time to wait for an appropriate legislation. Demands for investor protection regarding fragmented investments clearly existed at the time. It may be assumed that FSC would have felt the immediate necessity to uphold the purposes of financial regulations—facilitating financial innovation and fair competition in the capital market, as well as protecting investors and fostering the development of the financial investment business, thereby heightening the fairness, reliability, and efficiency of the capital market.<sup>57)</sup> Such an inconsistency with the existing law, however, could have only worsened the confusion within the industry and the disbelief towards the legal system. In addition, Musicow could have chosen to file a revocation suit as pursuant to the Article 4 of the Administrative Litigation Act and argued the illegality of the decisions, against which FSC might have not had a strong argument due to making the decisions based on a flawed logic

### *C. RPR as a Derivatives-linked Security?*

Given the circumstances, had FSC really intended to bring RPR under its purview, it would have made more sense for FSC to have viewed RPR as derivatives-linked securities (“DLS,” hereafter) instead of ICS. DLS is also an untraditional form of security like ICS that was added to the list of securities under the FSCMA upon its enactment. DLS, as defined in Article 4(7) of FSCMA is an instrument that the indication of a right under which money, etc. payable or recoverable shall be determined according to a predetermined formula linked to fluctuations in the price of any underlying assets, an interest rate, an indicator, a unit, an index based upon any of the aforementioned, or any other similar factor.

The biggest difference between DLS and ICS is how profit is generated, as DLS tends to depend on “outside factors” such as market fluctuation, while ICS requires efforts by the issuers or the third party.<sup>58)</sup> As aforementioned, FSC claimed that Musicow solely controlled the mechanism for generating profits with RPR by taking charge of (re)collecting royalties and

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<sup>57)</sup> Jabonsijanggwa geumyungtujaeobe gwanhan beobyul [Financial Investment Services and Capital Markets Act] art. 1 (S. Kor.).

<sup>58)</sup> KIM & JUNG, *supra* note 22, at 71.

operating markets for circulation and, therefore it had to label RPR as a type of ICS. However, i) profits from royalty collection are generated from the utilizations of the related music, and ii) the value of RPR depends mostly on the interest accrued on the investments of Musicow's customers. Both have either nothing or very little to do with Musicow's efforts and should be assumed that they depend on "outside factors." For this reason, RPR looks more like a DLS rather than an ICS.

Had they viewed RPR as a type of DLS, FSC could also have avoided the paradox it created of recognizing RPR as a type of ICS. Since DLS is not subject to the provisory clause of Article 4(2) of the FSCMA, it is susceptible of all the regulations under the FSCMA and related laws. Providing such a system for investor protection including bankruptcy remoteness is not a duty under FSCMA; however, viewing RPR as a form of DLS would have been, at the very least, more correct than viewing it as an ICS, in connection with which the clause of limited regulations is clearly evinced in the code.

Labeling RPR as DLS, however, may call for different kinds of troubles. The issuance of DLS requires much more than the mere submission of a registration statement. One of the core requirements is that, as pursuant to the Article 11 of FSCMA, the issuer of DLS must obtain authorization from FSC. Obtaining such an authorization necessitates the applier to meet extensive requirements listed within the Article 12 of FSCMA. Since this may be an unbearable burden for most service providers, the industry as a whole may even collapse if FSC insists on labeling RPR as DLS. Nevertheless, it will still have the more legally sound argument than labeling them as ICS.

#### *D. What Could Have Been Done Instead?*

If labeling RPR as DLS could not have been an option, FSC could have called for the immediate amendment of the Article 4(1) and waited for the appropriate legislation that would legally justify the restrictions on investment products for investor protection.

FSC could also have guided Musicow to reformat RPR into something other than ICS or DLS—beneficiary certificates, for example. In fact, Musicow has already attempted the reorganization of RPR into beneficiary certificates by entrusting the music copyrights to a trust company—

Kiwoom Securities Corp.—and let them issue the beneficiary certificates on its behalf.<sup>59)</sup> FSCMA allows such an entrustment<sup>60)</sup> and the Trust Act of South Korea allows the issuance of beneficiary certificates by trust companies<sup>61)</sup>; therefore, the legal basis for such a guidance was already well-prepared at the moment. Even if the legality of such a structure were to be an issue, FSC could also have advised service providers to apply for the recognition as an “innovative financial service” under SAOSFFI and grant exceptions from restrictions entirely or partially for a limited period of time. The similar level of investor protection would have been achieved thereby.

## VI. Conclusion

The younger generations in South Korea began to grow their interests on fragmented investment as it allowed them to access to investments they could not approach on their own. Musicow, which offered a financial product related to fragmented investment and K-Pop, emerged quickly as the epitome of fragmented investment in South Korea. While Musicow was enjoying much success as many participating in investing their savings to RPR, the idea of fragmented investment dispersed quickly into other areas like artwork and cow markets.

Responding to outcries of investors and experts about Musicow's lack of investor protection FSC issued a statement that i) RPR satisfied every requirement to be deemed as ICS under FSCMA and ii) Musicow was responsible for issuing and circulating ICS without fulfilling its legal duty to submit registration statement. However, FSC also grant Musicow an opportunity to avoid related sanctions under FSCMA by adding conditions to sanctions. The conditions included different orders to build a system for investor protection. In addition, FSC also released a guideline on its view

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59) Kyungchan Kim, *Myujigkau, Geumgamwone Saeobgujo Byeongyeong Bogo ... “Jeungseonwi Seungin Hu Seobiseu Jaegae”* [Musicow Reported FSC about Its Reorganization of Business], FNTIMES (October 21, 2022, 14:12), [https://www.fntimes.com/html/view.php?ud=20221021105042643ee0209bd21\\_18](https://www.fntimes.com/html/view.php?ud=20221021105042643ee0209bd21_18) (In Korean).

60) Jabonsijanggwa geumyungtujaeobe gwanhan beobyul [Financial Investment Services and Capital Markets Act] art. 103 para. 1 subpara. 7 (S. Kor.).

61) Sintagbeob [Trust Act] art. 78 para. 1-2 (S. Kor.).

towards fragmented investments in order to help service providers to properly anticipate if their business model would result in unlawful issuance and circulation of ICS under FSCMA and take a roundabout when they have to.

FSC's inconsiderate decisions on RPR, however, left a room for much controversy as it conflicted with the Article 4(1) of FSCMA. While the article requires issuers of ICS to only submit registration statement and avoid committing unfair tradings, FSC ordered Musicow and similar service providers to develop a very specific system for investor protection including plans for the bankruptcy remoteness. FSC's decisions caused an inconsistency with the law therefore, leaving a hole in their logic behind.

FSC could have labelled RPR as DLS because issuing DLS is free from the application of the Article 4(1) and thus will avoid the inconsistency caused by labelling RPR as ICS. However, it would also have been a problem because it would wage service providers an unbearable burden of meeting all the requirements to obtain FSC's authorization. It would have been the better for FSC and the industry if FSC asked for an immediate amendment of the Article 4(1) or guided the service providers to restructure their products into beneficiary certificates issued by trust company and, if necessary, apply for the recognition as an "innovative financial service," instead of making a haste attempt to regulate fragmented investments entirely.

Determining whether one activity constitutes a certain type of financial arrangement is a delicate and frustrating process. Musicow chose not to battle against FSC over this decision and abided by its orders regarding the preparation of a strong system for investor protection. However, such impulsive decisions by FSC leave much room for controversy. While such legal indeterminacy and overinclusion still last, FSC is labeling products regarding fragmented investments in other industries as ICS and ordering the providers for the similar changes. Again, Musicow and other service providers decided not to battle against FSC over this; however, it will not be a surprise if, one day, one service provider makes a problem out of this in court.

Nevertheless, FSC's statements clearly showed that the Korean financial regulatory body was willing to have fragmented investments under its influence. Although this issue has just entered the legal realm, it will



continue to become a target of much discussion in the finance industry of South Korea for a long time.

