

# Cryptocurrencies as a Challenge for Securities Regulation

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# I. Introduction

# 1. Background

- Emergence of new trading or fundraising instruments based on technological development
  - Virtual assets such as Bitcoin
  - Discussion begins on virtual assets as a means of blockchain finance
  - Cf. cryptoassets/currencies, virtual assets/currencies, digital assets/currencies
- Internationally
  - The need for regulation began to be emphasized in 2014
    - Possibility of being abused for money laundering was pointed out due to the speed, ease and anonymity of the transfer(FATF, **Virtual Currencies Key Definitions and Potential AML/CFT Risks, June 2014**)
      - **Leaders' Declaration G7 Elmau Summit 7-8 June 2015**
    - Legislation in some countries, such as the United States and Japan (various approaches)
  - International discussions are shifting towards regulation following the FTX bankruptcy

# 1. Background

- In Korea, discussions have begun on (i) the classification standards of securities-type virtual assets under the Capital Markets Act\* and (ii) regulatory legislation on non-securities-type virtual assets\*\*.
  - \* **Financial Investment Services and Capital Markets Act 2009**
  - \*\* Bill on Restoring Fairness in the Digital Asset Market and Creating a Safe Trading Environment (Bill No. 17994, October 31, 2022)
    - The 20th Presidential National Task [35] Establishment of digital asset infrastructure and regulatory system (Financial Services Commission) Enactment of the **Digital Asset** Framework Act
- Concerns about user loss have also been raised (ex. Tera Luna case)
  - Discussion on the role of the traditional financial industry in relation to virtual assets has also begun
  - The Bank of Korea also started discussing CBDC(**central bank digital currency**)
    - Sunseop Jung et al, Legal issues related to central bank digital currency (CBDC) and the direction of enactment and revision of laws and regulations, Bank of Korea Research Report, February 9, 2021

## 2. Definitions: Virtual assets, digital assets

### A. Definition

- Virtual assets
  - Act on Reporting And Utilization of Specific Financial Transaction Information ("Specific Financial Information Act") Art.2(3)
    - "**Virtual assets**" means **electronic certificates (including all rights thereto) that have economic value and that can be traded or transferred electronically**
- Digital assets
  - Bill on Restoring Fairness in the Digital Asset Market and Creating a Safe Trading Environment (Bill No. 17994, October 31, 2022) Art.2(1)
    - "**Digital assets**" refers to **virtual assets (including NFTs, etc.) pursuant to Article 2, Subparagraph 3 of the Specific Financial Information Act**
- In this paper, the terms "virtual assets" and "digital assets" are used interchangeably.

## 2. Definitions: Virtual assets, digital assets

### B. Economic Value

- Economic value of virtual assets(Supreme Court May 30, 2018. 2018Do3619)
  - “**Bitcoins** acquired by the accused for the crime of violating the Information and Communications Network Act (distribution of pornography) and the crime of aiding and abetting the opening of gambling, which are serious crimes stipulated in the Act on the Concealment of Criminal Proceeds, **should be regarded as intangible property with property value.**”
  - “The reason for this is as follows. ① Bitcoin is a type of so-called 'virtual currency' that digitally represents economic value and enables electronic transfer, storage, and transaction. ② The defendant operates “OOOOOOOOO.com” (hereinafter referred to as the “obscene site in this case”), an Internet site for distributing pornography, in exchange for bitcoins from users who use photos and videos and advertisers who want advertisements on the pornographic site in this case. It was paid and treated as having property value.”
- Specific Financial Information Act Art.2(3)
  - “**Virtual assets**” means **electronic certificates (including all rights thereto) that have economic value and that can be traded or transferred electronically**

### 3. Scope of Discussion

- The emergence of virtual assets raises various legal and regulatory issues
  - In financial law, the following issues are important
    - <1> payment services
    - <2> investment and capital market
    - <3> user protection
    - <4> financial crime(AML-CFT)
    - <5> Tax, foreign exchange regulation, etc
- Focusing on the above <2>-<3>, the direction of regulation is also reviewed.



## II. Capital Markets

# 1. Virtual assets and securities regulation

## A. General

- Whether digital assets can be regarded as securities under the Capital Markets Act is an important issue in most countries including Korea
- In this regard, the following 4 points are important:
  - <1> Whether a security is represented on paper or recorded in a blockchain-based token has absolutely no effect on the asset's function as a security.
  - <2> Strong distribution ability due to the combination of the Internet and blockchain is important
  - <3> There may be a function of raising capital for early-stage projects
  - <4> For investors, it constitutes an important part of their investment portfolio

# 1. Virtual assets and securities regulation

## B. Securities

### (1) Definition of securities and regulatory principles

- Security means *rights to the issuer* under the Capital Markets Act
  - Classification of 6 types of securities according to the nature of rights to the issuer
    - Debt securities, equity securities, beneficiary certificates, derivatives-linked securities, investment contract securities, and securities depository securities
  - As there exist no known issuer, their value based on the credit of the issuer and no obligation to repay, most virtual assets do not have essential elements of securities.
  - Even if virtual assets are classified as securities, they may be *asset-based securities*, not *corporate finance instrument*.
- If it falls under the definition of securities, it may be subject to the regulation of the Capital Markets Act regardless of its form and technical basis
  - Bill on Restoring Fairness in the Digital Asset Market and Creating a Safe Trading Environment (Bill No. 17994, October 31, 2022) Art.4 (Relationship with other laws) Except for cases where there are special provisions in other laws regarding digital assets and digital asset operators, the provisions of this Act shall apply.

# 1. Virtual assets and securities regulation

## (2) Discussion on securities-type virtual assets

- Recently, in Korea, among the types of securities, whether or not they fall under investment contract securities is mainly discussed
  - "investment contract securities": instruments bearing the indication of a contractual right under which a specific investor is entitled to the profits earned, or liable for losses sustained, depending upon the results of a common enterprise in which the specific investor invests money, etc. jointly with a third person (including other investors; hereafter the same shall apply in this paragraph) and which is to be run mainly by the third person(capital Markets Act Art.4⑥)
- The main issues are :
  - first, whether the *capital gains type* is included in relation to the division between the *profit-sharing type* and the resale profit type, and
    - capital gains type pursues resale profits only through selling to a third party, not distribution of business performance
    - CMA does not include the *capital gains type*
  - second, the legal structure of the issuing entity

# 1. Virtual assets and securities regulation

## (3) Securities-type virtual assets

- If securities-type virtual assets are regarded as investment contract securities, it is necessary to revise the regulation for investment contract securities.
- At the time of the 2013 revision of the Capital Markets Act, investment contract securities were considered non-floatable rights, and only the issuance disclosure (registration statement) and some market misconduct regulations may be applied.

# 1. Virtual assets and securities regulation

## (4) Securities settlement system and other infrastructure

- The availability of blockchain for issuance and settlement of securities requires revision of the Act on Electronic Registration of Stocks and Bonds 2016("Electronic Securities Act")
- Electronic securities settlement system(eSSS)
  - Based on two-tier system composed of Electronic Securities Registry(Korea Securities Depository) and Account Management Intermediaries(securities companies)
    - How to include blockchain-based system into the current eSSS
  - Covering all types of securities excluding investment contract securities
    - Whether to include investment contract securities into the current eSSS

# 1. Virtual assets and securities regulation

## (4) Securities settlement system and other infrastructure

- Financial Services Commission, [Press release] Measures to improve security token issuance and distribution regulatory system - We will allow STO within the capital market law. -, February 6, 2023
  - (i) Token securities that meet the requirements of the distributed ledger are accepted by the electronic registration method of securities under the Electronic Securities Act.
  - (ii) Issuers who meet certain requirements are allowed to record information on rights and holders of directly issued securities in the distributed ledger.
  - (iii) Authorization for OTC brokerage business that can match multilateral transactions of investment contract securities and beneficiary certificates (non-monetary trust) is newly established.
  - (iv) Since there is a limit to the processing speed of the distributed ledger, when listing, convert to the existing electronic securities and use the current trading, clearing, and payment infrastructure equally.
  - During the first half of 2023, to submit amendments to the Electronic Securities Act and the Capital Markets Act to the National Assembly.

## 2. Virtual assets and derivatives

- Underlying assets include currency(including foreign currency), commodity and “Other risk that is natural, environmental, or economic phenomena, which can be computed or assessed by price, interest, indicator, or unit in a reasonable and appropriate manner”(Capital Markets Act Art.4(10)(2)(3)(5) )
- <1> foreign currency?
  - “Foreign currency as an underlying asset under the Capital Markets Act should be interpreted the same as domestic currency in its essence as the Investor Protection Act(Capital Markets Act Art.4(10)(2)).” Jung(2021), p12
- <2> Commodity?
  - limited to tangible and deliverable
- <3> Valuation?
  - With regard to Item (5), discussions on the test of reasonable and appropriate valuation
    - “which can be computed or assessed by price, interest, indicator, or unit in a reasonable and appropriate manner”



### 3. Virtual assets and collective investment scheme

- The Capital Markets Act broadly stipulates the management assets of collective investment as “invested assets with property value” (Art.6⑤)
    - discussions regarding the essential element of the collective investment management assets which is characterized by,
    - first, the mark-to-market evaluation of the assets under management (Article 238, Paragraph 1)[valuation issue];
    - second, if there is a request for redemption, it must be responded to with the proceeds from the disposal of the collective investment property (Article 235, Paragraph 5)[liquidity issue]
  - Virtual assets are included in trust property under the Trust Act
    - However, the Capital Markets Act limits the types of trust property that a trust business operator can receive(Article 103①)
      1. Money
      2. Securities
      3. Monetary claims
      4. Movable property
      5. Real estate
      6. real estate-related rights
      7. Intangible property rights (including intellectual property rights)
- \* Dual system for trust : first, Trust Act (private law aspect), second, Capital Markets Act (financial regulation aspect)

## 4. Regulation of Non-securities Type Virtual assets

- Under the Specific Financial Information Act, the concept of virtual assets and businesses was introduced and implemented from March 2021, and the reporting system was applied from September 2021.
  - However, as there is no regulation on investor protection and unfair trade practices in the law, there is recent legislative discussion in Korea
- Bill on Restoring Fairness in the Digital Asset Market and Creating a Safe Trading Environment(Bill No. 17994, October 31, 2022)
  - "Therefore, rather than blindly waiting for international discussion trends and preparation of global standards, it is judged that it is appropriate to first establish a regulatory system for user protection through the minimum necessary regulations and to promote gradual and step-by-step legislation to supplement it later."
  - "Therefore, the Act enacts the protection of user assets (protection of user deposits from bankruptcy of digital asset operators, etc.), prohibition of unfair transactions (use of undisclosed information, manipulation of market prices, illegal transactions, etc.), responsibility for autonomous monitoring (imposition of market surveillance and reporting obligations, etc.) focused on unfair trade regulations, etc."
- The 20th Presidential National Task [35] Establishment of digital asset infrastructure and regulatory system (Financial Services Commission)
  - Enactment of the **Digital Asset** Framework Act

# III. Conclusion

## A. General

- Lack of discussion of general law issues, such as the legal nature of virtual assets as property or rights

## B. Capital markets

- Establishment of standards for classification of securities
- Possibility of using blockchain as a capital market infrastructure, including issuance and settlement of securities

## C. Digital Asset and Financial Industry

## D. User protection

- Discussions on the regulatory system for virtual assets are overly influenced by the protection of interests of users such as investors