LEXOLOGY

Register now for your free, tailored, daily legal newsfeed service.

Find out more about Lexology or get in touch by visiting our **About** page.

Korean Perspective on Crypto: Regulatory Developments and Outlook on Arbitration and Dispute Resolution

Bae, Kim & Lee LLC

South Korea | November 30 2023

I. Introduction

Disputes arising from crypto-related transactions are on the rise. A majority of these disputes will likely be arbitrated, considering the international elements often present in such disputes, and because arbitration appears to be the preferred dispute resolution mechanism for the players in the crypto industry. But in any crypto-related dispute, there might arise various complex issues—many of them legislative and regulatory in nature. Developing an in-depth understanding of such issues will likely be key to expertly navigating a crypto-related dispute.

In this context, we examine below the various legal issues and legislative developments related to cryptocurrency from a dispute resolution perspective, and from the perspective of a central crypto jurisdiction: Korea.

II. The uncertain legal nature of cryptocurrency globally

Cryptocurrency in its most basic understanding is a digital asset that can be used to store value or transactional information over a blockchain. Since 2008, when a developer with the pseudonym Satoshi Nakamoto published a paper about a digital currency named "bitcoin", the world of cryptocurrency has expanded significantly. Today, there are several thousand cryptocurrencies serving various functions such as currency tokens, utility tokens, security tokens, etc. Due in part to the myriad of functions that cryptocurrency can accomplish and the largely unregulated nature of the cryptocurrency industry, the exact legal nature of cryptocurrency has yet to be established. Given its decentralized nature, a significant part of transactions involving cryptocurrency are cross-border transactions, and due to the lack of a unified and consistent global regulation, cryptocurrency has become a breeding ground of various unscrupulous actors. This is evidenced, for example, by the recent spate of crypto scandals such as the bankruptcy and fraud scandals involving FTX and Celsius, among others.

There are several governments that have taken steps to grapple with this rise of cryptocurrency by implementing legislations. But certain major economies like China have simply declared them to be illegal, while other economies like India do not yet have rules or regulations surrounding cryptocurrencies. In the United States, there is no specific legislation regulating cryptocurrencies, but through the recent 2021 Infrastructure and Investment Jobs Act, the U.S. legislators attempted to define cryptocurrency by stating that cryptocurrency is "*any digital representation of value*

which is recorded on a cryptographically secure distributed ledger or any similar technology as specified by the Secretary." This is the first time that cryptocurrency has been defined by statute, but the issue with this generic understanding of cryptocurrency is that there is still uncertainty about its exact legal nature. This fact is further evidenced by the multiplicity of regulators that lay claim to regulating cryptocurrencies in the United States, including the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Federal Trade Commission (FTC), and the Treasury Department. And the fact that the regulatory ambits of all these entities are vastly different from one another brings to focus the lack of a cohesive understanding of the legal nature of cryptocurrency.

Meanwhile, we note that there is a gradual movement toward laying down an all-encompassing legal framework for the regulation of cryptocurrency, pre-emptively led by the EU and followed by other jurisdictions, including, but not limited to, Korea. In the EU, the Markets in Crypto Assets Regulation (MiCA) was entered into force in June 2023, with its implementing measures to be effective by June and/or December 2024, depending on the mandate. The regulation covers crypto-assets that are not currently regulated by the existing financial services legislation in the EU, and includes key provisions for transparency for those issuing and trading crypto-assets, as well as provisions for the disclosure, authorisation, and supervision of transactions. However, from a global perspective, legislation in this area remains an ongoing matter, and due to the rapidly evolving nature of the cryptocurrency market, the regulations still entail a significant level of uncertainty.

This lack of a definitive understanding regarding the legal nature of cryptocurrency was recently showcased in the decision of the United States District Court for the Southern District of New York in the case of Securities and Exchange Commission (SEC) v. Ripple Labs Inc by District Judge Analisa Torres. The case was bought by the SEC, which contended that Ripple Labs created a cryptocurrency, XRP, and sold it to investors to raise more that USD 1.3 billion, without registering XRP as a security with the SEC. According to the SEC, this attempt by Ripple Labs to raise money using an unregistered security violated the securities laws of the United States. In the court's view, the sale that Ripple Labs conducted could be divided into two categories – the first being the sales to institutional buyers pursuant to written contracts, and the second being sales to programmatic buyers (*i.e.*, public buyers who were using secondary markets, such as digital asset exchanges—*e.g.*, Binance) who engaged in blind bid/ask transactions and were unaware that the money was being given to Ripple Labs. The court thus found that these Programmatic Buyers did not "invest" their money in Ripple Labs—rather, they had simply bought XRP as a "secondary market purchaser", unaware to whom the money was being finally paid. Relying on this distinction between institutional buyers and programmatic buyers, the court concluded that while the sale of XRP to institutional buyers could constitute an offer and sale of an investment contract (which is covered within the scope of the definition of "securities"), the sale of XRP to programmatic buyers could not. Pursuant to the court's decision, the SEC would be able to prosecute Ripple Labs for their sale of XRP to institutional buyers but not to programmatic buyers.

This was a major decision that held that the cryptocurrencies that are bought by customers (non-institutional) on secondary exchanges do not constitute "securities" and are therefore outside the scope of the SEC's regulations. The SEC is appealing this decision, and the decision has also received a lot of backlash from other regulators, but it has been heralded by several cryptocurrency industry participants as being a seminal decision in creating a less uncertain regulatory environment for cryptocurrencies. As observed in this case, the countries that attempt

to regulate this industry often face challenges in meeting the demands of its participants, ranging from crypto companies to the customers/users of these companies and the entities tasked with regulating the industry.

But more recently, the United States District Court for the Southern District of New York in the case Securities and Exchange Commission v. Terraform Labs Ltd. disagreed with the understanding that cryptocurrency did not constitute "securities", as held in the Securities and Exchange Commission v. Ripple Labs case. In the judgment penned by District Judge Jed S. Rakoff, the court stated that since the digital assets (there, the Luna cryptocurrency) was being marketed as a profitable investment, it should have been sold only after registering the asset with the SEC. The Terraform Labs court did not adopt the approach in the Ripple Labs case, of a particular asset being considered a security or not based on its purchaser. According to the Terraform Labs court, since Terraform Labs marketed its asset as being a profitable investment, it was covered within the definition of a security and required registration.

It can be seen that in the absence of a uniform legislation governing the cryptocurrency industry, conflicting interpretations of the legal nature of cryptocurrencies will arise. This will impact the ability of market participants to invest in this industry and to develop their products, and might prevent customers from purchasing these crypto tokens and engaging with this industry.

III. Cryptocurrency regulation in Korea

According to a 2022 report by a cryptocurrency payment gateway company, Korea has become the "crypto hub of Asia" and is powering nearly 30% of all crypto transactions. As a natural consequence of this rapid growth, there has been notable developments in the virtual assets regulatory landscape in Korea. Namely, the Korean financial authorities have been capturing certain category of virtual assets, including cryptocurrency, into the realm of securities regulations and beginning to regulate the rest of virtual assets through a separate set of special regulations thereto.

Korea's first series of steps toward regulating virtual assets for the first time ever was to define "virtual assets," to introduce registration requirements for virtual assets service providers (VASPs), and to set certain rules of business conduct for VASPs by amending the existing Act on Reporting and Using Specified Financial Transaction Information, which became effective on March 25, 2021. The most recent step taken was the enactment of the Virtual Assets User Protection Act on July 18, 2023 which will come into effect as of July 19, 2024. The act, which is the first standalone enactment that regulates virtual assets, provides a set of rules for VASPs to abide by when providing services and/or products to investors. In particular, once in effect, the act will:

- Regulate VASPs' use of undisclosed material information, market manipulation, fraudulent transactions, and trading of self-issued virtual assets;
- Monitor abnormal transactions in the virtual asset markets at all times and take appropriate measures, including the obligation to notify the financial regulatory authorities, by VASPs; and
- In case of a violation, potentially impose sanctions, in the form of monetary damages, penalty surcharges, and criminal penalties.

On the other hand, through its announcement on May 3, 2022, the Korean government has outlined its plan to regulate "security-type tokens" by regulating the securities markets. In April 2022, as part of the plan, the Financial Services Commission of Korea (FSC) announced a guideline

setting out the criteria to determine whether a fractional investment product can be characterized as a "security", particularly an "investment contract security" (Guideline). Under the Guideline, any fractional investment product which is considered to be a security must comply with regulations under the Financial Investment Services and Capital Markets Act of Korea (Capital Markets Act).

On February 6, 2023, the FSC went on to announce a detailed plan to align the regulatory framework around the issuance and distribution of "security-type tokens" (Plan). The Plan defines a "security-type token" as a new form of digitalized security based on a distributed-ledger technology and provides that security-type tokens must be issued or otherwise distributed in accordance with the Capital Markets Act and its related laws and regulations. With the regulatory goal of fostering innovative markets and participants thereto and protecting investors, the Plan set out guidelines for identifying security-type tokens and proposed amendments to the relevant laws on their issuance and distribution. Though in defining a "security-type token" the FSC refers to the Guideline and the Plan, it also provides a set of principles on when an asset would be classified as a "security-type token":

- The investor has any equity interest in the operation of the business, any dividend right based on the performance of the business, or a right to claim distribution of residual assets; or
- The issuer distributes any profit generated from the business to the investor and such a payment made to the investor has an actual effect of distributing profits, even if it appears to be a consideration for the investor's investing activities.

Depending on how virtual assets are classified, virtual assets and investors thereto will be subject to different sets of rules and regulations which will consequently affect the causes of action through which investors will want to seek remedies.

The cryptocurrency landscape in Korea has perhaps taken a positive step forward, considering that certain aspects of the cryptocurrency industry have been clarified by this new legislation. However, in the process, certain products, such as initial coin offerings, which have been banned by the FSC, were clarified as still being illegal in Korea—a status many crypto players in Korea had hoped to change. This decision of the FSC was due to the recent spate of fraudulent activities that have been committed in the initial coin offering space. Therefore, to protect consumers and also the integrity of the cryptocurrency market of Korea, the regulators have chosen to keep initial coin offerings banned in Korea. This particular clarification has prompted several crypto players to shift their base of operations from Korea to friendlier jurisdictions such as Singapore.

IV. Jurisprudential understanding of cryptocurrency in Korea

There are only handful number of cases in which Korean courts ruled on the legal nature of cryptocurrency. For example:

A. Cryptocurrency is an intangible asset with property values

In the Supreme Court Judgment No. 2018Do3619 dated 30 May 2018, the court reviewed the lower court's ruling that a defendant's criminal proceeds in cryptocurrency could be confiscated under Korean law. The Supreme Court upheld the lower court's ruling, holding that cryptocurrency qualified as "intangible assets with property values" that was subject to confiscation under the

relevant enforcement decree—a conclusion the court arrived at based on the fact that the defendant had received the claimed cryptocurrency in consideration for the pornographic material that it had disputed.

B. Securities nature of Cryptocurrency was denied

In the Seoul Southern District Court Judgment No. 2019Gadan225099 dated March 25, 2020, the plaintiffs sought a claim for damages on the ground that the defendants issued certain virtual assets, listed them on the exchange, where the defendants operated and distributed them, and in doing so violated the Capital Markets Act. The court dismissed the plaintiff's claims because it held that the virtual assets in the case were not "securities" under the Capital Markets Act and that the defendants were thus not legally obligated to comply with the securities regulations under the act. Specifically, the court reasoned that the virtual assets at issue were not "investment contract securities", because the main purpose of acquiring the virtual assets were the capital gains that were realized when the "investment contract securities" was presented with the contractual dividend right to business gains and loss. Although the court did not further present clear standards as to what may consist the "contractual dividend right to business gains and loss," the judgment is significant because it is the first case that determined whether virtual assets has the nature of "securities" and what factors may be considered in making the determination.

V. Issues with arbitration of crypto disputes

In the midst of the uncertainty surrounding cryptocurrencies (both in terms of its uncertain legal nature and the lack of regulations), parties to crypto-related disputes have been choosing arbitration as the preferred method of dispute resolution. Their choices, as many writers have observed, can be traced to the fact that the major advantages of arbitration align well with the core aspects of crypto related transactions. The protection of the users' identities, such as through the use of aliases, is one of the major advantages of using cryptocurrencies. Similarly in arbitration, confidentiality regarding the dispute and the identity of the parties is essential key element of arbitration. Furthermore, the parties' ability to choose the governing law of their dispute along with the adjudicators for the dispute (people who are knowledgeable about the crypto industry) is another reason parties often choose arbitration as their dispute resolution mechanism for crypto disputes. Indeed, there have been several high profile crypto-related disputes that have been recently been referred to arbitration, such as the CoinFLEX arbitration that concerned a claim amounting to USD 84 million of unpaid debt arising from a margin call, or the arbitration concerning a claim of USD 2.4 billion arising from certain crypto related loans that had been taken by Three Arrows Capital which could not be repaid due to the declining crypto market.

That said, the current uncertainties regarding the cryptocurrency jurisprudence and its regulation can cause several issues over the course of an arbitration.

These issues include the following:

A. Issues related to the characterization of the cryptocurrency and whether the subject matter of a particular claim is against the public policy of the seat of arbitration – Due to the ever-evolving nature of cryptocurrencies and their regulations, a "seat" selected for an arbitration during the drafting and execution of an agreement might have later changed its position regarding cryptocurrencies. Such changes can be seen, for example, in jurisdictions that have declared that certain crypto related industries or products are illegal, such as Korea, which recently clarified that initial coin offerings are illegal. And if the subject matter of a claim is

illegal in a jurisdiction, the courts of that jurisdiction may be reluctant to move the parties' dispute to an arbitration, provide interim relief, or enforce an eventual arbitral award—because doing so may be against the jurisdiction's public policy. Therefore, changes in cryptocurrency jurisprudence or regulations in the seat of the parties' arbitration have the potential to impact the ability of the parties to successfully conduct an arbitration under their arbitration agreement.

B. Issues related to various laws and regulations enacted toward the subject matter of dispute – More broadly, the various laws and regulations currently being enacted will likely have the effect of a mandatory statute in the relevant jurisdiction. This is likely to result in these laws and regulations having a substantial impact on the outcome of crypto-related contractual disputes, even when they are enacted *after* the parties have entered into the disputed contract. For example, if a new regulation provides that a specific type of arrangement between a crypto buyer and a crypto trading company is illegal, the outcome of an arbitration whose subject matter is the same or similar type of crypto arrangement will most likely be materially impacted. In the same vein, most crypto arbitrations are likely to be accompanied by criminal or regulatory proceedings arising from related laws and regulations. Hence, the outcome of any concurrent or related arbitration will likely be materially impacted by the outcome of these related proceedings also.

C. Issues relating to the identity of the counterparty and the location of assets – Due to the unregulated nature of the crypto industry in most jurisdictions, companies in this industry often have intricate structures either to avoid crypto-unfriendly jurisdictions or for taxation purposes. Therefore, while these companies have a single public-facing identity, they can have several different structures and entities that the customer is actually dealing with. This creates an issue of the identification of the appropriate entity to initiate claims against in an arbitration. In the recent Binance (ICC) case, a total of no fewer than 45 Binance-related entities were identified as the counterparties, because it was unclear which of these parties had entered into the terms of use with the users of the Binance platform. In this context, we note that in most cases in which customers enter into standard form agreements with crypto companies, there is limited visibility regarding the identity of the exact crypto entity that will be the counterparty under the agreement.

During an arbitration, it is often necessary for parties to approach the relevant courts to obtain interim injunctions/orders to preserve the assets under the control of the counterparty. But due to the limited visibility regarding the identity of the counterparties in many crypto disputes, parties are often not aware about the location of the assets of the counterparty, which can give rise to certain hurdles when seeking interim relief.

Also, because cryptocurrencies are maintained on a decentralized ledger, it is difficult to point the exact location of the assets, which has implications for the final enforcement of the award. For an award to be enforced, the award creditor must approach the courts where the award debtor's assets are located and execute the award as a judgment of the relevant court. But when the exact location of the assets is unclear it can be difficult for the award creditor to identify and approach the relevant court.

D. Issues regarding forum selection – While terms of use that is used by crypto-related companies often provide for arbitration as the default dispute resolution mechanism, users can sometimes rely, among other things, on consumer protection laws to seek a more favourable

dispute resolution mechanism. In Ang v Reliantco Investments Ltd, a user of a cryptocurrency platform relied on the Brussels Regulation in the English court and sought to disregard the platform's standard terms that gave the Cypriot courts exclusive jurisdiction. The court in that case concluded the user was a consumer under the Brussels Regulation and was entitled to bring her claim in England. Even if the parties have agreed to having their disputes resolved by arbitration (or the courts of a particular jurisdiction), the ever-evolving and complicated nature of cryptocurrencies seems to motivate jurisdictions to allow deviations from such agreements, to provide greater protection to naive consumers.

While a party can approach arbitration, litigation, or specialized forums like consumer redressal forums, in cases of massive frauds, the governments of different states might get involved to prosecute the people in charge of the crypto company. For example, after the Terra/Luna crypto currency crash, jurisdictions such as the USA and Korea wanted to indict its founder Do Kwon in their respective jurisdictions for violating their respective laws. This dispute brings to the fore the cross-border nature of crypto disputes and the far-reaching impacts that fraudulent activities can have on the entire cryptocurrency market.

E. Issues regarding the enforceability of arbitral awards – Even after the parties have obtained a successful arbitral award, due to the uncertain legal status of cryptocurrency in many jurisdictions, the enforcing courts might refuse enforcement by, for example, citing the public policy exception under the New York Convention. In the case Yue 03 Min Te No 719 (2018), the Shenzen Intermediate People's Court in China set aside an arbitral award on public policy grounds, stating that China has banned crypto and does not recognize digital currencies as having any legal status. More recently, in the case of Payward Inc v Chechetkin [2023] EWHC 1780 (Comm), the English courts refused to enforce an arbitral award on public policy grounds, stating that since the arbitrator had not considered or applied English consumer rights and financial services laws, the award did not align with the public policy of England. This case highlights that the courts of England and Wales want to extend robust protections, including consumer protections, to users of crypto-related services.

F. Issues regarding using cryptocurrencies in legal proceedings – During an arbitration, interim measures, such as security for costs or the freezing of assets, can be essential to ensure the integrity of the arbitration. But in cases involving cryptocurrencies, where the only available asset for the parties is cryptocurrency, a tribunal might have difficulty ensuring the effectiveness of the interim measures that they are ordering. Due to the volatile nature of cryptocurrencies, the value of a cryptocurrency during the course of an arbitration might fluctuate significantly. Therefore, parties are not assured whether at the conclusion of the arbitration, the asset (cryptocurrency) would hold any value. This volatility was recognised in the recent English decision of Tulip Trading Ltd v Bitcoin Association for BSV & Ors [2022] EWHC 2 (Ch), where cryptocurrencies were not considered good security for costs in a dispute. There, the court adopted the view that a potential fall in the value of the cryptocurrencies would render it as an ineffective security.

VI. The way forward globally and in Korea

As discussed above, the crypto industry is a global industry, and its market participants across jurisdictions are interconnected. Therefore, it is essential that countries adopt global best practices to deal with crypto regulation.

Certain regulations that the Korean authorities have implemented aligning with such practices include the following:

a)The FSC announced a guideline setting out the criteria in determining whether a fractional investment product or token is considered a security;

b)The Korean legislature introduced protection measures available to virtual asset investors by enacting the Virtual Asset User Protection Act;

c)The government mandated new accounting rules for the domestic crypto sector so that virtual asset service providers will now have more transparency as to their financial status; and

d)The government established an inter-agency investigative unit under the Seoul Southern District Prosecutor's Office, consisting professionals across a wide range of authorities, to investigate and tackle crypto-related crimes.

Similarly, given the unique nature of the crypto industry, arbitral institutions should also consider implementing best practices from different arbitral institutions, making it easier for parties to commence and conduct arbitrations in crypto-related disputes. These best practices might include the following:

A. Provisions for initiation of class action arbitrations – Given the far-reaching nature of crypto disputes, which can have multiple impacted parties, as well as the high cost of arbitration for individual investors/consumers, arbitral institutions like the Singapore International Arbitration Centre (SIAC), the Hong Kong International Arbitration Centre (HKIAC), and the International Chambers of Commerce International Court of Arbitration (ICC) should consider implementing specific rules that permit class action arbitration. Arbitral institutions like the American Arbitration Association (AAA) and the Judicial Arbitration and Mediation Services (JAMS) have already implemented similar rules that allow adjudicators to determine whether a specific dispute can be referred to a class action arbitration.

But even if parties adopt rules that allow class action arbitrations, parties may still be forced to execute standard form arbitration agreements that do not allow class action arbitrations. An example of this is the recent Binance case that is being heard under the aegis of the HKIAC rules. The terms of use of Binance state that "*Aside from where Applicable Law requires or provides you with a choice otherwise, you and Binance agree that, subject to the immediately preceding clause above (Notice of Claim and Dispute Resolution Period), any Claim shall be determined by* ***mandatory final and binding individual (not class) arbitration*** *administered by the Hong Kong International Arbitration Centre ("HKIAC") in accordance with the HKIAC Rules for the time being in force, which rules are deemed incorporated by reference in this clause.*"

B. Provisions regarding consumer protection – As discussed above, consumers who wish to participate in the crypto industry are often required to enter into standard form arbitration agreements that might be severely burdensome, preventing them from fully realizing their rights under the agreement. As has been seen in cases like Ang v Reliantco Investments Ltd, the consumer in crypto related disputes is especially in a precarious position because the crypto industry is particularly complicated. Therefore, arbitral institutions should consider adopting consumer friendly regulations that prevent market participants from being strong-armed into arbitrations that might prevent the consumer's full exercise of their rights. For instance, the JAMS provides for a consumer arbitration minimum standard that states that "no party *shall be*

precluded from seeking remedies in small claims court for disputes or claims within the scope of its jurisdiction"; "*Remedies that would otherwise be available to the consumer under applicable federal, state or local laws must remain available under the arbitration clause, unless the consumer retains the right to pursue the unavailable remedies in court*", and "*with respect to the cost of the arbitration, when a consumer initiates arbitration against the company, the only fee required to be paid by the consumer is $250, which is approximately equivalent to current Court filing fees. All other costs must be borne by the company, including any remaining JAMS Case Management Fee and all professional fees for the arbitrator's services".* Providing these minimum standards would allow market participants to be assured that their rights will be protected.

VII. Conclusion

As participants in the crypto industry and their counsel, we are no strangers to the constantly shifting and evolving jurisprudential and regulatory landscape of cryptocurrency. Naturally, being alive to the latest developments and the future direction of that landscape has become synonymous with protecting our rights (or our clients' rights) to the fullest extent. We hope this article will help readers do just that, from a Korean perspective.

Bae, Kim & Lee LLC - Woojae Kim, Seungil Hong, Yelim Hyon and In Hyuk Hwang

Powered by
LEXOLOGY.