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THE VIRTUAL ASSET USER PROTECTION ACT: KOREA' FIRST LAW DEDICATED TO REGULATING THE VIRTUAL ASSET INDUSTRY COMES INTO EFFECT

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INTRODUCTION

The Virtual Asset User Protection Act (the "**Protection Act**"), enacted on July 18, 2023, has come into effect in the Republic of Korea ("**Korea**") as of July 19, 2024. **The Protection Act is the first law solely dedicated to regulating the virtual asset industry and represents the first stage in the "two-step process " announced by the Financial Services Commission (the "FSC"), the primary financial regulatory authority in Korea, for establishing industry-specific legal frameworks for not only the protection of users but also the fostering of the industry.**

The key details of the Virtual Asset User Protection Act and the relevant Enforcement Decree and Supervisory Regulations[1] are as follows.

SCOPE OF APPLICATION

The Protection Act broadly defines virtual assets as "electronic certificates (including all associated rights) that have economic value and can be traded or transferred electronically" while explicitly enumerating exceptions for those that cannot be exchanged for monetary value, goods or services and those regulated under other laws like game products, electronic prepayment means, and electronically registered shares. In short, the Protection Act adopts almost the same definition of virtual assets as set out in the Act on Reporting and Using Specified Financial Transaction Information (the "**AML Act**") [2] except that the carve-outs for central bank digital currencies ("**CBDCs**")[3] and non-fungible tokens ("**NFTs**").[4]

1 The Enforcement Decree and the Supervisory Regulations have also come into effect together with the Virtual Asset User Protection Act on July 19, 2024. As the final form of the Supervisory Regulations were not publicly available when this article was written, we rely on the latest draft form disclosed by the FSC. Further, in this article, unless otherwise specified, the reference to the Protection Act includes references to the Enforcement Decree and the Supervisory Regulations.

2 The AML Act is the first law in Korea that has begun regulating virtual assets though within the existing anti-money laundering regime. The AML Act governs the reporting process (or de facto license process) for virtual asset service providers.

3 The main definition of virtual assets under the Protection Act excludes the CBDCs.

4 The Enforcement Decree and the Supervisory Regulations carve out the NFTs from the application of the Protection Act.

EXCLUSION OF NFTS FROM THE PROTECTION ACT

With respect to NFTs, the FSC issued their guidelines (the "**NFT Guidelines**") on June 10, 2024 on how to classify NFTs from virtual assets and thereby "help improve predictability and remove obstacles in the application" of the Protection Act. Accordingly, the FSC defines NFTs–outside of the scope of "virtual assets" under the Protection Act–as "a digital identifier that is unique and irreplaceable (i.e., non-fungible), used mostly for the purpose of content collection or verification of transactions between users, which cannot be used as payment methods for goods or services".

The FSC highlights that the legal nature of any NFT must be determined on a case-by-case basis based on the actual substance of the underlying digital asset (and not their name, technology or format), first by assessing whether they could be deemed as securities under the Financial Investment Services and Capital Markets Act (the "**Capital Markets Act**") by reference to the February 2023 Security Token Guidelines of the FSC, followed by the test under the Protection Act by reference to the NFT Guidelines.

The NFT Guidelines add that digital assets are likely to be deemed as virtual assets, regardless of being named as NFTs, if they fail either the "singularity" or "irreplaceability" test, and provides a number of examples.

The Protection Act together with the NFT Guidelines represent the latest regulatory position on NFTs in Korea where the FSC has urged relevant businesses to conduct timely self-assessment. Any digital assets that fail to be classified as NFTs would trigger the application of the reporting requirement under the AML Act as well as the Protection Act, violations of which may incur criminal penalties.

REQUIREMENTS AROUND SAFEGUARDING USERS' ASSETS WITH IMPLICATIONS ON STAKING SERVICES

The Protection Act introduces requirements on safeguarding users' assets affording a similar level of protection as assets deposited with financial institutions, violations of which would incur administrative penalties of up to KRW 100 million per violation.

For example, the Protection Act requires virtual asset service providers to segregate their funds from users' funds which may be invested only in safe assets like government bonds in return for fees payable to its users. Moreover, the Protection Act prohibits virtual asset service providers from "arbitrarily blocking users' deposits and withdrawals in principle without justifiable grounds", which include computer failures, requirements by courts or regulatory authorities and hacking risks. Even with justifiable reasons, virtual asset service providers are required to comply with the requirements for notice and management under the Protection Act around blockages.

Virtual asset service providers must "ensure that they in effect possess the types and quantities of virtual assets entrusted by the users" and hold at least 80% of users' assets offline (i.e., in cold wallets), whether on their own or via qualified custodians. The cold wallet threshold is to be calculated monthly based on the economic value of users' assets. We expect the introduction of such above requirements to essentially ban or significantly restrict the provision of staking or deposit services made available by third-party service providers.

While it remains unclear how the requirement for "possession in effect" of the same types and quantities of users' assets deposited with a virtual asset service provider would be enforced in practice, **we expect a relatively higher level of scrutiny from the regulators**, based on the legislative intent to avoid incidents such as those where major virtual asset service providers suspended withdrawals upon the FTX collapse after having arbitrarily invested their users' assets.

PROHIBITION OF UNFAIR TRADE PRACTICES

The Protection Act implements similar unfair trade restrictions under the Capital Markets Act like prohibition on use of material non-public information, market price manipulation, fraudulent transactions, self-dealings. Specifically, the Protection Act prohibits executives, employees, major shareholders, issuers, public officials and quasi-insiders as well as those who have received information from them from trading virtual assets using material non-public information (which shall be deemed non-public until six hours after any disclosure on an exchange or one day after disclosure by issuers on their website or whitepaper). Market price manipulation by disguised trading or actual trading (including potentially market making and liquidity provision) and self-dealings, for instance, by issuers of virtual assets including any affiliates, are also prohibited.

Engagement in unfair trade practices would lead to imprisonment of up to one year or criminal penalties amounting to three to five times of any profits gained or losses avoided by engaging in unfair trade practices (or, if calculation is difficult, up to KRW 500 million). The FSC has the discretion to impose a penalty surcharge of two times of any profits gained or losses avoided by such unfair trade practices (or, if calculation is difficult, up to KRW 4 billion).

CONCLUSION

While the Protection Act's primary objective is to protect users and their assets, we foresee its requirements to significantly reconfigure the landscape of the virtual asset industry, ranging from existing virtual asset services to possible business constructs. This transition will be seen not only in Korea but also overseas, given the cross-border nature of the industry and the explicit provision in the Protection Act that it shall apply to any actions undertaken overseas with impact on Korea.

The scope of NFT businesses to be regulated has been broadened. It is unclear whether and how the staking and deposit services offered by Korean virtual asset service providers prevalently through collaboration with local and foreign virtual asset staking, management or investment service providers will change. Unfair trade practices in the market will become subject to heavy criminal punishments. Close monitoring of the market's adjustment to and the regulators' actual enforcement of the Protection Act is necessary to gauge the practical impact that the Protection Act would have on the industry.

In any case, the Protection Act epitomizes the Korean regulators' timely efforts to integrate the virtual asset industry into the regulatory framework, with the introduction of the second stage law to follow.

Things 3 cannot be physically possessed, like Things 1, and cannot be established through legal action as a matter of law, like Things 2. Because digital assets are wholly virtual, certain of them can fall within the Things 3 grouping, but it depends on the bundle of rights, item or thing that is represented, so they might also be either Things 1 or Things 2. The June 2023 report provides detailed discussions of the antecedents of its recommendation to explicitly recognize Things 3 as well as how Things 3 might be defined, all of which makes for a dense read into the personal property law of England and Wales.