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KIMCHI, K-POP AND CRYPTO?

A look at Korean cryptocurrency exchanges and the regulatory environment

The global market capitalization of cryptocurrency is estimated to be about USD 175 billion with bitcoin, Ethereum and Ripple representing over 75% of the market cap: bitcoin (USD 94 billion/~54%), Ethereum (USD 32 billion/~19%) and Ripple (USD 10 billion/~6%); and the estimated daily global trade volume of all cryptocurrencies is about USD 4.5 billion with bitcoin, Ethereum and Ripple comprising almost 80% of this figure. The top cryptocurrency exchanges in South Korea – bithumb, Coinone and Korbit – handle a remarkable volume of global trade for these leading cryptocurrencies: Ripple (70-75%), Ethereum (30-40%) and bitcoin (8-10%). Accordingly, despite the relatively smaller size of Korea's population (~51 million) and economy (GDP of USD 1.4 trillion), these Seoul-based exchanges are among the top cryptocurrency exchanges in the world.

Many of the top exchanges are based out of the US – Poloniex, Bittrex, Kraken, and GDAX – with trading in USD and other cryptocurrencies, and the daily trading volume of the Korean exchanges is comparable with these US exchanges, often ranking first for Ethereum and Ripple trading. Providing some context, the Korean exchange "bithumb" recently disclosed that its trade volume surpassed the trade volume on the KOSDAQ (Korea's version of NASDAQ), and the growth of cryptocurrency trading in Korea does not look to slow down. Kakao, which operates an instant messaging app used by 93% of Korean smartphone users, announced in September that it will launch a new exchange in Korea with Bittrex.

Why Korea?

How did a country ranked 11th in GDP and 29th in GDP per capita become 2nd in gross trading volume and 1st in trading volume per capita for cryptocurrency? The relatively light regulatory environment and ease of accessibility for foreigners are likely two major reasons for this rapid growth.

Crypto-traders typically evaluate an exchange based on factors such as the available payment options and trade types, the cryptocurrency portfolio, cybersecurity and customer service. In the case of Korea, the regulatory and business environment likely played a major role in the popularity of the exchanges. Although Korean regulators announced on September

Steve Ahn
Partner
steve.ahn@seumlaw.com

29 of this year that it plans to ban all ICOs (initial coin offerings), it did not mention a ban of secondary trading of crypto and this is consistent with the position taken so far by the Korean government. Since 2013 when the first bitcoin exchange opened in Korea, no negative statements about secondary crypto-trading have been made by any Korean regulatory body including the Financial Services Commission, National Tax Service, Bank of Korea or Fair Trade Commission. Thus far, Korean exchanges have been able to operate as an e-commerce platform with minimal regulation.

The growth of Korean exchanges has also likely been boosted by the participation of foreign persons. Although Korean exchanges only permit trading between crypto and Korean Won and therefore require that users have a Korean bank account, unlike some other major markets, it is relatively easy for foreigners to set up a bank account in Korea. In most cases, a foreign company can set up a subsidiary or branch office in Korea in less than a month, and these subsidiaries and branch offices can open Korean bank accounts in one day.

A Demilitarized Zone

Typical "exchanges" that deal in securities (e.g., a stock exchange) are regulated in Korea under the Financial Investment Services and Capital Markets Act. Brokers that are licensed under this Capital Markets Act will trade on behalf of buyers and sellers on these exchanges with a custodian bank handling the cash on behalf of the buyers and sellers. Although cryptocurrency exchanges are referred to as an exchange, they do not perform the functions of a traditional "stock exchange" such as listing of securities and overseeing brokers.

Technically, cryptocurrency exchanges perform the actions of a trader or broker, without the involvement of an exchange. To buy crypto on a Korean exchange, the customer will send Korean Won to the exchange's bank account, not a custodian bank account. The exchange will hold cash and cryptocurrency in accounts that it controls and will execute transactions based on requests from a customer (e.g., buy or sell) if and when there is a corresponding request from another customer (e.g., sell or buy). If viewed as a trading business, the crypto exchanges are essentially buying and selling virtual items and this type of e-commerce business is not strictly regulated in Korea. If viewed as a broker, crypto exchanges are essentially engaging in a payment gateway business by handling electronic payments between buyers and sellers.

Pen Pineapple Apple Pen? Or Gangnam Style?

Whether viewed as an e-commerce business or a payment gateway business, thus far, the cryptocurrency exchanges have been lightly regulated. Considering the volume of trade occurring on the Korean exchanges, it seems unlikely that the government will allow this status quo to continue indefinitely. There are a number of implications to be addressed, such as taxation (capital gains and VAT), abusive practices (self-dealing, high-frequency trading) and money-laundering. Going forward, it is unclear if the Korean government will enact a new law to regulate cryptocurrency trading such as Japan (which created licensing requirements for crypto exchanges) or attempt to regulate these exchanges under existing laws. This past July, a Korean lawmaker announced that he plans to introduce a bill to regulate crypto exchanges in a manner similar to the Japanese system. If passed, crypto-traders will eagerly monitor the impact of the law on trading in Korea.

SEUM
13F, KFAS Bldg., 211 Teheran-ro, Gangnam-gu, Seoul, Korea
T: (82) 2 562 3115
F: (82) 2 562 3393
W: www.seumlaw.com