16 February 2024

To:
Financial Innovation Division
Korea Financial Services Commission
Seoul Government Complex
209 Sejong-daero
Jongno-gu, Seoul, 03171

ASIFMA Response to Korea FSC Proposed Rules on The Protection for Virtual Asset Users

Dear Sir/Madam,

On behalf of the Asia Securities and Financial Markets Association ("ASIFMA")[1] members, we would like to thank you for the opportunity to respond to the Korea Financial Services Commission ("FSC") consultation on Proposed Rules on the Protection of Virtual Asset Users ("The Proposal").

We understand that the consultation period closed on 22 January 2024, and we would like to express our utmost gratefulness for the opportunity to provide our response with and thank you in advance for your understanding.

The feedback set out in this response has been collected from the ASIFMA's Fintech Working Group and Crypto Sub-Working Group, which have been closely following global, regional, and local developments related to digital assets in recent years.

Scope of definition of digital assets
We note in the Proposal that the Act will not cover certain types of tokens: game money, electronic money, electronic stocks, electronic bills, electronic B/L and central bank digital currency ("CBDC"), electronic bonds, mobile gift certificates, deposit tokens linked to CBDC, and non-fungible tokens ("NFTs") to the list of excluded tokens.

We respectfully submit that further exclusions are needed:

[1] ASIFMA is an independent, regional trade association with over 160 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, and competitive Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region. More information about ASIFMA can be found at: www.asifma.org.

1) **Limited purpose tokens:** The Proposal does not contemplate that digital assets could be held on closed-loop systems such as private blockchains that are owned, operated, and controlled by trusted third parties such as financial market infrastructures ("FMIs") or other banks. Specifically, the guidance should not apply to the use of Distributed Ledger Technology ("DLT")- or blockchain-based books and records systems used by FMIs or other banks to record traditional assets (securities, cash, etc.) and support their existing internal electronic recordkeeping, accounting, reporting, and other back-office functions ("Books and Records"). The method of recordkeeping and reporting does not fundamentally change the traditional asset into a digital or crypto asset. Securities remain in the FMI or other bank's omnibus account at the central securities depository, subcustodian, or registrar, and cash remains a deposit liability of the FMI or other bank to the customer. Additionally, the use of a private, permissioned DLT- or blockchain- based Books and Records system by a securities depository or registrar uses in their role as the central account keeper or registrar does not automatically transform a traditional security into a digital or crypto asset. Because the legal nature of a service or a function does not change, we do not believe that the use of a blockchain or DLT-based technology or system to support or record the provision of that service or function should result in a change in the regulation or regulatory characterisation of that service or function. The Books and Records systems of regulated financial institutions, and the adoption and use of any new replacement technology, are subject to existing regulatory requirements and ongoing comprehensive supervisory oversight frameworks where firms have integrated governance and controls to help identify and mitigate risks. We therefore suggest adding the below to the list of excluded tokens from the Proposal:

    a. **FMI tokens:** a digital unit of account issued by an FMI to its participants reflecting deposits held at a central or commercial bank in a single fiat currency that may or may not pay interest; and
    b. **Settlement tokens**: representations on DLT of underlying traditional securities / financial instruments issued on a different platform (e.g. a traditional Central Securities Depository or registrar) where such representation itself does not satisfy the definition of a security or financial instrument under local law and is used solely to transfer or record ownership or perform other mid/back-office functions (e.g. collateral transfer, recording of ownership).

2) **Tokenised bank liabilities:** Tokenised deposits, which evidence a deposit claim against an issuing bank subject to capital and fractional reserve requirements applicable to deposits. Members believe that banks that issue tokenised bank liabilities that can be used either within or outside a bank's ecosystem (i.e. can be transferred on a peer-to-peer basis using private crypto wallets, or through third-party service providers) should be out of scope, as banks and bank liabilities, such as deposits, are highly regulated and existing frameworks are appropriate to address banking activities carried out in this new electronic form. Additional requirements on such tokenised bank liabilities would cause a barrier to entry to banks looking to enter this space, which would be disadvantageous to the market as banks are highly regulated and trusted actors which bring stability to the digital assets space.

    We have seen other regulators in the region considering these differences and have made a conscious effort to remove it from their regulatory frameworks, which is evident from Paragraph 2.14 of the Monetary Authority of Singapore's response to the public consultation of their Proposed

Regulatory Approach for Stablecoin-related Activities[2], Paragraph 4.2 of the Hong Kong Monetary Authority ("HKMA") Consultation Paper on their Legislative Proposal to Implement the Regulatory Regime for Stablecoin Issuers in Hong Kong[3], Paragraph 4 Article 2 of the European Securities and Markets Authority ("ESMA") Market in Crypto-Assets Regulation Document[4], as well as Footnote 7 of the ESMA Consultation Paper on the draft Guidelines on the conditions and criteria for the qualification of crypto-assets as financial instruments[5].

Need for calibration depending on type of network used

We suggest there should be no one-size-fits all approach and that the risk profile and therefore appropriate controls and mitigants, depend on the network archetype. DLT network archetypes have differing defining characteristics and technical attributes which impacts their suitability for different use cases. For example, private-permissioned networks are particularly well-suited to use cases that prioritize a closed network of permissioned participants for confidentiality and defined finality of settlement, rather than requirements for broad interoperability and access. The largest public-permissionless networks, on the other hand, offer a proven channel to reach a mass market that may be advantageous in the development of secondary market liquidity for some asset classes. Each network-type has advantages and trade-offs that should be optimized for the specific requirements of a given use case.

We therefore suggest the FSC adopts a risk-based approach taking into account the network archetype used and continue to monitor technological developments and amend and allows FMIs to implement the appropriate network archetype for its use case, as well as a related set of controls, on a risk-based approach.

Our global umbrella association, the Global Financial Markets Association[6], in June 203 released a report titled "Impact of DLT in Global Capital Markets" which highlights how DLT network archetypes have differing defining characteristics and technical attributes which impacts their suitability for different use case, which in turn also requires specific mitigations approaches for their differing risk profiles:[7]

1. **Private-Permissioned:** Closed-loop, private networks, which restrict access to only predetermined users and are typically governed by rules agreed to by, and that apply to, all

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[2] https://www.mas.gov.sg/-/media/mas-media-library/publications/consultations/pd/2023/response-to-consultation-on-stablecoins-regulation_15aug2023.pdf

[3] https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2023/20231227e4a1.pdf

[4] https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32023R1114#d1e1143-40-1

[5] https://www.esma.europa.eu/sites/default/files/2024-01/ESMA75-453128700-52_MiCA_Consultation_Paper_-_Guidelines_on_the_qualification_of_crypto-assets_as_financial_instruments.pdf

[6] The Global Financial Markets Association (GFMA) represents the common interests of the world's leading financial and capital market participants, to provide a collective voice on matters that support global capital markets. We advocate on policies to address risks that have no borders, regional market developments that impact global capital markets, and policies that promote efficient cross-border capital flows to end-users by efficiently connecting savers and borrowers, benefiting broader global economic growth. The GFMA brings together three of the world's leading capital markets trade associations to provide a forum for the largest globally active financial and capital market participants to develop standards to improve the coherence and interaction of cross-border financial regulation. We aim to improve the functioning of global capital markets to support global economic growth and to support lending and to serve clients in those jurisdictions they want to do business. The Association for Financial Markets in Europe (AFME) in London, Brussels and Frankfurt, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and Singapore, and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA.

[7] https://www.gfma.org/wp-content/uploads/2023/05/impact-of-dlt-on-global-capital-markets-full-report.pdf

users. Authentication can be used to determine privileges. This is the most common archetype used in capital markets today, and is characterized by its security and central control, which has proven to be well-suited to certain capital markets use cases. They may be less suited to use cases requiring large-scale interoperability given the closed nature of these networks and limited user bases, but interoperability can be achieved if required.

2. **Public-permissioned:** By using permissioned network-level participants, effectively created closed access networks that can vary by design, given defined selective restriction of access through authentication for certain governance, administration, or other privileges. They can also include designs with more open or publicly-available access (i.e., access is open, but authentication is used to restrict privileges to pre-determined users only). In these instances, public access could introduce new considerations around security and risk mitigations for use in capital markets use cases, while balancing the benefits of offering access to a broader user base and stronger network effects as adoption scales. There can also be benefits around operational resilience given the potential for broader distribution across a greater number of nodes.
3. **Public-permissionless:** Open, public networks that do not restrict access for privileges. These include some of the largest distributed ledger networks adopted at scale today, and therefore offer proven potential for significant network effects. For example, the leading public-permissionless networks have demonstrated strong operational resilience given distribution across many nodes. However, the absence of defined restrictions of access gives rise to heightened levels of potential risks and therefore the need for market participants to leverage and adopt appropriate governance and control frameworks.

Other regulators regionally have recognised the need to calibrate requirements depending on the network archetype. For example, the HKMA in their revised draft guidance on Expected Standards on Provision of Custodial Services for Digital Assets by Authorized Institutions, recognises the nature, features and risk on the type of DLT network used as well as the specific mitigation measures needed to be put in place. With this consideration, they are suggesting AIs to adopt a risk-based approach in developing systems and controls to safeguard client digital assets.

Insurance requirements

a) The proposed FSC insurance requirements are significantly more prescriptive than the recent IOSCO crypto asset recommendation number 16 (securing client money and assets)[8]. We therefore suggest recalibrating the recommendation.

b) It should be noted that insurance providers typically only provide insurance cover up to a specific amount of loss of virtual assets (i.e., a 'cap' on the loss coverage). Even if an insurance company provided insurance covering as proposed by the FSC, it may be prohibitive from a cost perspective for FIs to offer digital asset custodial services without being forced to pass such onto their customers. This may not be beneficial, either from an industry perspective or from a customer perspective and would ultimately have a dampening effect on the digital asset sector in Korea.

Need for international alignment

Members would also encourage the FSC to continue its engagement with global standard-setting bodies such as IOSCO and regulators alike to develop a consistent approach to the definition, categorisation, and regulatory treatment of custodial activities in respect to digital assets in order to minimise regulatory arbitrage across jurisdictions and to create a technology agnostic, globally consistent, and effective

[8] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD747.pdf

regulatory framework that will be fit for purpose and future proof, as technologies relating to digital assets continue to rapidly evolve.

Prohibition of Trading VAs issued by Virtual Asset Service Providers ("VASPs") or their related parties
Under the Proposal, VASPs are prohibited from trading or engaging in other transactions involving VAs issued by themselves or their related parties bar certain exceptions. The scope of "related parties" for such purpose has been adopted from the definition of related parties in Article 3(1) of the Enforcement Decree of the Corporate Governance of Financial Companies Act. Even if a VASP is permitted to acquire VAs issued by any of its related parties based on any of the exceptions set out under the Proposal (such as acquisition of utility tokens in consideration for the use of its services), such VASP required to publicly disclose and report to the FSC details of such acquisition.

Given such interpretation and more stringent rules under the Proposal, it has become even more critical to carefully evaluate whether one may be considered as VASP before commencing any project or transaction involving VAs.

ASIFMA wishes to thank the FSC for the opportunity to share this feedback on the Proposal. Members are supportive of continued dialogue between the FSC and the industry as regulatory standards and guidelines are being developed to ensure the appropriate calibration of the twin objectives of effectively managing risk whilst supporting responsible and sustainable innovation.

We welcome the opportunity to contribute to future consultations and remain at your disposal for further engagement or any further questions you might have. Please do not hesitate to reach out to us at lvanderloo@asifma.org or phone: +65 6622 5972.

Sincerely,

Laurence Van der Loo
Managing Director, Head of Technology & Operations
Asia Securities Industry & Financial Markets Association