NAGASHIMA OHNO & TSUNEMATSU
長島・大野・常松 法律事務所

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This issue covers the following topic:

■ **Financial Regulations**

Amendments to Laws Regulating Crypto Currencies

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I. Introduction

On March 15, 2019, the Cabinet submitted a bill to the 198th session of the Diet to amend, among others, the Payment Services Act (the "PSA") and the Financial Instruments and Exchange Act (the "FIEA") to (a) strengthen the regulations on virtual currency exchange service providers under the PSA; and (b) introduce new regulations on the issue of security-type digital tokens (ICO/STO) and derivative transactions of crypto currencies and certain other regulations under the FIEA (the "Bill").

II. Amendment of the PSA

(i) Security-type digital tokens will be regulated by the FIEA and not by the PSA

Currently, the PSA defines what constitutes a 'virtual currency' and regulates providers of exchange services of virtual currencies ("Virtual Currency Exchange Service Providers"). However, it has been discussed that the issue of security-type digital tokens, such as ICO and STO, ought to be regulated under securities (financial instruments) regulations since security-type digital token functions similar to other securities and investors in security-type digital tokens should be protected in the same way as investors in other securities. Therefore, under the Bill, rights or interests to receive dividends from funds or certain other types of interests or rights which are represented by electronically transferable and electronically recorded proprietary values (digital tokens) (excluding those to be specified by relevant regulations in light of assignability and other circumstances) are defined as "Electronically Transferable and Electronically Recorded Rights" and are regulated as securities under the FIEA, not as "Crypto Assets" (which have been renamed from "Virtual Currencies" and, similarly, the providers of exchange services have been renamed, "Crypt Asset Exchange Service Providers") under the PSA.

(ii) Method of custody of customers' Crypto Assets and money and obligation to reserve Crypto Assets for repayment

Recently there has been a series of incidents where Crypto Assets held by Crypto Asset Exchange Service Providers in hot wallets (which are directly connected to the internet) have been misappropriated after being accessed illegally. Therefore, under the Bill, as a general rule, Crypto Asset Exchange Service Providers shall keep customers' Crypto Assets in cold wallets (which are not directly connected to the internet). However, as an exception to the new rule, Crypto Asset Exchange Service Providers may keep Crypto Assets in hot wallets if it is necessary for customers' convenience and for the smooth operation of day-to-day transactions of the Crypto Asset Exchange Service Provider. However, in such exceptional cases, Crypto Asset Exchange Service Providers shall reserve their own Crypto Assets in a cold wallet of the same type and the same amount as the abovementioned customers' hot wallet Crypto Assets as a performance guarantee of their repayment obligations. In the event of the bankruptcy of a Crypto

Authors in this Issue

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Masayuki Fukuda
Partner
+81-3-6889-7214
masayuki_fukuda@noandt.com

Hideaki Suda
Partner
+81-3-6889-7373
hideaki_suda@noandt.com

Asset Exchange Service Provider, customers will be entitled to receive preferential payment from the Crypto Assets deposited by such customers and the Crypto Asset Exchange Service Provider's own Crypto Assets reserved for its performance guarantee as outlined above.

The money deposited by the customers with the Crypt Asset Exchange Service Providers shall be entrusted to trust companies so that they will be protected from misappropriation or bankruptcy of a Crypto Asset Exchange Service Provider.

(iii) Regulation on the custody business of Crypto Assets

Currently, a person who engages in the Crypto Asset custody business without conducting the sale or purchase of Crypto Assets is not regulated as a Crypto Asset Exchange Service Provider under the PSA. However, under the Bill, such person will be regulated as a Crypto Asset Exchange Service Provider under the PSA and shall be required to pursue KYC (Know Your Customer) and suspicious activity reporting and other obligations imposed by the Act regarding Preventing the Transfer of Criminal Proceeds.

(iv) Advance notification will be required for a change of types of Crypto Assets handled by a Crypto Asset Exchange Service Provider

Recently, there have been problematic Crypto Assets with an untraceable transfer record which are inclined to be used for money laundering or financing of terrorism. Therefore, under the Bill, if a Crypto Asset Exchange Service Provider changes the types of Crypto Assets it manages or the content or method of its Crypto Asset exchange operation, an advance notification (currently only an ex post facto notification is required) must be filed with the Prime Minister, unless otherwise exempted under a Cabinet Office ordinance.

(v) Regulation of the advertisement and solicitation of Crypto Assets

Under the Bill, a Crypto Asset Exchange Service Provider will be required to show its trade name, registration number and certain other items to customers. In addition, Crypto Asset Exchange Service Providers will be prohibited from (a) making false representations upon executing contracts for exchange of Crypto Assets or the solicitation or advertising of a Crypto Asset exchange business; or (b) making representations that would have customers misunderstand the nature of Crypto Assets or induce them to buy or sell Crypto Assets solely for the purpose of gaining profit, rather than using them as a means of payment.

(vi) Regulation of margin transactions of Crypto Assets

Given that Crypto Asset margin transactions have the same economic function and risks as those for Crypto Asset CFDs (contracts for difference), which are categorized as derivative transactions of Crypto Assets; see Section III(iv) below, Crypto Asset Exchange Service Providers are obliged to provide customers with information concerning the contents of Crypto Asset exchange contracts and to take other measures necessary to protect customers and to secure the appropriate and reliable conduct of the Crypto Assets exchange business pursuant to the provisions of a Cabinet Office ordinance.

(vii) Requirement of joining certified self-regulatory organizations or establishing equivalent internal rules

As the content and the methodology of Crypto Asset exchange services may change rapidly due to technological innovation in the field, regulations based solely on laws and regulations will not be sufficient to ensure an appropriate and reliable Crypto Asset exchange industry. Instead, self-regulatory rules of self-regulatory organizations may respond flexibly and promptly to any changes in the market. Therefore, under the Bill, registration as a Crypto Asset Exchange Service Provider under the PSA must be refused by the relevant government authority (a) if such service provider is not a member of a self-regulatory organization certified by the government authority and

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(b)(i) it has not established internal rules which are equivalent to the self-regulatory rules of the self-regulatory organization; or (ii) if no internal compliance system has been established to comply with the internal rules referred to in item (i) above.

(viii) Effective date and grandfathering rules

The Bill shall be enforced from a date to be separately specified by a Cabinet order within one year from the date of promulgation of the Bill which is currently expected to be around June 2020.

Previously registered virtual currency exchange service providers will be treated as Crypto Asset Exchange Service Providers registered under the amended law, and so-called deemed virtual currency exchange service providers who have applied for registration but have not yet been so registered will also be treated the same as before the Bill is enforced.

III. Amendment of the FIEA

(i) Application of regulations on ICOs and STOs in consideration for Crypto Assets

Under the current FIEA, when digital tokens are issued in the process of ICO and STO in consideration for Crypto Assets in lieu of cash or cash equivalents, from the literal reading of the relevant provisions, the investors' rights represented by such digital tokens do not satisfy the criteria for a so-called "Collective Investment Scheme", which is deemed as Securities under the FIEA (Deemed Securities). However, according to the Japanese Financial Services Agency's (the "FSA") interpretation under the current laws, if the investment by virtual currencies is essentially equivalent to the investment by fiat currencies, relevant investors' rights are regarded as Deemed Securities.

With regard to ICO and STO, various problems have been pointed out in the process of discussing the reform of legislation by the study group established in the relevant government council. In order to clarify the scope of the regulations and ensure investors' protection as well as the fairness of transactions, the Bill deems Crypto Assets as "cash", which is eligible as consideration for the subscription of interests in a "Collective Investment Scheme" or for the purchase of securities, and thereby clarifies that digital tokens issued in consideration for Crypto Assets shall be regarded as Deemed Securities and subject to the regulations of the FIEA.

(ii) Information disclosure system for security-type digital tokens

When the Bill is enacted and takes effect, the security-type digital tokens falling under "Electronically Transferable and Electronically Recorded Rights" will be excluded from the definition of Crypto Assets under the PSA, and the rights represented by such digital tokens will become subject to stricter regulation under the FIEA (see Section II(i) above).

The term "Electronically Transferable and Electronically Recorded Rights" is defined in Section II(i)above, but, in short, it is Deemed Securities for which the rights of investors are represented by digital tokens. Given higher assignability, such digital tokens are subject to the strict public information disclosure system as "Paragraph 1 Securities", a category of Securities under the FIEA (e.g. stocks). In principle, the issuer of such digital tokens must file a Securities Registration Statement ("SRS") that is available to the general public except where the strict statutory criteria for private placements are satisfied. The issuer shall also file annual reports and be subject to other continuous public disclosure obligations after the filing of SRS (and such obligations shall apply in the case where no SRS has been filed but the number of owners exceeds a certain level). The public disclosure requirements are severe compared to those on other Deemed Securities (for other Deemed Securities, generally speaking, the same level of disclosure is required only if (a) the issuer invests more than half of the funds raised by issuing such Securities back into securities, and (b) the Deemed Securities are distributed to 500 or more investors through the offering).

(iii) Regulation of security-type digital token intermediaries

Under the Bill, regulations on intermediaries handling the rights represented by the security-type digital tokens will also be strengthened to the extent such rights are "Electronically Transferable and Electronically Recorded Rights".

Under the FIEA, as amended by the Bill, the right represented by such digital tokens will be treated as "Paragraph 1 Securities" in a similar manner as stocks because of its high degree of assignability. In principle, the intermediaries will be required to register as a Type I Financial Instruments Business Operators ("FIBO") subject to strict registration requirements and other regulations when compared to those of Type II FIBO (the type of registration required for intermediaries of other Deemed Securities). Type I FIBOs are members of the Japan Securities Dealers Association and subject to its self-regulatory rules and thus, in practical terms, subject to the impact of how such rules restrict the solicitation and access by general investors to such digital tokens.

On the other hand, the issuers of such digital tokens are only required to be registered as a Type II FIBO unless it

delegates the solicitation to a Type I FIBO. The self-regulatory rules of the Type II Financial Instruments Firms Associations would, in this case, be the applicable practical rules in effect.

The intermediaries and issuers registered as FIBOs are subject to the sales and solicitation regulations under the FIEA. In general, the principle of suitability is applicable and the delivery of explanatory documents prior to the closing is required with respect to the sales and solicitation of security-type digital tokens.

(iv) Regulation on derivative transactions using Crypto Assets

In Japan, the majority of virtual currency transactions through virtual currency exchanges are derivative transactions regarding Crypto Assets. Before submitting the Bill, the relevant governmental study group discussed complaints from investors to regulators about inadequate systems and unclear services regarding such derivative transactions and the necessity to protect investors and to ensure the fairness of such transactions.

Under the FIEA, as amended by the Bill, derivative transactions relating to Crypto Assets will be regulated basically in the same manner as derivative transactions relating to other financial instruments such as currency and interest rates.

(v) Prevention of unfair transactions

The Bill also newly prohibits unfair trading of Crypto Assets in basically the same manner as securities and derivatives transactions except that, as to enforcement measures, the Bill only sets out criminal penalties for violators (unlike unfair trading of securities and derivatives transactions, no administrative penalties are applicable). The Bill does not introduce any insider trading regulations on Crypto Assets.

(vi) Effective date and transitional provisions

The Bill shall be enforced from a date to be separately specified by a Cabinet order within one year from the date of promulgation of the Bill which is currently expected to be around June 2020.

The Bill also includes some grandfathering clauses; for example, if ICO / STO commenced prior to the effective date of the Bill continues following the effective date, such ICO / STO will be subject to the current FIEA.

IV. Conclusion

The Bill may be amended during its deliberation in the Diet and further details of the amendments to the regulations of crypto currencies will be specified in Cabinet orders, Cabinet Office ordinances and the guidelines and rules of self-regulatory organizations, all of which will be enacted and issued by the effective date of the Bill. It is expected that once these amendments are effective, there will be much greater clarity around the regulations concerning the issue of security-type digital tokens, such as ICO/ STO, and derivatives transactions of Crypto Assets and the volume of crypto currency-related transactions in Japan will increase.

NAGASHIMA OHNO & TSUNEMATSU

www.noandt.com

JP Tower, 2-7-2 Marunouchi, Chiyoda-ku, Tokyo 100-7036, Japan
Tel: +81-3-6889-7000 (general) Fax: +81-3-6889-8000 (general) Email: info@noandt.com