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Alert | Blockchain

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Proposed Amendment to Japanese Crypto Asset Laws

Introduction

A bill to amend the Japanese laws regulating cryptocurrency exchange businesses or financial instruments transactions, including the Act on Settlement of Funds (Act No. 59 of 2009, the Settlement Act) and the Financial Instruments and Exchange Act (Act No. 25 of 1948, the FIEA), was submitted to the Diet on March 15, 2019. The bill proposes to call cryptocurrencies "Crypto Assets" (CA) rather than "Virtual Currencies" (VC) and intends to introduce additional regulations to ensure user protection, regulate derivatives trades on cryptocurrencies, and establish a more transparent regulatory framework on cryptocurrencies.

Background

In response to increasing international demand for robust Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT) compliance measures, the registration regime for virtual currencies exchange businesses (VC Exchange Business) was implemented by amendment of the Settlement Act in April 2017. The regulators examined each applicant's internal control and compliance systems, including customer intake process and trade monitoring, financial strength, and measures for safe custody of customer assets, including the safe management of trading system, measures against cyberattacks or segregation of customers' assets, etc., before granting registration as a VC Exchange Business operator (VC Exchanger).

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However, in 2018, a couple of Japanese VC Exchangers, Coincheck (during the application review process) and Tech Bureau/Zaif (after formal registration was completed), suffered hacks and lost their users' and their own cryptocurrencies valued at approximately 58 billion yen ($518 million) and 7 billion yen ($63 million), respectively. Although user number had increased and the business of VC Exchangers had expanded rapidly, internal control and compliance systems were inadequate to conduct the VC Exchange Business with sufficient protection for user interests/assets.

Furthermore, cryptocurrencies became a tool of speculation for individual traders with margin trading of highly leveraged cryptocurrencies. Although new types of transactions with cryptocurrencies, such as margin trading, initial coin offerings, or security token offerings, were developed and growing, they remained unregulated, with rules and regulations applicable to these new transactions unclear.

Given the above challenges, the bill was submitted to enhance user protection and articulate applicable rules and regulations by streamlining the regulatory framework on cryptocurrencies.

Major Amendments and Newly Employed Provisions

Settlement Act

- In line with the international trend of treating cryptocurrencies as assets rather than mere payment devices, the definition of cryptocurrencies will be changed from "Virtual Currencies" to "Crypto Assets," from which security tokens shall be excluded. As discussed below, security token offerings (STO) will be regulated by the FIEA, as STOs function closer to investment products (e.g., private equity funds) than a means for settlement. As such, existing registered CA Exchangers may not handle STOs unless they are also registered as securities brokers, i.e., Type 1 financial instruments dealers.
- CA Exchange Business registration shall also be required for custody service of CAs that are not operated by a registered CA Exchanger (e.g., wallet solution providers).
- Prior notification to regulators is required for CA Exchangers to trade a new type of CA, cease to trade a CA, or change the contents or method of their business.
- CA Exchangers will be subject to advertisement or marketing regulations like registered securities brokers regulated under the FIEA.
- CA Exchangers shall retain customer cash in a trust account opened with a trust company, etc., and segregate customers' CA from CA Exchangers' own assets to minimize the risk of harm to users (e.g., a "cold wallet"). If a CA Exchanger retains customer CA by an unsafe method (e.g., a "hot wallet"), then the same amount of the CA Exchanger's own assets shall be segregated from its other assets in a cold wallet or other secure method.
- In case of CA Exchanger insolvency, customers who executed CA custody contracts with the CA Exchanger are entitled to be paid prior to other creditors.

Financial Instruments and Exchange Act (Derivative Transactions with CA and ICO, etc.)

- CA will be included in the definition of financial instruments under the FIEA. Accordingly, CA derivative transactions shall also be subject to FIEA regulations.
- A right to receive profit distributions embodied in a proprietary value (to the extent recordable in electronic devices) that is transferrable through electronic information processors, also known as "security tokens," shall be regulated like other conventional securities as "Paragraph 1 Securities." Thus, STOs, whether contributions are made by cash or cryptocurrency, are subject to the disclosure

requirement under the FIEA, and business operators who sell/buy such security tokens with their customers or provide intermediary service thereof shall be registered as and comply with the regulations on Type 1 financial instruments business operators.

- Fraudulent acts will be prohibited in CA-related trades, e.g., spreading rumor, market manipulation, etc.

In summary, “cash” CA trades and ICOs (except for STOs) remain governed by the Settlement Act. The amendment will require providers of CA derivative trades and the issuers or brokers of STOs to be subject to the FIEA regulations.

Schedule

The bill was just submitted by the Financial Services Agency to the Diet for consideration and discussion. It will likely pass in June 2019 with few changes by the Diet. After passage, amendment of related orders or ordinances to specify the details of the regulations would be published toward the end of 2019, with amendment of the law currently expected to take effect in April 2020.

End Notes

This GT Alert provides a general overview of the bill to amend cryptocurrency law in Japan. It is not intended as a comprehensive analysis of all provisions of the regulations that may apply to cryptocurrencies. Further, this GT Alert is not intended to provide an overview or guidance regarding regulation of cryptocurrencies under any other applicable laws and regulations, including laws or regulations outside of Japan. Also, it is important to keep in mind that the bill is still under discussion at the Diet; thus, the amended laws are not yet finalized and the substantive provisions of the amendment are subject to change. Please contact us for additional information on the crypto assets in Japan that may affect your business or transaction with Japanese residents.

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