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New Regulations in Japan on Security Token Offerings

Introduction

A bill to amend 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) has passed both the upper and lower houses of Japan's National Diet and was enacted on May 31, 2019.[1] The amendments enhance the regulations on ICOs (Initial Coin Offerings)[2] by applying the securities regulations under the FIEA when an ICO is an investment program, i.e., the investors expect to receive distribution of profits from the issuer. This form of ICO is sometimes referred to as an STO (Security Token Offering), and the tokens or the rights represented on such tokens issued in an STO are called "security tokens."[3] STOs will be subject to disclosure requirements, and the issuers or brokers who deal with STOs will be subject to registration requirements under the amended FIEA.[4]

[1] For additional background on the bill, see our April 2019 GT Alert here.
[2] While the definition of ICO is not well-established yet, it generally means a fundraising project by issuing digital "tokens" on the web in exchange for investors' contributions made in money or cryptocurrencies.
[3] "Security token" is not a term used in the amended FIEA. It is used here for ease of reference, meaning digital tokens (an electronic record of value transferrable through electronic information processors) representing collective investment scheme interests (rights of STO investors) or such collective investment scheme interests represented by digital tokens.
[4] The FIEA does not regulate ICOs other than STOs, i.e., if the token holders do not have the right to receive profit distribution from the issuer, such ICOs are not regulated by the FIEA. Such ICOs may be regulated by the Settlement Act if the tokens fall under the definition of "crypto assets" under the Settlement Act.

Security Tokens as Collective Investment Scheme Interests

The amended FIEA regulates security tokens as "interests in a collective investment scheme that are represented by tokens" (*denshi kiroku iten kenri*). Interests in a collective investment scheme are investors' rights to receive distribution of profits generated from the common business project undertaken by the promoter (issuer); such interests are deemed security under the FIEA.

There was an ambiguity as to whether collective investment scheme interests are regulated when investors make contributions in cryptocurrencies rather than fiat currency. But, the amended FIEA clearly states that cryptocurrencies will be deemed money for this purpose. Thus, STOs, whether contributed in fiat currency or cryptocurrencies, are subject to the regulations under the FIEA as collective investment scheme interests.

Disclosure Regime

Basic Rules

When offering financial products in Japan, the issuer is in general required to disclose material information on both itself and the product. This principle applies to STOs as well, and issuers are required to comply with disclosure requirements such as filing a securities registration statement and ongoing semiannual securities reports. The detailed items to be disclosed are not yet specified.[5] However, preparation of disclosure documents would likely be even more time-consuming and costly than conventional securities, since the issuer needs to explain the mechanics for the token issuance, settlement, and transfer.

Private Placement

As a general rule, an issuer is exempt from the basic disclosure requirements when an STO is conducted on a private placement basis. However, because security tokens are electronically recorded and can be easily transferred on a blockchain, it is likely that such digital tokens could be widely disseminated to the public. Due to such high liquidity, the amended FIEA distinguishes security tokens from other non-digital collective investment scheme interests and categorizes them as "Paragraph 1 Security" like other liquid securities (e.g., stocks, bonds, or other conventional securities).

The threshold of the private placement exemption for STOs as Paragraph 1 Security is stricter than those for other collective investment scheme interest offerings. Issuers may rely on the private placement exemption when security tokens are offered to Qualified Institutional Investors (QIIs)[6] and/or less than 50 non-QIIs with necessary resale restrictions embedded in the smart contract for the security tokens.[7] Please note that the limitation on the number of non-QIIs is with respect to solicitation rather than final sale.[8] One question to be addressed is how a restriction on the solicitation and resale of security tokens could be viable in the typical ICO protocol where the tokens are offered on the Internet and the participants can freely resell the tokens they purchased in a token sale.

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[5] The details will be specified by related orders or ordinances, which will be also amended in relation to the amendments to the FIEA.
[6] A qualified institutional investor (*tekikaku kikan toushika*) as defined under the FIEA, such as investment manager, securities brokers, banks, companies with JPY 1 billion, etc.
[7] A QII may not transfer the interests to non-QIIs. A non-QII may not transfer the interests in part, i.e., need to transfer all of his/her interests to one investor as a block.
[8] On the contrary, offerings of other collective investment scheme interests (Paragraph 2 Security) may rely on a private placement exemption when the number of acquirers of the interests is less than 500.

The issuers need to carefully tailor the offering process for a private placement of security tokens offered on the Internet, so that investors are only able to access the offering materials through a restricted or password-protected site in order to comply with the limitations on solicitation of non-QIIs.

Distribution & Investment Management Business Registrations

Self-Offering by Issuers

To conduct self-offering of collective investment scheme interests, the issuers are required to be registered as a Type II financial instruments business operator (FIBO) under the FIEA. This principle is applicable to STOs as well, and the issuers need Type II FIBO registration for offering their security tokens to the investors by themselves as a general rule (please see Article 63 Exemption as discussed below in the case of self-sale by the issuer).

In addition, if an issuer uses investors' funds mainly for investment in securities or derivative trades, such issuer is also required to be registered as an investment manager under the FIEA.

For such registration, issuers are required to establish and maintain a sufficient staffing and governance regime to properly conduct such businesses. Once registered, they are supervised by regulators and subject to regulatory filings.

Broker-Dealer or Investment-Manager Registration

Issuers may, alternatively, opt to rely on a registered FIBO's services rather than take on such burden themselves.

The amended FIEA requires distributors/intermediaries of STOs to be registered as Type I FIBO. Of note, Type II FIBOs can distribute collective investment scheme interests other than security tokens.[9] The amended FIEA, however, specifically requires Type I FIBO registration to deal with security tokens. (Please note that if the issuer of security tokens itself offers the security tokens, then Type II FIBO registration is required for the issuer as discussed above. The Article 63 Exemption may be available as discussed below.) This shows the regulators' stricter view toward security tokens, which have more liquidity and may raise unusual issues of custody and control than other collective investment scheme interests. Accordingly, current crypto-asset exchangers registered under the Settlement Act are not permitted to handle STOs or security tokens unless and until they obtain Type I FIBO registration in accordance with the amended FIEA.

With respect to investment manager registration, if applicable, issuers may fully delegate their management authority to a registered investment manager to be exempt from the registration requirement.

Article 63 Exemption – Specially Permitted Business for QIIs

Self-offering or management by the issuer of security tokens may be conducted relying on the Article 63 Exemption[10,11] if the offering is conducted as a private placement with at least one QII onboard and no more than 49 eligible non-QII investors such as listed companies and individuals holding a securities

[9] Regulations imposed on Type II FIBOs are relatively lighter than those on Type I FIBOs.
[10] Please see GT Alert, "Major Changes to the Fund Distribution Exemption in Japan: The Amendment to the FIEA's Article 63 Exemption," published July 6, 2016.
[11] Applicability of the Article 63 Exemption to STOs (and the detailed requirements if applicable) will be provided by the amendments to related orders or ordinances, which are not published yet.

portfolio of JPY 100 million.[12] The issuer can be exempt from the registration requirements as a FIBO by notifying the regulators, a much simpler and less time-consuming process. However, the restriction on the type of investors may be a major downside, as general investors are not eligible for investing in collective investment scheme interests offered under the Article 63 Exemption, in addition to the restrictions on solicitation and resale required as a private placement.

Schedule

The amended FIEA only provides the framework of regulations on STOs; the details will be provided in the amendments to enforcement orders or ministerial ordinances to be issued by Japan's Financial Services Agency (JFSA). It is expected that the JFSA will provide the draft order or ordinances in late 2019. After being released for public comment, the amended order and ordinances will become effective simultaneously with the amended FIEA.

End Notes

This GT Alert provides a general overview of the amendment on laws related to STOs in Japan. It is not intended as a comprehensive analysis of all provisions of the regulations that may apply to STOs. Further, this GT Alert is not intended to provide an overview or guidance regarding regulation of STOs under any other applicable laws and regulations, including laws or regulations outside of Japan. Also, it is important to keep in mind that while the amended laws are finalized, the amendment of related orders or ordinances to specify the details of the regulations is not yet published. Please contact us for additional information on STOs in Japan that may affect your business or transaction with Japanese residents.

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[12] Listed companies, foreign corporations, domestic corporations with JPY 50 million or more of stated capital, and individual investors with JPY 100 million or more of financial assets who hold a securities account at a broker for more than a year, etc.