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Re: New Crypto Regulations of Japan

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Japan's Financial Services Agency (the "FSA") imminently contemplates reforming the crypto regulations to address the problems that arose after Phase 1 of the virtual currency legislation, effected in April 2017. The FSA published a draft bill for the amendment of the virtual currency regulation on March 15, 2019. Stated below is our current understanding of the amendment. Please note that as the national diets will discuss the draft from now and the FSA will draft subordinated provisions of the laws from now, there is still some uncertainty on the amendment, and our analysis is expressly subject to changes in the future.

I Background Information about Japanese Crypto Regulation

1 Existing crypto legislation and regulations

The Payment Services Act (the "PSA") and the Act on Prevention of Transfer of Criminal Proceeds (the "AML Act"), as amended together in April 2017, are the base of the Phase 1 virtual currency legislation, as supplemented by the related ordinances, orders, and guidelines (most notably the Guidelines for Administrative processes concerning virtual currency exchange service providers (FSA Guidelines)).

2 The Payment Service Act

The PSA (so amended in 2017) is an act which currently regulates a virtual currency exchange. The PSA stipulates "Virtual Currency," "Virtual Currency Exchange Service," and "Virtual Currency Exchange Service Provider" therein. It requires registration of Virtual Currency Exchange Service Providers, and the FSA regulates and supervises them.

The PSA will be amended and involve more detailed regulation on crypto exchanges and new regulation on crypto custody business.

3 The Financial Instruments Exchange Acts (The "FIEA")

The FIEA regulates financial instruments, which typically include securities/derivatives, financial instruments, exchange business and operators thereof.

Currently, virtual currency does not fall under securities, in principle. Some STO tokens fall under collective investment schemes (funds) that are securities (see item

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7 below).

Margin trading of virtual currencies (NDF, leveraged trades, physically settled trades by loans in virtual currency) are currently non-regulated through FIEA.

4 The AML Act

The Act on Prevention of Transfer of Criminal Proceeds (so amended in 2017) has subjected VC exchanges to the AML/CTF regulations and imposed such duties as customer identity verification at the time of the transaction, etc.

5 Self-Regulatory Organization

In April 2018, sixteen (16) registered VC exchanges joined to establish a self-regulatory organization, the Japan Virtual Currency Exchange Association (the “JVCEA”). In October 2018, the JVCEA got certified by FSA as a Certified Association for Payment Service Providers under PSA.

JVCEA established the self-regulation rules in furtherance of the existing regulations that are based on, amongst others, PSA, AML Law and FSA Guidelines with a view to better protect users. Examples of self-regulation are as follows.

- Handling of virtual currency
- User property management
- Management of system-risk and information security
- Contingency
- AML/CFT
- Complaint processing and dispute processing
- Solicitation and advertisement
- User management
- Order management system
- Prevention of illicit transactions
- Management system of virtual currency-related information
- Financial management

6 The status and prospect of pending Registration of Exchanges

Currently, to earn a VC exchange license is perceived to be staggeringly burdensome for leanly staffed startups. The screening standard now imposes a heightened level of internal control and security, so that no applicant may escape hiring compliance officers, AML officers and internal auditors who are versed with the industry and drafting of internal rules that are extensive and voluminous.

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It is said that 190 companies have approached the FSA to take an exchange license, but no new exchanges were eventually approved through 2018. In January 2019, Coincheck Inc. finally got registered, and it is rumored several others will get the license in 2019.

7 Current ICO /STO (Security Token Offering) regulation

Currently, the ICO is subject to the regulation of the PSA. For certain STOs, the regulation of the PSA and the regulations of the FIEA are superimposed.

In December 2017, the FSA interpreted that ICO tokens may broadly be listed as corresponding to "virtual currency." As a result, registering a "virtual currency exchange business" and "notification of coin" has become required for the sale of ICOs in Japan. It is difficult to comply with these regulations, and no lawful ICOs have come out in Japan since December 2017.

An STO is deemed to be a kind of ICO, and the same regulation applies. In addition to the PSA regulation, FIEA regulations are applied to tokens that are paid in cash and pay dividends or principal redemption of 100% or more as collective investment schemes.

II Proposed Amendments to the Law

1 General Information

1.1 Which laws will be amended?

The PSA and FIEA will be amended.

1.2 Why crypto regulations are being reformed

Japan had massive cryptocurrency hacking incidents against two major Japanese crypto exchanges in 2018—Coincheck in January and Zaif in September.

After the Coincheck hack, the FSA tightened its oversight of crypto exchanges, including imposing stricter registration requirements and on-site inspections. It handed out many business improvement orders and suspended a few exchanges.

In light of highly volatile cryptocurrency prices and explosive trading volumes in 2017, a surge of ICOs in 2017, and hacking incidents in 2018, FSA created a Study Group on Virtual Currency Exchange Services in March 2018 to discuss appropriate crypto regulations. After eleven (11) sessions of discussion, the group published a final report last December. The FSA drafted bills based on this report and the national government submitted the draft to the national diets in March 15, 2019.

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1.3 When will the amendments be enacted?

The timeline still remains uncertain. Quite a few people seem empirically to infer the schedule as follows.

- (1) The national government submitted the amended bill to the national diets in March 15, 2019, and the national diets will discuss them.
- (2) The national diets will approve the bill around this May.
- (3) The FSA will draft government ordinances and guidelines which are subordinated rules of the amended law around the end of 2019. They will be on public comment procedure and be finalized around March 2020.
- (4) The amended law will be valid within one year after the enactment of the acts (i.e. around April or May 2020).
- (5) Some of the new regulations, such as regulation on custody and derivative, might have a six (6)-month transition period after the enactment.

1.4 Way of Calling of Virtual Currency will be changed to Crypto Asset

The way of calling of Virtual Currency will be altered to Crypto Asset with the PSA amendment. In this memorandum, we will call virtual currency crypto assets hereafter.

2 Exchange Business

2.1 Additional Duty Imposed on Exchanges

Exchanges will have the following requirements in addition to the current requirements:

- to establish and publish policy on incidents of virtual currency thefts
- to hold virtual currencies that are not less than the value of the customer's virtual currencies in hot wallets (if any) as the exchange's own assets
- to trust customers fiat into a trust company
- to disclose financial statements publicly
- to publish, when conducted, OTC deals with customers as well as bid prices, ask prices, and bid-ask spreads for such OTC deals, etc.
- to refrain from making excessive advertisements, misrepresentations, conclusive assessments, cold calls, inadequate solicitations in light of the customer's knowledge, etc. or advertisements and solicitations to induce speculative trading

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- to replace the current ex-post notification requirement of any change in tradable virtual currencies with a prior notification requirement thereof in order to exclude problematic virtual currencies

We believe that one of the most onerous burdens is the second one. The definitions of “hot wallet” and “cold wallet” are not stipulated in the law, and we believe that SRO will discuss it.

If an exchange holds 5% of users’ BTC in a hot wallet, such exchange needs to have the same amount of BTC as its own asset. As there is little hedge market, an exchange should owe a volatility risk of crypto. An exchange shall consider how much it holds in a hot wallet and how to manage the volatility risk of its own crypto in order to do a healthy business.

2.2 Preferential Right of Customer

The amended PSA stipulates a new right of customers. Customers will have the right to receive a preferential return of crypt assets they deposited with an exchange and the exchange segregated upon its insolvency.

2.3 Regulation on Unfair Trading

The amended FIEA will regulate unfair trading. The regulation applies not only exchanges but every person, including customers.

Prohibition of unfair trading includes following but does not include prohibition of insider trading:

- prohibition of unfair trading
- prohibition of fraudulent acts, spreading rumors, using fraudulent means or intimidation
- prohibition of market manipulation

3 Custody Business

3.1 Currently, custody business is not regulated.

The current PSA regulates virtual currency exchange businesses and does not include businesses that just provide a custody service. The definition of a virtual currency exchange business is as follows, and does not include mere custody business.

- (i) Sale and purchase of VC (i.e., an exchange between VC and fiat currency) or exchange of a VC into another VC;
- (ii) An intermediary, brokerage, or agency service for the acts described above (i); and

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(iii) Management (custody) of a fiat currency or VC on behalf of the users/recipients in relation to the acts described above in (i) and (ii).

3.2 Custody businesses will be regulated

The amended PSA will regulate custody businesses. The definition of custody is “to manage crypto assets for others except for the case such business is allowed in other laws). ” Custody businesses will not be able to do business to Japanese residents without a license.

3.3 What kind of custody businesses will be regulated?

As the definition of “custody business” is unclear, the types of custody businesses that will be regulated are still uncertain.

Generally speaking, we believe that businesses that hold customers’ secret keys and sends crypto for customers will be regulated. However, whether or not multi-sig custody is regulated, a company that sets a node for the Lightning network and holds its customers’ crypto is uncertain.

3.3 Will a software wallet service that does not hold customers’ secret keys be regulated?

We believe no.

3.4 Regulations a custody business operator should obey.

It is believed that the custody business operator should abide by similar obligations to virtual currency exchange, such as those below.

- the requirements of registration
- the establishment of an appropriate internal control system • the requirements of segregation of customers’ virtual currencies
- external audit of customer audit, customer asset segregation, and financial statements
- to establish and publish its policy on incidents of virtual currency thefts
- to hold virtual currencies which are not less than the value of the customer’s virtual currencies in hot wallets (if any) as its own assets
- to give customers the right to receive a preferential return of the virtual currencies they deposited with custody upon its insolvency [that takes precedence over the right of general creditors]

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- not to handle virtual currencies recognized to be likely to hinder user protection and/or appropriate and reliable performance of the virtual currency exchange business
- the know-your-customer (KYC) requirements under the AML law
- suspicious activity reporting requirements under the AML law

4 Crypto Derivative

4.1 What is the current regulation on crypto derivatives?

As has been said in I. 3. above, there is no regulation by law on crypto derivatives right now. The JVCEA, however, exerts control over crypto derivatives through the provisions in its self-regulation rules.

4.2 Does FIEA regulate crypto derivative transactions? Will the FIEA regulate crypto derivative transactions?

The FIEA regulates derivatives such as foreign exchange derivative transactions (IR/FX-related derivatives), equity derivatives (securities-related derivative transactions), and credit derivative transactions. The regulations on derivatives only apply a stipulated derivative on FIEA, and the crypto derivative is not stipulated in FIEA. We believe the amended FIEA will add a crypto derivative in the enumeration.

4.3 What kind of regulation will a crypto derivative dealer be required to obey?

Currently, a forex derivative dealer should register as a Type I Financial Instruments Business Operator. This means registration as a full-fledged security company, and it is difficult to take the license.

4.4 What will be a maximum leverage ratio?

It is currently discussed that a maximum leverage ratio should be two (2) times.

4.5 Will there be any exemptions to a license?

Derivative dealers are currently exempted from taking a license if they only trade with institutional investors such as banks, security companies, and corporations that have more than JPY1 billion capital. We expect that a similar exemption applies to a crypto derivative dealer.

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5 Regulation of ICO and STO

5.1 The regulation of ICOs

As for the regulation of ICOs, no major changes are being made by the legislative reform at this time. To conduct/carry out ICOs, it is believed that the registration of crypto assets exchanges *plus* the filing of the coins with the FSA will be required. The registration requirement can be met by either the ICO issuer himself or by an ICO sales broker. The ICO coins that will be approved for sale in Japan are being discussed by the FSA and JVCEA, and it is believed that the JVCEA will publish the rules governing the self-regulation of ICOs in the near future.

5.2 The regulation of STOs

FIEA now defines STOs independently of ICOs under this amendment. Since an STO is clearly positioned as a Security, FIEA applies. A seller of an STO other than the issuer (such as an STO broker) must register as a Type I Financial Instrument Operator. If an issuer sells STOs directly, the issuer must register as a Type II Financial Instrument Operator, which is less complicated. FIEA regulations such as the duty to disclose information, the regulation of sales, and invitation will apply.

Currently, unlike ICOs, there are exemption provisions for the sale of securities, such as Regulation D and Regulation S in the U. S. The sale of securities only to qualified institutional investors or selling securities to a small number of people are exempt from some regulations. It seems that such exceptions will be applied to the sale of STOs, but the details of these exceptions will only be defined in future ordinances.

6 Other

6.1 ETF: I read an article that states that the Japanese government will allow crypto ETF. Is it true?

We do not have any information that the Japanese government will allow crypto ETF. The study group did not discuss crypto ETF, so we do not have any information.

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