



DIGITAL ASSETS IN JAPAN

Digital assets, crypto derivatives, primary markets, secondary markets, and key market infrastructure

08/04/2020 (FINAL)

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DIGITAL ASSETS IN JAPAN

Digital assets, primary markets, secondary markets, and key market infrastructure

Starting with Bitcoin in 2009, crypto assets have come a long way. Now, more than ten years later, the ecosystem is more diverse than ever, and bitcoin and other crypto assets are on the verge of becoming a new asset class. At the same time, blockchain technology has made significant progress and evolved from a pure state transition system to fully programmable networks. 2nd and 3rd generation networks allow other projects to build dApps on their platform and to deploy smart contracts to issue their own tokens. With the rise of these platforms, Initial Coin Offerings (**ICOs**), Initial Exchange Offerings (**IEOs**), and Security Token Offerings (**STOs**) have become a popular mechanism to raise funds. The flexibility offered by 2nd and 3rd generation networks also opened up new possibilities for more complex applications such as DeFi.

The potential of blockchain technology has also been recognized by governments around the globe. Experiencing pressure from projects such as Libra, some of them have intensified their research on central bank digital currencies and other blockchain applications.

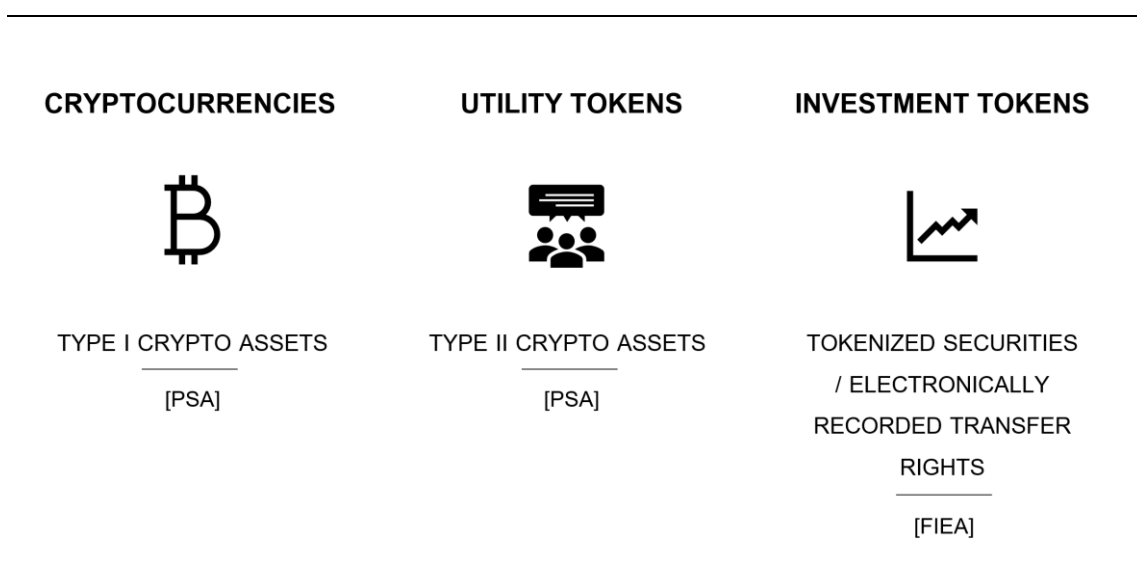
While the industry is increasingly professionalized, major hacks exposed vulnerabilities in the existing infrastructure. Money laundering is another concern for policymakers. In view of these challenges and an increasingly diversified environment, the Japanese legislator amended the Japanese crypto regulations and published subsidiary legislation more recently. The changes are entering into force on May 1, 2020.

In this article, we take a closer look at the regulatory treatment of different digital assets, analyze the primary and secondary markets for them and provide an overview of different players in the industry, reaching from exchanges to liquidity providers and custodians.

Our article does not consider the current regulatory environment. For more information on the existing framework, please visit our older articles, which can be found [here](#).

1. DIGITAL ASSETS

There is no general definition of digital assets under Japanese laws. Rather, the Payment Services Act (**PSA**) and the Financial Instruments and Exchange Act (**FIEA**) define certain types of digital assets. The definitions are mutually exclusive and – seen as a whole – form a complete picture covering cryptocurrencies, utility tokens and investment tokens.¹ Non-fungible tokens (NFT) and stable coins² are not necessarily covered by the definitions in the PSA and the FIEA.



1.1. Crypto assets under the PSA

The PSA defines crypto assets exhaustively. Type I crypto assets are defined as property value that can be (i) used with unspecified persons for purchasing goods or services, (ii) purchased from and sold to unspecified persons acting as counterparty, and (iii) transferred electronically.³

¹ In this article cryptocurrencies, utility tokens, and investment tokens have the following meanings: (i) cryptocurrencies are tokens which are intended to be used as means of payment, (ii) utility tokens give token holders access to an application or service and often serve as a platform-internal currency, (iii) investment tokens allow token holders to participate in the profits of the issuer or the underlying network. Besides these pure forms, hybrid forms exist. The regulatory treatment of these hybrid tokens must be assessed carefully on a case-by-case basis and are therefore not covered by this article.

² To learn more about the regulatory treatment of stable coins under Japanese laws, please visit https://innovationlaw.jp/wp/wp-content/uploads/2019/06/ENstable_coin_article_190621.pdf.

³ Article 2(5)(i) PSA.

Type II crypto assets are property values that can be (i) mutually exchanged with type I crypto assets with unspecified persons acting as a counterparty and (ii) transferred electronically.⁴

Currency denominated assets and electronically recorded transfer rights as defined in the FIEA are explicitly excluded from the definition of crypto assets.⁵

Type I crypto assets: cryptocurrencies

Type II crypto assets: utility tokens

1.2. Electronically recorded transfer rights under the FIEA

For a better understanding of electronically recorded transfer rights, it is worth looking at the definition of securities under the FIEA. The FIEA contains a comprehensive list of securities and distinguishes between type I and type II securities. Type I securities are traditional securities such as bonds and stocks, which are generally perceived as being highly liquid.⁶ Type II securities are, for example, units in a fund, beneficial interests in a trust, membership rights in a general partnership or limited partnership, and equity in limited liability companies.⁷ These securities are generally much less liquid than type I securities and are therefore subject to lighter regulation. With the occurrence of tokenization, type II securities became, however – at least in theory – much more liquid. As a response, the legislator introduced electronically recorded transfer rights into the FIEA. These rights represent type II securities which are treated as type I securities.⁸

The FIEA defines electronically recorded transfer rights as (i) electronically recorded property values that (ii) represent type II securities and can be (iii) transferred by electronic means. In addition, (iv) there must not be any liquidity constraints or other circumstances specified by cabinet order.⁹ Tokens that are sold to professional investors and for which the transferability is technically restricted, fall under the exemption of item (iv).¹⁰

⁴ Article 2(5)(ii) PSA.

⁵ Article 2(5) PSA.

⁶ See Article 2(1) FIEA.

⁷ See Article 2(2) FIEA.

⁸ Article 2(3) FIEA.

⁹ Ibid.

¹⁰ See Article 9-2(1)(i) and Article 9-2(1)(ii) Cabinet Order on Definitions under Article 2 of the FIEA in connection with Article 17-12 Order for Enforcement of the FIEA.

Tokens representing type I securities are not covered by the definition of electronically recorded transfer rights and are therefore not excluded from the definition of crypto assets.¹¹ According to unofficial statements, the Financial Services Agency (FSA) considers type I securities as currency denominated assets, however, which are excluded from the definition of crypto assets as well.

1.3. Crypto derivatives

Crypto derivatives such as CFDs, futures, options, and swaps have become increasingly popular more recently. Some of them are said to legitimize crypto assets as a whole and to provide additional liquidity to crypto markets. In Japan, crypto derivatives account for roughly 90 percent of the total crypto trading volume.¹²

Crypto assets as defined in section 1.1 above are financial instruments within the meaning of the FIEA.¹³ Derivatives using crypto assets as underlying or crypto asset indices as reference indices are therefore covered by the FIEA.¹⁴ The FIEA distinguishes between derivatives transactions conducted on financial instruments market and OTC derivatives transactions.

Market derivatives transactions include¹⁵

- futures
- index futures
- options
- swaps

OTC derivatives transactions include¹⁶

- forward contracts
- index forward contracts
- options
- index options
- swaps

¹¹ See Article 2(5) PSA.

¹² See <https://jvcea.or.jp/cms/wp-content/themes/jvcea/images/pdf/statistics/2019-12-KOUKAI-01-FINAL.pdf>.

¹³ Article 2(24)(iii-2) FIEA.

¹⁴ Article 2(20) FIEA.

¹⁵ Article 2(21) FIEA.

¹⁶ Article 2(22) FIEA.

Excursion – Physical Settlement and Crypto Asset Exchange License

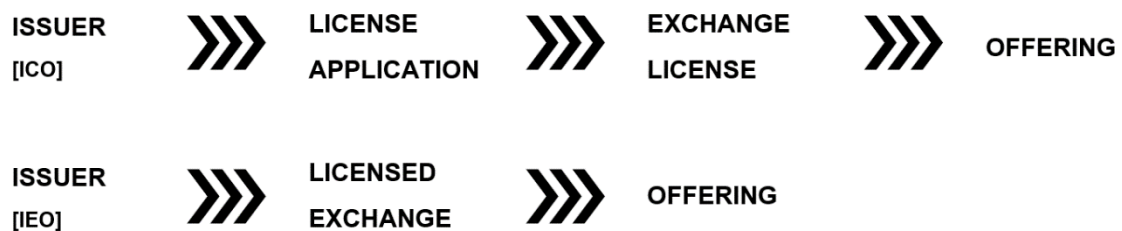
Crypto assets are deemed money under certain provisions of the FIEA.¹⁷ Derivatives transactions may therefore be settled in cash or physically, i.e. by using crypto assets for settlement. The guidelines for crypto asset exchanges explicitly state that a crypto asset exchange license is not required in such cases.¹⁸ In cases of margin trading where crypto assets are taken as collateral, something different might apply.

2. PRIMARY MARKETS

Tokens are often used for fundraising purposes. In this section, we take a closer look at fundraising via initial coin offerings (**ICOs**), initial exchange offerings (**IEOs**), and security token offerings (**STOs**).

2.1. Utility tokens

The offering of utility tokens for fundraising purposes is commonly known as ICO. Under the PSA, the offering of new tokens in exchange for fiat or cryptocurrencies is considered a crypto asset exchange service.¹⁹ An issuer must therefore either register as a crypto asset exchange service provider²⁰ or sell his tokens via one of the registered exchanges. In the latter case, the exchange may either act as an intermediary or buy and sell the tokens on its own account.²¹



¹⁷ Article 2(2) FIEA in connection with Article 1-23 Order for Enforcement of the FIEA.

¹⁸ I-I-2-2(5) Guidelines on Crypto Asset Exchange Business.

¹⁹ For the definition of crypto asset exchange service see Article 2(7) PSA.

²⁰ Article 63-2 PSA in connection with Article 2(8) and Article 2(7) PSA; see also II-2-2-8-1 Guidelines on Crypto Asset Exchange Business.

²¹ See also item 6 concerning Article 2 JVCEA Guidelines on the Sale of New Crypto Assets.

Excursion – Registration as crypto asset exchange

To register as a crypto asset exchange, companies must meet certain criteria. Local companies must be incorporated as a stock company²² and have a minimum capital of JPY 10 million²³. An exchange must further ensure that its net assets do not fall below the amount of users' funds that are stored in a hot wallet.²⁴

Aside from this, crypto asset exchanges must implement corporate governance and security systems that ensure fair dealing on the exchange and reduce operational risks.²⁵ The latter includes the separation of funds – both for crypto assets²⁶ and fiat currencies²⁷ – and the proper management of users' funds held by the exchange (for more details, see section 4.1 below). Crypto asset exchanges violating their obligations under the PSA are subject to fines of up to JPY 3 million.²⁸

While foreign crypto asset exchanges are generally able to register and operate in Japan, none of the 23 registered exchanges is currently a foreign exchange.²⁹

2.1.1. Self-offering

Under the ICO regulations of the Japan Virtual Currency Exchange Association (**JVCEA**), an issuer who has successfully applied for a crypto asset exchange license must analyze its internal control and the feasibility of the target business comprehensively before launching its ICO.³⁰ The analysis must be based on certain documents, including the issuer's financial statements, material agreements, business plan, whitepaper, and other documents deemed necessary by the issuer.³¹ The results of the analysis must be submitted to the JVCEA for final review.³² Only if the

²² Article 63-5(1)(i) PSA.

²³ Article 63-5(1)(iii) PSA in connection with Article 9(1)(i) Cabinet Order on Crypto Asset Exchange Service Providers.

²⁴ Article 25 Cabinet Order on Crypto Asset Exchange Service Providers.

²⁵ Article 63-5(iv) and (v) PSA.

²⁶ Article 63-11(2) PSA in connection with Article 27 Cabinet Order on Crypto Asset Exchange Service Providers.

²⁷ Article 63-11(1) PSA in connection with Article 26 Cabinet Order on Crypto Asset Exchange Service Providers.

²⁸ See Articles 107 et seq PSA.

²⁹ A list of all registered exchanges in Japan can be accessed under the following link <https://www.fsa.go.jp/menkyo/menkyoj/kasoutuka.pdf>

³⁰ Article 4(1) JVCEA Rules for the Sale of New Crypto Assets.

³¹ Article 4(2) JVCEA Rules for the Sale of New Crypto Assets.

³² Article 4(4) JVCEA Rules for the Sale of New Crypto Assets.

JVCEA does not raise any objections, the issuer may launch its ICO in Japan³³ after giving notice to the FSA³⁴.

When selling tokens to the broader public, an issuer must disclose a wide variety of information to the public in order to allow investors to make an informed decision. This includes among others:³⁵

- i. information on the issuer
- ii. information on the tokens and the token sale (incl. pricing information, incentives, sales period, token allocation, caps, future distributions)
- iii. information on the use and the accounting treatment of the raised funds
- iv. information on the project
- v. governing law and jurisdiction

Once the ICO is completed, the issuer must provide token holders with sales data, including information on the number of tokens issued and the total amount collected.³⁶ Token issuers are further subject to ongoing disclosure and must publish data about the status of the project and market value of the tokens at regular intervals.³⁷ This generally applies for a period of five years unless the protection of users is not compromised, and the issuer has informed the JVCEA.³⁸

An issuer may not use the raised funds for any other purpose than disclosed to investors during the ICO³⁹ and must manage them separately from its other funds⁴⁰. The private key controlling the raised funds must generally be stored offline.⁴¹ The issuer must further establish an internal control system to prevent the misappropriation of funds by its officers and employees or the theft by third parties.⁴²

2.1.2. IEO

Registered exchanges that allow other projects to launch their token offerings via their exchange must implement internal control systems to

³³ Article 4(5) JVCEA Rules for the Sale of New Crypto Assets.

³⁴ Article 63-6(1), 63-3(1)(vii) and (viii) PSA.

³⁵ Article 5(1) JVCEA Rules for the Sale of New Crypto Assets.

³⁶ Article 5(2) JVCEA Rules for the Sale of New Crypto Assets.

³⁷ Article 5(3) JVCEA Rules for the Sale of New Crypto Assets.

³⁸ Ibid.

³⁹ Article 6(2) JVCEA Rules for the Sale of New Crypto Assets.

⁴⁰ Article 6(1) JVCEA Rules for the Sale of New Crypto Assets.

⁴¹ Article 6(4) JVCEA Rules for the Sale of New Crypto Assets.

⁴² Article 6(5)-(7) JVCEA Rules for the Sale of New Crypto Assets.

safeguard investors from investing in projects which are not feasible or an outright scam.⁴³ At the same time, they must ensure that the token issuer has systems in place to prevent inappropriate solicitation of the token sale or the misappropriation of funds.⁴⁴

When assessing whether a token offering can be launched via its platform, an exchange must consider the issuer's financial situation. To do so, an exchange must review the financial statements of the token issuer and, if possible, conduct a hearing with a certified accounting or auditing firm.⁴⁵ The sales price of the newly issued tokens must be determined in accordance with reasonable valuation methods (e.g. surveys on investment demand).⁴⁶ Registered exchanges must also ensure that the raised funds do not exceed the amount which is determined in the business plan of the issuer.⁴⁷ The results of the overall assessment must be submitted to the JVCEA for final review.⁴⁸ If the JVCEA finds that the offering is not feasible, the exchange must not proceed.⁴⁹

To ensure that the trading of tokens is safe, exchanges must audit the smart contract and the blockchain protocol before launching the token sale.⁵⁰ The duty to ensure safety does, however, not end with the token sale. Rather, exchanges are required to monitor the system on an ongoing basis and report vulnerabilities to the JVCEA.⁵¹

Before offering new tokens on their platform, cryptocurrency exchanges must further publish certain information on their homepage. This information is largely identical to the information indicated in section 2.1.1.⁵² Following the offering, the cryptocurrency exchange must ensure that the issuer properly maintains the internal control systems and disclosure mechanisms.⁵³ This does not apply if five years have passed since the offering or where the exchange has informed the JVCEA that investor protection is not compromised if compliance is no longer monitored by the exchange.⁵⁴

⁴³ Article 9 et seq. JVCEA Rules for the Sale of New Crypto Assets.

⁴⁴ Article 15(1) JVCEA Rules for the Sale of New Crypto Assets.

⁴⁵ Article 15(3) JVCEA Rules for the Sale of New Crypto Assets.

⁴⁶ Article 18(1) JVCEA Rules for the Sale of New Crypto Assets.

⁴⁷ Article 18(2) JVCEA Rules for the Sale of New Crypto Assets.

⁴⁸ Article 18(3) JVCEA Rules for the Sale of New Crypto Assets.

⁴⁹ Article 15(5) JVCEA Rules for the Sale of New Crypto Assets.

⁵⁰ Article 17(1) JVCEA Rules for the Sale of New Crypto Assets.

⁵¹ Article 17(2)-(5) JVCEA Rules for the Sale of New Crypto Assets.

⁵² Article 15(6) JVCEA Rules for the Sale of New Crypto Assets.

⁵³ Article 16(1) JVCEA Rules for the Sale of New Crypto Assets.

⁵⁴ Ibid.

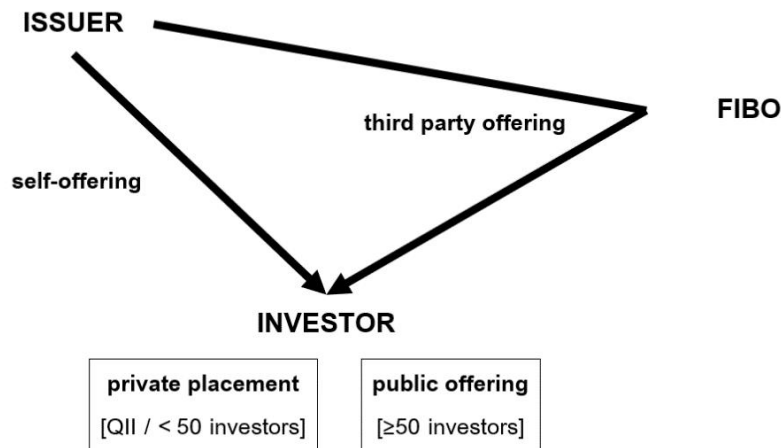
Note: If an issuer actively engages in the token sale, this might be considered a crypto asset exchange service by the issuer and trigger registration requirements under the PSA despite selling the tokens via a registered exchange.⁵⁵ Whether this is the case must be determined on a case-by-case basis considering the degree of engagement and other factors.

2.2. Security tokens

The solicitation of an offer to sell securities in Japan is generally regulated under the FIEA. The term is understood broadly and covers any communication which allows investors to decide whether to purchase or subscribe for the offered securities. While there is no bright-line test, providing information on the terms of an offering is a clear indication of solicitation. As a rule of thumb, the more granular the information, the more likely it is that the marketing is considered a solicitation. Offers via the internet are generally considered a solicitation to invest in securities if they are made through a website that is publicly accessible. The use of the Japanese language is not necessarily required. Only where investors from Japan are effectively excluded from participating in the offer, for example, by geo-blocking or a KYC-process, an offering is not considered a solicitation of an offer to sell securities in Japan. A disclaimer, according to which Japanese investors are excluded from the offer, is not sufficient on its own but may, in combination with other measures, prevent the FIEA to apply.

The FIEA distinguishes between public offerings and private placements, self-offerings, and offerings via intermediaries.

⁵⁵ See also item 3 concerning Article 1 JVCEA Guidelines on the Sale of New Crypto Assets.



2.2.1. Public Offering

The offering of tokenized type I securities and electronically recorded transfer rights is considered a public offering if the tokens are offered to 50 or more investors.⁵⁶ Qualified institutional investors (**QII**) and professional investors as defined in the following section, are not considered when assessing the number of investors.

Public offerings with a total issue price of JPY 100 million (~ USD 915,000) or more must be registered with the FSA⁵⁷ and accompanied by a prospectus⁵⁸.

2.2.2. Private Placement

Offerings via private placements must not be registered with the FSA. Under the FIEA, the following offers are considered private placements⁵⁹:

- i. offers to QII only where the transfer to persons other than QII is unlikely
- ii. offers to professional investors only which satisfy all of the following requirements
 - solicited party is not the state, the Bank of Japan (**BoJ**), or a QII
 - solicitation by a Financial Instruments Business Operator (**FIBO**) on its own behalf or on behalf of a client

⁵⁶ Article 2(3) FIEA, Article 1-5 Order for Enforcement of the FIEA.

⁵⁷ Article 4(1)(v) FIEA.

⁵⁸ Article 13(1) FIEA.

⁵⁹ Article 2(3) FIEA.

- transfer to persons other than professional investors is unlikely
- iii. offers to a small number of investors (< 50)

The definition of QIIs is rather extensive and consists of a long list of examples.⁶⁰ The list includes investment corporations, venture capital companies with a stated capital of JPY 500 million or more*, investment limited partnerships as well as special purpose companies*, other legal persons* and individuals* holding securities of at least JPY 1 billion.

Professional investors within the meaning of the FIEA are QIIs, the state, the BoJ, investor protection funds, and other corporations specified by cabinet order. The latter includes among others foreign corporations, specific purpose companies, and listed companies.

Tokens acquired in a private placement by QII or professional investors may not be resold to persons other than QII or professional investors as the case may be. If the tokens are resold in violation of the restrictions on resale, the issuer must file a registration statement with the FSA. This does not apply if the tokens are sold to a small number of investors and are subsequently resold by the initial investors to more than 49 persons.

2.2.3. Self-Offering

Companies selling their own tokens in a private placement or public offering do generally not have to register as a FIBO. This applies to both the offering of tokenized type I securities and the offering of electronically recorded transfer rights.

Only where the tokens represent beneficial interests in a (foreign) investment trust, (foreign) mortgage securities, units in (foreign) collective investment schemes, or where another case explicitly mentioned in the FIEA applies, the issuer must register as type II FIBO.⁶¹ The registration requirements apply irrespective of whether the offering is a public offering or a private placement.

2.2.4. Third Party Offerings

Intermediaries who are engaging in the offering of security tokens must register as a type I FIBO under the FIEA.⁶²

⁶⁰ Article 10 Cabinet Order on Definitions under Article 2 FIEA.

⁶¹ Articles 28(2)(iii), 2(8)(vii) FIEA.

⁶² Article 28(1) and 29 FIEA.

tokenized type I securities

type I FIBO

electronically recorded
transfer rights

type I FIBO

Excursion – Other laws

Token issuers must not only comply with the PSA or the FIEA but also with other laws and regulations. The applicable laws do not only depend on the features assigned to a token but also on the way the tokens are distributed. Certain laws may contain form requirements (e.g. physical form), which must be carefully considered when structuring the token and offering. As a general rule, it is however possible to tokenize most assets, including private shares. This topic will be covered in more detail in another article.

3. SECONDARY MARKETS

Similar to the offering of tokens on the primary market, the trading on the secondary market is subject to different laws depending on whether the token is a crypto asset under the PSA or a tokenized security/electronically recorded transfer right under the FIEA. Crypto asset exchanges licensed under the PSA may not trade security tokens and vice versa.

In this section, we take a closer look at the secondary markets and other key players supporting the trading infrastructure.

CRYPTO ASSETS



CRYPTO ASSETS
EXCHANGE

**TOKENIZED SECURITIES /
ELECTRONICALLY RECORDED
TRANSFER RIGHTS**



FINANCIAL INSTRUMENTS
MARKETS

3.1. Utility tokens

3.1.1. Crypto Asset Exchanges

Under the PSA crypto asset exchanges and other companies providing crypto asset exchange services must register as crypto asset exchange service providers with the FSA.⁶³ Crypto asset exchange services are defined broadly and cover the following activities, provided they are carried out as a business:

- i. purchase and sale of crypto assets or exchange with other crypto assets
- ii. intermediary, brokerage or agency services for the purchase and sale of crypto assets or exchange with other crypto assets
- iii. custody services for crypto assets⁶⁴

Given the broad definition of crypto asset exchange services, not only crypto asset exchanges must register with the FSA but also other service providers engaging in crypto-related activities (for custody services see section 4.1 below).

Crypto asset exchanges must implement corporate governance and security systems that ensure fair dealing on the exchange and reduce operational risks.⁶⁵ This includes among others to

- i. establish and maintain a business management system
- ii. comply with AML/CFT regulations
- iii. eliminate relationships with anti-social forces
- iv. ensure the protection of customers and their funds (e.g. segregation of funds, storing funds in cold wallets, and retaining own funds equivalent to the users' funds held in a hot wallet)
- v. implement and maintain an information security management system
- vi. prepare, submit, and maintain records related to crypto asset exchange services
- vii. prohibit misleading advertisement and advertisement of speculative trading
- viii. prohibit and report unfair trading practices (e.g. market manipulation)

⁶³ Article 63-2 PSA.

⁶⁴ Article 2(7) PSA.

⁶⁵ Article 63-5(iv) and (v) PSA, Cabinet Order on Crypto Asset Exchange Service Providers.

- ix. make prior notification to the FSA in case of changes (e.g. listing of new tokens, change of scope of crypto asset exchange services)

This list is not exhaustive, and further obligations arise under subsidiary legislation and self-regulation imposed by the JVCEA. The self-regulation rules by the JVCEA consistently extend existing regulations and specify in greater detail the obligations under the PSA and AML/CFT regulations.

Crypto asset exchanges and other service providers registered as crypto asset exchange service providers must not engage in activities related to security tokens. These activities are exclusively subject to the FIEA and require additional registrations/licenses.

Excursion: Listing of new tokens

Each token must be analyzed in detail before listing. Where a token violates laws or is likely to be used for criminal activities (incl. money laundering), it must not be listed.⁶⁶ This applies in particular for privacy coins for which transactions are anonymous or extremely difficult to track. The results of the analysis must be reported to the board of directors and eventually to the JVCEA.⁶⁷ In cases in which the JVCEA does not approve the listing, the respective token must not be listed.⁶⁸ The listing of the new token must further be notified to the FSA prior to the token being listed.⁶⁹

Excursion: Margin trading

Crypto asset exchanges providing leverage must inform their users about the risks of margin trading, circuit breakers (if any), as well as the deadline and modalities of repayment.⁷⁰ For retail investors, the leverage must not exceed 2x.⁷¹ For corporate clients, there is no fixed maximum leverage. Instead, the ratio may be determined independently by the respective exchange based on a quantitative calculation model or by the JVCEA.⁷² Crypto asset exchanges that do

⁶⁶ Article 4(1) JVCEA Guidelines on Handling Crypto Assets.

⁶⁷ Article 5 JVCEA Guidelines on Handling Crypto Assets.

⁶⁸ Article 4(2) JVCEA Guidelines on Handling Crypto Assets.

⁶⁹ Article 63-6, 63-3(3)(vii) PSA, Article 12(1) Cabinet Order on Crypto Asset Exchanges.
⁷⁰ Article 63-10(2) FIEA, Article 25 Cabinet Order on Crypto Asset Exchanges, II-2-2-2-2(1) Guidelines: Crypto Asset Exchanges.

⁷¹ Article 25(4)(5)(i) Cabinet Order on Crypto Asset Exchanges, II-2-2-2-2(2)(i) Guidelines: Crypto Asset Exchanges.

⁷² Article 25(4)(5)(ii) Cabinet Order on Crypto Asset Exchanges, Article II-2-2-2-2(2)(ii) Guidelines: Crypto Asset Exchanges.

not wish to use these ratios may alternatively use the standard leverage of 2x for corporate clients as well.⁷³ Security deposits may be paid both in fiat and crypto assets. The amount required as a security deposit is calculated each business day.⁷⁴ In case of deficiencies, additional payments must be made within 48 hours from the time detecting the deficiency.⁷⁵

Crypto asset exchanges lending fiat to their users must additionally apply for a money lending license under the Money Lending Business Act.⁷⁶ Exchanges lending crypto assets do not have to apply for such license.

3.1.2. OTC trading

Given the broad definition of crypto asset exchange services, OTC desks generally seem to be regulated under the PSA at first sight. This applies to both principal desks and agency desks. A closer look at the definition of crypto asset exchange services reveals however, that this is not necessarily the case.

Principal desks: Principal desks buy and sell crypto assets in their own name and on their own account and become counterparty to each transaction. Exchanging crypto assets into fiat currencies and vice versa generally falls under buying and selling of crypto assets as defined in the PSA. The same is true for exchanging crypto assets with other crypto assets.

Agency desks: Agency desks do not become a counterparty to transactions. Rather they act as pure intermediaries and broker deals on behalf of their clients. Such activities constitute intermediary services that are generally covered by the PSA.

The reason why many OTC activities are excluded from the registration requirement under the PSA is that those activities are not performed '*in the course of business*' as interpreted by the FSA. While the term is generally interpreted broadly, it only covers situations in which the respective party faces the public, i.e. an unspecified large number of

⁷³ Ibid.

⁷⁴ II-2-2-2-2(2)(3) Guidelines: Crypto Asset Exchanges.

⁷⁵ II-2-2-2-2(2)(4) Guidelines: Crypto Asset Exchanges.

⁷⁶ Article 3(1) Money Lending Business Act.

people, and does so with a certain continuity.⁷⁷ Whether this is the case must be determined on a case-by-case basis. Depending on the facts and circumstances of each case, OTC desks may or may not be covered by the definition of crypto asset exchange services. Engaging in trades with one or a few registered crypto asset exchanges does generally not trigger the license requirement under the PSA. A one-size-fits-all solution does, however, not exist.

3.1.3. Professional Traders / Market Makers / Liquidity Providers

Trading activities of professional traders and market makers do not constitute crypto asset exchange services under the PSA. This is due to the fact that proprietary trading is not considered a purchase or sale of crypto assets as a business under the PSA. The reason for this is that the PSA aims to regulate certain activities that pose a risk to the public. It does, however, not intend to regulate all activities related to crypto assets. Trading on regulated exchanges does not pose additional risks to the public and does therefore not fall within the ambit of crypto asset exchange services under the PSA.

3.2. Security tokens

The trading of security tokens on secondary markets is a problem not solved yet. While crypto asset exchanges typically have the infrastructure, they are not allowed to list security tokens on their exchanges. Regulated exchanges, OTC markets, and proprietary trading systems (PTS), as defined in the FIEA, on the other hand, are permitted to trade security tokens but currently lack the required infrastructure.

3.2.1. Exchanges for tokenized securities and electronically recorded transfer rights

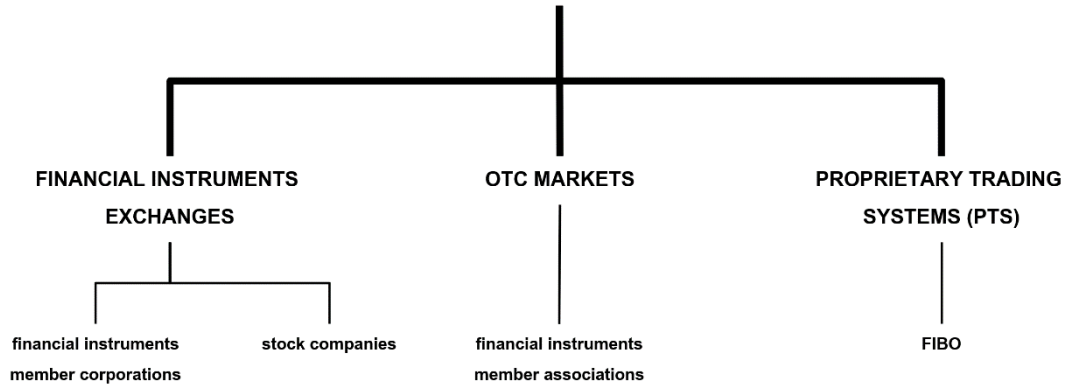
The FIEA defines a financial instruments market as a market for the purchase and sale of securities and market derivatives.⁷⁸ Accordingly, the definition comprises markets for tokenized securities and electronically recorded transfer rights as defined in section 1.2 above. Persons who intend to operate a financial instruments market must obtain a license by the FSA.⁷⁹ Something different only applies to the operators of OTC markets and PTS.

⁷⁷ I-1-2-2(1) Guidelines: Crypto Asset Exchanges.

⁷⁸ Article 2(14) FIEA.

⁷⁹ Article 80(1) FIEA.

FINANCIAL INSTRUMENTS MARKETS



Financial Instruments Exchanges: Under the FIEA, a financial instruments exchange may only be established and operated by (i) a financial instruments membership corporation or (ii) a stock company.⁸⁰

A financial instruments member corporation is a legal entity established by a FIBO to operate a financial instruments exchange. Membership in financial instruments member corporations is restricted to FIBOs only.⁸¹ If the number of members falls below six members, the financial instruments member corporation must be dissolved.⁸² The same applies if the corporation is not granted a financial instruments exchange license by the FSA.⁸³ Unlike financial instrument exchanges established by stock companies, exchanges established by financial instruments member corporations may not be operated for profit.⁸⁴

Stock companies establishing a financial instruments exchange must have a stated capital of at least JPY 1 billion.⁸⁵ Shareholders are generally prohibited from holding 20 percent or more of the total voting rights.⁸⁶

Out of the five stock exchanges in Japan, two are established as financial

⁸⁰ Article 83-2 FIEA.

⁸¹ Article 91 FIEA.

⁸² Article 100(1)(iv) FIEA.

⁸³ Article 100(1)(vii) FIEA.

⁸⁴ Article 97 FIEA.

⁸⁵ Article 83-2 FIEA, Article 19 Order for Enforcement of the FIEA.

⁸⁶ Article 103-2 FIEA.

instruments member corporations – namely the Fukuoka Stock Exchange (FSE) and the Sapporo Securities Exchange (SSE) – and three as stock companies. The latter comprise the Tokyo Stock Exchange (TSE), the Osaka Stock Exchange (OSE), and the Nagoya Stock Exchange (NSE).

None of the existing exchanges has expressed the intention to establish an exchange for tokenized securities and electronically recorded transfer rights so far. Since this is unlikely to change any time soon, this opens opportunities for challengers in the digital assets space.

OTC Markets: For securities not listed on a financial instruments exchange, the FIEA provides that these securities may be traded on an OTC market established by an authorized financial instruments firms association (**SROs**).⁸⁷ SROs are incorporated by FIBOs as general incorporated associations⁸⁸ to ensure fair and orderly trading of securities and derivatives as well as to protect investors⁸⁹. To be recognized as an SRO, the association must be authorized by the FSA.⁹⁰ Only then it may carry out the self-regulatory functions laid down in the FIEA⁹¹ and operate an OTC market. Membership in an SRO is limited to FIBOs.⁹² Similar to financial instruments exchanges operated by financial instruments member corporations, OTC markets must not conduct business for profit.⁹³

Under the FIEA, SROs operating an OTC market are required to register the class and issues of securities traded on the OTC market and make a copy of the register available for public inspection.⁹⁴ The SRO must further disclose the trading volume and other particulars for each trading day and issue to its members and the public and report the same to the FSA.⁹⁵

Securities traded on an OTC market may only be traded among the members of the SRO either on their own account or as intermediaries.⁹⁶ Depending on its articles of incorporation, an SRO may prohibit its members from taking purchase orders other than from professional

⁸⁷ Article 67(2) FIEA.

⁸⁸ Article 78(1) FIEA.

⁸⁹ Article 67(1) FIEA.

⁹⁰ Article 67-2(2) FIEA, Article 78(1) FIEA.

⁹¹ Article 78(2) FIEA.

⁹² Article 68(1) FIEA.

⁹³ Article 67-7 FIEA.

⁹⁴ Article 67 FIEA.

⁹⁵ Article 67(19) and 67(20) FIEA.

⁹⁶ Article 67(2) FIEA.

investors.⁹⁷

Currently, the only eligible SRO, the Japanese Securities Dealers Association (**JSDA**), does not operate an OTC market. The Japan STO Association, which currently applies to become the SRO for security tokens and comprising of six major Japanese brokerages, has not expressed the intention to operate an OTC market for tokenized securities or electronically recorded transfer rights yet.

PTS: PTS are similar to Alternative Trading Systems (ATS) in the U.S. and Multilateral Trading Facilities (MTF) in the EU. They were introduced in 1998 to improve investor confidence through competition and to respond to investor demands for more options. Until then, listed securities could only be traded on financial instruments exchanges.

A person operating a PTS conducts financial instruments business within the meaning of the FIEA⁹⁸ and must, therefore, register as a type I FIBO with the FSA.⁹⁹ According to the FIEA, the prices for securities traded on the PTS must be determined by one of the following methods¹⁰⁰:

- (i) methods that use the trading price of securities listed on a financial instruments exchange
- (ii) methods that use the trading price published by the financial instruments dealer association for securities traded OTC
- (iii) methods that use the price negotiated by buyer and seller
- (iv) methods that use prices indicated by a buyer and a seller and that match corresponding orders¹⁰¹
- (v) methods by which the operator of a PTS offers ask or bid prices on its own or through price feeds of other FIBOs excluding such cases in which the FIBOs are legally obliged to constantly quote bid and ask prices (so-called market-making method)¹⁰²
- (vi) double auction methods

For PTS using a double auction method for price discovery, there are certain restrictions. According to the FIEA Enforcement Order, the average daily trading volume of listed securities on PTS may not exceed a certain percentage of the average daily trading volume on all financial instrument exchanges and OTC markets. Broadly speaking, the threshold is 1 percent of the total average daily trading volume for all securities

⁹⁷ Article 67(3) FIEA.

⁹⁸ Article 2(8)(x) FIEA.

⁹⁹ Articles 28(1)(iv), 29 FIEA.

¹⁰⁰ Article 2(8)(x) FIEA.

¹⁰¹ Article 17(i) Cabinet Order on Definitions under Article 2 FIEA.

¹⁰² Article 17(ii) Cabinet Order on Definitions under Article 2 FIEA.

listed on a financial instruments exchange or OTC market¹⁰³ and 10 percent of the total average trading volume for single securities listed on a financial instruments exchange or OTC market¹⁰⁴. PTS exceeding these thresholds must apply for a financial instruments exchange license.

Given the fact that there are no security token markets which are operated by financial instrument exchanges or OTC markets, it is unclear whether PTS can only determine the prices of security tokens in accordance with the methods described under in item (iii) to (v) above.

Discussions are still ongoing, and the outcome is not clear yet. The argument for making PTS subject to the existence of financial instruments exchanges and OTC markets – at least for the methods indicated under items (i), (ii), and (iv) – is that the legislator only intended to increase competition with existing markets, but not to establish an independent framework for secondary markets. In order to maintain a level playing field between traditional securities markets and markets for security tokens, the same must apply to security token markets. On the contrary, it can be argued that the legislator only wanted to prevent liquidity drainage from financial instruments exchanges. For securities not listed on one of the licensed exchanges, such risk does not exist. Unlisted securities, whether tokenized or not, may therefore be traded on PTS, provided of course, the company establishing the PTS complies with other requirements laid down in the FIEA. The same applies to OTC markets. Where none of them exist, the risk of liquidity drainage is effectively non-existent.

Allowing FIBOs to operate PTS would also be in line with developments in other jurisdictions, namely the U.S., where crypto companies have acquired ATS in the past to get access to the desired license and to operate secondary markets for security tokens. Provided, the FSA follows this approach, companies seeking to establish a trading platform for security tokens by way of PTS must register as FIBO or acquire a company already registered. Compared to obtaining the financial instruments exchange license, this would most likely be the way to go for most companies. It is reported that several securities companies intend to jointly establish a new PTS securities company in 2020.

3.2.2. OTC

Proprietary trading of securities, and therefore also of tokenized securities and electronically recorded transfer rights, does generally not constitute

¹⁰³ Article 1-10(i) Order for Enforcement of the FIEA.

¹⁰⁴ Article 1-10(ii) Order for Enforcement of the FIEA.

financial instrument business under the FIEA.¹⁰⁵ Something different applies, however, if the respective entity deals with an unspecified large number of people with a certain degree of continuity.

Intermediary services for OTC trading also fall under the definition of financial instruments business, so that it is necessary to register as a FIBO.

3.2.3. Professional Traders and Liquidity Providers

Proprietary trading on financial instruments exchanges and PTS is generally not regulated under the FIEA. This also applies to the vast majority of liquidity providers. An exception is made, however, for high-frequency traders¹⁰⁶ which are not subject to other registration requirements under the FIEA. These traders are required to register with the FSA.¹⁰⁷

3.3. Derivatives

As indicated above, the FIEA distinguishes between market derivatives transactions and OTC derivatives transactions. Market derivatives transactions are such derivatives transactions that are conducted on a financial instruments market. The focus here will be on OTC derivatives transactions, i.e. derivatives transactions, which are performed on a bilateral basis.

Entities engaging in crypto derivatives transactions engage in the financial instruments business as defined in the FIEA¹⁰⁸ and must, therefore, register as a Type I FIBO¹⁰⁹. An exception is generally made for entities engaging in crypto derivatives transactions with certain counterparties.¹¹⁰ This includes among others derivative transactions with type I FIBO and qualified institutional investors as defined in the Cabinet Order on Definitions¹¹¹ (e.g. financial institutions, high-net-worth individuals). The same applies where the counterparties are equivalent to the aforementioned persons under the laws of another jurisdiction¹¹² or

¹⁰⁵ For the definition of financial instruments business see Article 2(8) FIEA.

¹⁰⁶ For the definition see Article 2(41) FIEA, Article 26 Cabinet Order on Cabinet Order on Definitions under Article 2 FIEA.

¹⁰⁷ Article 66-50 FIEA.

¹⁰⁸ Article 2(8)(iv) FIEA.

¹⁰⁹ Articles 28(1)(ii), 29 FIEA.

¹¹⁰ Article 1-8-6 Order for Enforcement of the FIEA.

¹¹¹ Article 1-8-6(1)(ii) Order for Enforcement of the FIEA in connection with Article 15(1) and Article 10 Cabinet Order on Definitions under Article 2 FIEA.

¹¹² Article 1-8-6(1)(ii) FIEA Enforcement Order in connection with Article 15(1) and Article 10 Cabinet Order on Definitions under Article 2 FIEA.

where the counterparty is a company with a stated capital of JPY 1 billion or more¹¹³. While this seems to be good news, crypto derivatives are explicitly excluded from the exemption.¹¹⁴ Companies engaging in crypto derivatives transactions must therefore generally register with the FSA as a type I FIBO.¹¹⁵ Something different only applies in cases where a FIBO, which conducts an OTC crypto derivatives business in Japan, executes cover transactions with a person engaging in the crypto derivatives business under the laws of another jurisdiction. Provided the foreign entity does not conduct the crypto derivatives transactions from Japan, it does not have to register as a type I FIBO in Japan.¹¹⁶

Except from this particular case, companies engaging in crypto derivatives must register as type I FIBO in Japan.

Excursion: Margin trading

The maximum leverage for crypto derivatives transactions is 2x for individuals.¹¹⁷ For corporations, there is no maximum threshold.¹¹⁸ Similar to margin trading on crypto asset exchanges, the ratio must be determined by the service provider on a case-by-case basis. In the absence of such a decision, the maximum leverage will be 2x for corporate clients as well.¹¹⁹

4. CUSTODY SERVICES – CUSTODIANS AND CRYPTO ASSET EXCHANGES

Crypto assets, tokenized securities, and electronically recorded transfer rights all rely on some form of public key cryptography. The person holding the private key corresponding to the public-key controls the assets. In most cases, the user does not hold the private key himself. Instead, he transfers the control to an exchange or a wallet service provider which introduces new risks. With the amendment of the PSA, the legislator responded to these risks. It is possible that the regulator will

¹¹³ Article 1-8-6(1)(ii) FIEA Enforcement Order in connection with Article 15(2) Cabinet Order on Definitions under Article 2 FIEA.

¹¹⁴ Article 1-8-6(1)(i) FIEA Enforcement Order.

¹¹⁵ See also IV-3-3-1(3) FIBO guidelines.

¹¹⁶ Ibid.

¹¹⁷ Art. 117(41) and (42) Cabinet Order on Financial Instruments Business.

¹¹⁸ Art. 117(51) and (52) Cabinet Order on Financial Instruments Business.

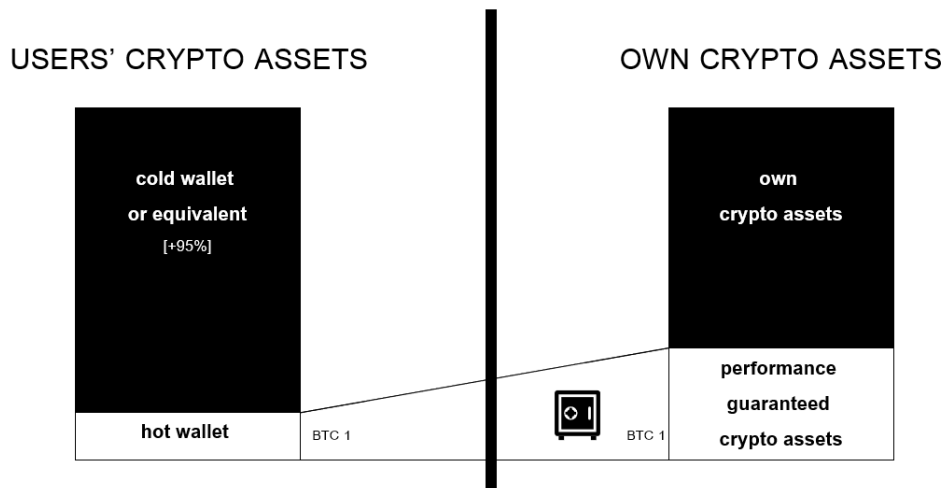
¹¹⁹ Art. 117(51) and (52) Cabinet Order on Financial Instruments Business.

introduce similar obligations for security tokens in the future.

4.1. Crypto Assets

The term crypto asset management is understood broadly and covers any activity where a service provider controls the crypto assets of another party.¹²⁰ In cases in which the service provider holds the private key(s) of a user, and is able to initiate a transfer of the crypto assets, the services constitute crypto asset management services within the meaning of the PSA and are subject to registration.¹²¹ Given the broad definition of crypto asset management services, the term does not only cover traditional custody solutions, but also certain types of wallets that manage their users' private keys.

CRYPTO ASSETS MANAGED BY EXCHANGE



Crypto asset custodians as defined above must not only manage the crypto assets of their users separately from their own¹²², but also separately from the other users' assets to allow easy identification¹²³. The private keys controlling the users' crypto assets must generally be managed via devices which are permanently disconnected from the

¹²⁰ I-1-2-2(3) Guidelines on Crypto Asset Exchanges.

¹²¹ Article 63-2 PSA in connection with Article 2(7)(4) PSA; I-1-2-2(3) Guidelines on Crypto Asset Exchanges.

¹²² Article 63-11(2) PSA.

¹²³ Article 27(1)(i) Cabinet Order on Crypto Asset Exchanges.

internet or by other methods that provide a similar level of security.¹²⁴ It is well possible that other solutions, such as multi-party computation (MPC), satisfy these requirements. Crypto assets which are held in hot wallets, i.e. where the private keys are stored on devices that are permanently connected to the internet, must be backed by the custodian's own funds. Under the PSA, custodians are required to hold the same amount of the same crypto asset as their own assets in a cold wallet or in a wallet secured by a method providing a similar level of security, as the funds stored in a hot wallet. By way of example, if a custodian holds 1 BTC of the users' funds in a hot wallet, it must hold the same amount of BTC as its own assets in a cold wallet. The maximum amount of users' crypto assets which can be stored in a hot wallet is limited to 5 percent of the total assets under management.¹²⁵

The same applies to crypto asset exchanges, which manage their users' crypto assets. Additionally, exchanges may entrust their users' crypto assets to a trust company. Since all of the registered exchanges are centralized exchanges, this applies to all of them. Decentralized exchanges may not have to fulfill these requirements depending on the degree of decentralization. For more information on the regulatory treatment of decentralized exchanges click [here](#).

With respect to exchanges managing their users' fiat money, they must store these funds separately from their own funds with a trust.¹²⁶ In case of insolvency, the funds, both crypto and fiat, are protected, and users of the crypto asset exchange are given priority over the other creditors.

4.2. Security tokens

For security tokens, no similar framework exists so far. It is possible that future subsidiary legislation will provide for similar regulations as for crypto assets – at least, in cases where a public blockchain is used. The risk of losing funds is likely smaller, however, since the token will be issued in a more controlled environment. Exchanges being hacked, may simply issue new tokens or ask the issuer to issue new tokens and put the stolen tokens/addresses on a blacklist.

¹²⁴ Article 63-11(2) PSA in connection with Article 27(3) Cabinet Order on Crypto Asset Exchanges; see also II-2-2-3-2(5) Guidelines on Crypto Asset Exchanges.

¹²⁵ Article 63-11(2) PSA in connection with Article 27(2) Cabinet Order on Crypto Asset Exchanges.

¹²⁶ Article 63-11(1) PSA in connection with Article 26 Cabinet Order on Crypto Asset Exchanges.

5. CONCLUSION

Irrespective of whether a token is a crypto asset under the PSA, a tokenized security or an electronically recorded transfer right under the FIEA, the market is highly regulated in Japan. What seems to be a regulatory overkill, at first sight, is likely to help the market to mature in the mid to long term. This will allow more institutional players to enter the market and to increase their stake in the digital asset space. Companies that intend to operate on the Japanese market are well advised to analyze carefully whether their activities are regulated under Japanese laws. It should be noted that despite the tight regulations, there is still plenty of room for companies to operate on the Japanese market without a license. This is particularly true for companies that are licensed under the laws and regulations of other jurisdictions or who are willing to enter into strategic partnerships with licensed Japanese entities. For some companies, these entities might even become attractive takeover targets.

If you want to learn more or should you need legal or regulatory advice, please feel free to contact us directly under s.saito@innovationlaw.jp.

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