

Fintech

Staking and Securities Regulation

In the U.S., SEC Sues the World's Largest Crypto Exchange.

On June 5, 2023, the Securities and Exchange Commission (SEC) charged Binance Holdings Ltd. (Binance), one of the largest crypto exchanges in the world, and its related parties, with various securities act violations. One of the charged violations was that the provision of staking services by a Binance affiliate constituted an unregistered sale of securities. As we have often been asked the legal status of staking in Japan, we will provide an overview of staking and Japanese securities regulations.

What are Staking and Staking Service?

Crypto assets which adopt a consensus algorithm called proof-of-stake can be rewarded from the network by staking the crypto assets and being involved in the block generation. Staked crypto assets are locked in the protocol and cannot be withdrawn. In some networks, staking more crypto assets may yield more rewards. A person can stake crypto assets on their own, but this requires considerable technical know-how. To solve this issue, crypto exchanges and staking service providers accept deposit or delegation of crypto assets from their users for staking and promise to give the users a portion of the reward.

A risk called slashing penalties exists in some staking. Staking service providers may forfeit staked crypto assets as penalties if they fail to fulfill their expected role, such as keeping online and providing some auditory service. Some staking service providers owe those slashing penalties risks by themselves, but others distribute the penalties to the users.

Japanese Securities Regulation.

The Financial Instruments and Exchange Act (FIEA) treats specific partnership interests, namely interests in so-called "collective investment schemes (CIS)," as securities. Although there is no standard indicated by the Supreme Court like the Howey Test in the U.S., the elements extracted from the definition of CIS under the FIEA are as follows:

- (i) Investors invest or contribute money (including crypto assets).
- (ii) The collected funds are used for businesses.
- (iii) The investors are entitled to receive dividends or to participate in the profits arising out of the business or the distribution of assets.

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Activities involving a CIS are subject to disclosure and registration requirements, as well as conduct controls. The solicitation of interests in a CIS to investors is considered a solicitation of securities. It must be registered with the Financial Services Agency.

Is Staking a Security?

Considering the staking mechanism described above, it is necessary to consider whether the commitment of crypto assets from users to service providers constitutes investments or contributions. Although there is no clear definition, considering that deposits and loans of crypto assets are not considered investments or contributions, the allocation mechanism of risk and profit would be a key factor.

Staking services in which users take the risk of breaking the principle, such as distributing slashing penalties to the users, and the rewards may fluctuate depending on the performance of the service provider may constitute investments or contributions.

Depending on the design of the mechanism, it may be possible to structure the service as loans of crypto assets, which are not regulated by current Japanese regulations, rather than investments or contributions, but in any case, careful consideration is required.

Custody Regulation.

Please note that in addition to the above security regulations, custody regulations may also apply when managing private keys of crypto assets for users.



Practice Area News

Amended Payment Services Act. The amended Payment Services Act governing crypto assets and other payment methods was enacted on June 1, 2023. The concept of "electronic payment instruments" has been newly established as a correspondence to stablecoins, which had not been clearly defined, and regulations regarding their issuance and intermediation have been clarified.

Stricter Travel Rules. Stricter regulations for anti-money laundering came into effect on June 1, 2023. According to the new "Travel Rules," when assets over a certain amount are sent by a customer, the receiving and sending crypto exchanges must share information about the customers. The lack of interoperability in such information sharing systems has prevented users from sending and receiving crypto assets between crypto exchanges.

Investment in security tokens by LPS. The businesses that Investment Limited Partnerships (LPS) may engage in are limitedly listed in the LPS Act. It was not clear whether security tokens were included in the list. On April 19, 2023, the Ministry of Economy, Trade and Industry (METI) published a notice clarifying the interpretation regarding the ability of LPS to invest in security tokens. The notice also clarified that LPS might not acquire or hold crypto assets and stablecoins.

In the Firm

So & Sato Law Offices was highly recognized in the "FinTech" and "Investment funds" categories of the Legal 500 Asia Pacific 2022 – 2023.

Chambers & Partners ranks So Saito top FinTech lawyer 2022.

Best Lawyers recognizes So Saito for Banking and Finance Law, Financial Institution Regulatory Law and FinTech Practice for 2024.

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