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Japanese Regulations on Crypto Fund

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I. Introduction

We posted (1) an article titled "Crypto Fund"（in Japanese) on 1 June, 2018, and (2) an article titled "Funds Regulations in Japan" on 30 June, 2020.

In 2021 and 2022, we received many inquiries regarding setting up crypto funds. Considering (i) the amendments in 2020 to the Payment Services Act(**PSA**), (ii) the rise of NFT, DeFi, and stablecoins, and (iii) changes to the taxation of crypto assets, we therefore are updating (1) the article titled "Crypto Fund."

In general, the term "crypto fund" can be used in a variety of ways, such as where (i) the fund's financial source is crypto assets which include Bitcoin and Ether, (ii) the fund's investment targets are crypto assets or crypto related businesses for instance BTC, ETH, SAFT, ICO tokens, NFT, stablecoins, security tokens, DeFi, and stocks of crypto related companies, and (iii) the investor's rights are tokenized.

Therefore, the following is an overview of the regulations that apply to each type of structure.

Since this article focuses on crypto funds, other kinds of funds (investment in fiat currency and securities management) are not mention in this article, except in section VIII.1. For regulations on other kinds of funds, please refer to (2) the above article titled "Funds Regulations in Japan. "

II. Regulations on Fund Raising

1. Regulations on Fund Raising in Fiat Currency

Under the Financial Instruments and Exchange Act (**FIEA**), soliciting investments in money (fiat currency), using it to conduct business, and distributing the proceeds from the business falls under a collective investment scheme (Article 2(2)(v) of the FIEA).

Soliciting investments in a collective investment scheme (public offering or private placement, Article 2(8)(vii)(f)) falls under the Type II Financial Instruments Business (**Type II FIB**) (Article 28(2)(i) of the FIEA) in principle, and public offering or private placement is not allowed without registration as a Type II Financial Instruments Business Operator (**FIBO**) (Article 29 of the FIEA). This is also the case for crypto funds where the means of fundraising is money, and the investment targets are crypto assets.

There are some exceptions to this fund regulation under the FIEA, such as (i) cases where the fund completely outsources the solicitation to another Type II FIBO and does not solicit any acquisitions on its own, (ii) cases where the fund uses the exemption so called Specially Permitted Businesses for Qualified Institutional Investor (**QII**) (Article 63 of the FIEA) (**Article 63 Exemption** or **QII etc. Exemption**), and (iii) cases where the fund is more than 50% funded by overseas investors and the domestic investors are limited to certain investors such as QII (**Overseas Investor's Exemption**)(Article 63-8 of the FIEA).
Whether or not the issuer does not conduct any solicitation for acquisition is determined by the circumstances in each case. Solicitation for acquisition refers to the solicitation of an application to acquire newly issued securities and similar activities (Article 2, Paragraph 3 of the FIEA). Solicitation is generally understood to be an act that attracts and encourages investors to acquire a particular security, whether in writing, verbally or through advertising.

Specially Permitted Businesses for QII is an exemption that allows a fund manager to engage in fund services by making a simple notification to the Financial Services Agency (**FSA**) when all investors in the fund are QII or when the investors include one or more QII and 49 or fewer persons who are expected to have certain investment abilities. However, that exemption has been subject to tighter regulations under the 2015 amendment to the FIEA. Before the amendments, the scope of 49 or fewer investors included general individual investors. It should be noted that after the amendment, individual investors whose total amount of investable financial assets (referring to securities, etc., but not including crypto assets) is 100 million yen or more and who have been in a security account for one year would be able to invest.

2. Regulations on Fund Raising in Crypto Assets

Until the amendment of the FIEA in 2020, soliciting investments in funds with crypto assets was not subject to the FIEA regulation. However, due to the amendment, crypto assets are now considered as money equivalent in relation to fundraising (Article 2-2 of the FIEA). Fund raising with crypto assets is now subject to the same regulations as fund raising with money.

(Summary of Regulations on Fund Raising)

	General Registration Requirements	Exceptions		
		When Completely Outsourced to a Third Party	Article 63 Exemption (QII etc. Exemption)	Overseas Investor's Exemption
Sales by Issuer	Type II FIBO Registration	N/A (for the third party, Type II FIBO registration)	Available	Available
Sales by Third Party (on behalf of the issuers)	Type II FIBO Registration	N/A if sales activities are sub-delegated to a registered third party (rarely the case)	N/A Type II FIBO Registration	N/A Type II FIBO Registration

III. Regulations on Investment Management of Funds

1. Regulations When Investments are Primarily in Securities or Derivatives

With respect to funds the term investment management business is understood as the management of money or other property invested by a person connected with investments primarily in securities or derivatives which are based on investment decisions requiring the valuation and analysis of such instruments. In this context, "primarily" means that generally more than 50% of the assets under management are invested in securities or derivatives. To conduct an investment management business, a company must register as an Investment Management Business Operator (Article 28(4) of the FIEA). Similar to Type II FIBO, persons engaging in the investment management business must meet certain criteria, including minimum capital requirements and hiring proper personnel (e.g. a compliance officer with eligible knowledge and experience) for operating the business.

The securities include stocks as well as general security tokens. In order to avoid this regulation, it is necessary to set a limit on the investment objectives to the effect that no more than 50% of the investment should be in securities or derivatives. Similar to the above II.1, there are some exemptions. For example, registration as an investment management business is not required if (i) the fund meets requirements such as full outsourcing of management to other investment management companies, (ii) the fund is conducted as Article 63 Exemptions, or (iii) the fund is set up in a foreign country and investment from Japan is limited.

2. Regulations When Investments are Primarily in Crypto Assets

If the investment target is mainly crypto assets, the FIEA does not apply to the management. Since the management of crypto assets is for investment purposes and not for business purposes, the PSA does also not apply. When investing in NFT, SAFT, DeFi, stablecoins, the FIEA and the PSA do not apply to the management, as it does when investing in crypto assets.

(Summary of Regulations on Investment Management)

	General Registration Requirements	Exceptions		
		When Completely Outsourced to a Third Party	Article 63 Exemption (QII etc. Exemption)	Foreign Funds that Meet Certain Requirements
Management of Funds that Invest +50% in Securities by GP	Registration of GP as Investment Management Business Operator	N/A (For the third party, Investment Management Business Operator Registration)	Available	No registration required
Management of Funds that Invest +50% in Securities by Third Party	Third party must register as Investment Management Business Operator	N/A If management activities are sub-delegated to a registered third party (rarely the case)	N/A Third party must register as Investment Management Business Operator Registration	N/A Third party must register as an Investment Management Business Operator registration
Management of	N/A	N/A	N/A	N/A

Other Funds (incl. crypto assets)				

IV. Regulations on the Content of Investors' Rights

1. Regulations on the Distribution of Money and Crypto Assets

A fund is generally set up by using a silent partnership agreement, a limited partnership agreement, or an overseas partnership agreement (collectively, partnership agreement), and investors have rights under such partnership agreement. In a crypto fund, it is assumed that there are cases where (1) the fund's investment is solicited in crypto assets and then dividends or principal redemption in money, (2) the fund's investment is solicited in money and then dividends or principal redemption in crypto assets, and (3) the fund's investment is solicited in crypto assets and then dividends or principal redemption in crypto assets.

Since the transfer of the crypto assets is not a sale or exchange thereof, we believe that the PSA does not apply except in cases of legal evasions, such as formally soliciting investment in a fund with money and immediately redeeming the principal with crypto assets.

2. Regulations on the Tokenized Interest

With the 2020 revision of the FIEA the concept of Electronically Recorded Transfer Rights (ERTR) were introduced. Article 2(3) of the FIEA defines ERTR as follows:

> "Electronic Recorded Transfer Right" are rights that fulfill all requirements from (1) to (3) and do not fall under (4):
> (1) Rights listed in Article 2(2) of the FIEA (funds, beneficial interest in a trust, membership rights of general partnership company, etc.)
> (2) which are recorded electronically, and
> (3) may be transferred by using an electronic data processing system.
> (4) Cases specified by Cabinet Office Ordinance taking into account the liquidity constraints and other circumstances.

Some crypto funds may also consider tokenizing their rights. Interests in a fund which are tokenized are generally considered ERTR. Given their (potentially) increased liquidity they are subject to the same regulations as more liquid Type I Securities. Third parties engaging in the sale of tokenized

interests must therefore register as Type I FIBO (Article 28 (1) (i), Article 2 (8) (ix) of the FIEA).
The self-solicitation of tokenized interests by a fund is subject to the same registration requirements as the self-solicitation of funds in general. A fund must therefore register as a Type II FIBO and, if ≥50% of the money is invested in securities or derivatives, as an Investment Management Business Operator, unless an exemption applies. The QII exemption [1] and the exemption in case of entrustment of all sales and investment activities to third parties also apply to tokenized funds.
For more detailed information on security token offerings (STOs), please click here.

(Business Regulations and Notifications Requirements under the FIEA for the Sale and Management of Tokenized Funds)

	General Registration Requirements	Exceptions		
		When Completely Outsourced to a Third Party	Article 63 Exemption (QII etc. Exemption)	Foreign Funds that Meet Certain Requirements
Sales				
Sales by Issuer	Type II FIBO registration	N/A (for the third party, Type II FIBO registration)	Available	Available
	Type I FIBO registration	N/A If sales activities are sub-delegated to a registered third party (rarely the case)	N/A Type I FIBO registration	N/A Type I FIBO registration
Investment Management				
Management of Funds that Invest +50% in Securities by GP	Registration of GP as Investment Management Business Operator	N/A (for the third party, Investment Management Business Operator registration	Available	No registration required
Management of	Third party must	N/A	N/A	N/A

[1] In order to use the QII exception in a self-solicitation or management of ERTR, it is necessary to apply certain technical transfer restrictions to the ERTR.

Funds that Invest +50% in Securities by Third Party	Register as Investment Management Business Operator	If management activities are sub-delegated to a registered third party (rarely the case)	Third party must register as Investment Management Business Operator Registration	Third party must register as Investment Management Business Operator registration
Management of Other Funds (incl. crypto assets)	N/A	N/A	N/A	N/A

V. Disclosure Regulations

Since ERTR are generally subject to the same regulations as Type I Securities, disclosure requirements apply if investors' rights are tokenized. An issuer of ERTR is therefore obliged to prepare a prospectus (Article 13 (1) of the FIEA) and to register the offering with the FSA (Article 4 (1)). In addition to the initial disclosure, ongoing disclosure requirements apply (Article 24). Something different only applies in the case of private placements. These are placements with QII, professional investors or a small number of investors (≤ 50 investors) only.

If investors' rights are not tokenized, disclosure requirements apply to public offerings of type II securities, which fall under the category of Rights in Securities Investment Business, etc. (Article 3 (iii) (a)) that mainly invest in securities. In the case of Type II Securities, if the number of holders is less than 500 in response to a solicitation for acquisition, it does not fall under public offerings (Article 2 (3) (iii) and Article 1-7-2 of the FIEA Enforcement Order), and disclosure requirements do not apply.

(Disclosure Regulations)

Type of Securities	Type of Solicitation		Investors	Obligation to Disclose
Type I Securities	Private placement	Private placement with QII only*	QII only	Notification of specific matters (Article 23-13 (4) of the FIEA, Article 20 (1) of the Cabinet Order on Disclosure of Regulated Securities)
		Private placement to a small number of	≤49 investors	

		investors*		
		Private placement to specified investors*	Specified investors only	N/A
	Public offerings		Unlimited number of investors	Securities registration statement ** (continuing disclosure of semiannual reports, extraordinary reports, etc.)
Type II Securities	Private placement		≤499 investors	N/A
	Public offerings		Unlimited number of investors	Generally not applicable Rights in Securities Investment Business, etc. are regulated

* Technical measures must have been taken to restrict resale.

** When the total issue price is less than JPY 100 million the obligation to file a securities registration statement does not apply (Article 4(1)(v) of the FIEA).

VI. Fund Scheme

1. Fund Scheme if Investing in Crypto Assets

Funds are generally structured using various types of partnership agreements. In Japan, investment Limited Liability Partnership (**LLP**) agreements are often used to set up PE funds and VC funds, etc. However, LLP is legally only allowed to engage in certain businesses (Article 3 (1) of the Act on LLP), and it does not include the acquisition and holding of crypto assets or stablecoins. Therefore, if the investment target is crypto assets or stablecoins, LLP cannot be used, and silent partnership agreements should be considered[2].

2. Fund Scheme if Investors Rights are Tokenized

Suppose a fund tokenizes rights under a partnership-type agreement and transfers the token to investors. In that case, it seems necessary to consider whether simply tokenizing existing rights on the agreement will work properly.

For example, the following issues should be considered:

- Whether rights under partnership agreements are validly transferred only by transferring the

[2] That is called "GK-TK scheme" using a limited liability company and a silent partnership.

tokens[3]

- If the governing law is not specified as in the case of *The Dao*, what will be the tax and accounting treatment in Japan

VII. Supplement

1. Investment in Crypto-Related or Blockchain-Related Companies

Funds that are financed in cash and invest primarily in shares of crypto-related or blockchain-related companies are sometimes called crypto-related funds.
As a fund that invests primarily in securities, such as this fund is, in principle, required to be registered as a Type II FIBO for its public offering or private placement and as an investment management business operator for its management (refer to II1. and III1.).

2. Management of Own Funds

When a company launches an "in-house fund" to invest its own funds in shares of crypto-related or blockchain-related companies, it may also be called crypto-related funds.
However, this does not fall under "investment of money or other properties invested or contributed from a person who holds the following rights or other rights specified by the Cabinet Order" (Article 2 (8) (xv) of the FIEA), so fund regulations under the FIEA do not apply.

3. Tax Issues of Crypto Funds

We are not experts in tax issues, but we describe here for your reference since tax issues are often a significant issue when setting up a crypto fund.[4]
If a company owns actively traded crypto assets in Japan, it is taxed at market value at the end of the term (so-called unrealized gains tax).
When a crypto fund is set up with TK-GK scheme, the silent partnership investors are not considered to own the assets, but GK is deemed to own, and therefore, in principle, unrealized gains are taxed in GK. However, if such unrealized gains are distributed to investors based on the silent partnership agreement, GK will not be taxed on that portion (effectively pass-through), while the portion equivalent to such gains will be treated as income of the investors (both individual and corporate investors).

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[3] Under Japanese law, the transfer of claims is perfected by notice or acknowledgment with a fixed date or registration under the Special Law for Transfer of Movables and Claims

[4] We would like to thank Mr. Kenji Yanagisawa, a certificated public tax accountant, for his comments on the description of tax issues. However, the responsibility for potential errors lies with us.

When a crypto fund is set up with an overseas partnership, it is taxed as if investors themselves own assets of the fund (pass-through). Therefore, corporate investors of the overseas partnership are subject to unrealized gains tax.

Unrealized gains tax might be avoided by using a scheme in which a company is set up in a foreign country that does not tax unrealized gains and Japanese investors invest in the company as a silent partnership, and then unrealized gains are not allocated to the investors. However, it is necessary to consider Anti-Tax Haven Rules when using this scheme. If the overseas company's shareholders are domestic companies or domestic individuals, the overseas company may be deemed to be a paper company or not meet the economic activity standards, and income of the overseas company might be deemed as income of the shareholders.

Therefore, you should consider the following factors and consult with legal and tax professionals to structure a crypto fund.

- Attributes of primary investors (Japanese company, Japanese resident, foreign company, or foreign resident)
- Whether tokens to invest in are subject to unrealized gains taxes (if the tokens are listed on a crypto exchange or DEX, whether you can sell them before the end of the fiscal year).
- Whether shareholders or GPs of overseas entities can move to Singapore or other countries.

Scheme	Unrealized Gains Taxation on SPV	Unrealized Gains Taxation on Corporate LP	Unrealized Gains Taxation on Individual LP	Taxation on Shareholders of SPV
TK-GK	Taxed on GK (if unrealized gains are distributed, GK will not be taxed)	Taxed if it is distributed	Taxed if it is distributed	N/A (in principle)
Overseas Partnership	N/A (depending on country)	Taxed	N/A	N/A (depending on country)
TK-Overseas Company	N/A (depending on country)	N/A (in principle)	N/A (in principle)	Anti-Tax Haven Rules may apply

Disclaimer

The content of this article has not been confirmed by the relevant authorities or organizations mentioned in the article but merely reflects a reasonable interpretation of their statements. The

interpretation of the laws and regulations reflects our current understanding and may therefore change in the future. This article does not recommend the investment in crypto funds. This article provides merely a summary for discussion purposes. If you need legal advice on a specific topic, please feel free to contact us.

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