September 4, 2024

Crypto Regulations in Japan 2024

So Saito
Kazuki Imanari
So & Sato Law Offices

I. Introduction

Japan has enacted and improved crypto regulations since 2017. Japan was once one of the most crypto-friendly nations in the world, but after 2018, it adopted a stricter regulatory stance. It is, however, now becoming more friendly to the Web3 industry again, with an intention to attract foreign investment.
This article provides an overview of cryptoasset regulations in Japan in 2024.

History of Cryptoasset Regulations in Japan

Early Friendly Era	
February 2014	MtGox, located in Shibuya, Tokyo, and the largest exchange in the world, went bankrupt.
March 2014	Japanese LDP (Liberal Democratic Party, a governing party in Japan) discussed with the government and decided not to regulate virtual currency at that stage but asked the industry to form a self-regulatory organization.
May 2016	Japan enacted the first virtual currency act in the world. The act was made as an amendment to the Payment Service Act ("PSA"). The act was friendly to startups and intended to foster the industry.
April 2017	The amended PSA stated above was enforced.
2017	There were ICO booms all over the world, and the price of crypto went up. The trading volume of Japanese exchanges became number 1 in the world. Many foreign players came to Japan to start their business.
Era of Stricter Regulation	
February 2018	A massive hacking incident, under which approximately JPY 58 billion equivalent NEM was hacked, happened in Japan (Coincheck incident).
2018-2021	After the Coincheck incident, the Japanese government tightened the operation of the regulation. Many exchanges received business improvement orders and suspension orders, and the market became shrunk.
May 2020	The amended PSA and the amended FIEA were enforced.
Era that Web3 became a national strategy	
2021-	The Japanese government's national growth strategy in 2021 includes the statement that Web3 became one of the national strategies. Under this

	strategy, the LDP's Web3 project team has issued policy recommendations titled the Web3 White Paper[1] in order to foster Web3 every year since 2022.
June 2022	Japan enacted one of the world's earliest stablecoin regulations. The act was made as an amendment of the PSA and the Banking Act
2022	In 2022, there were collapses of Tera Luna, Three Arrows Capital, and the FTX Group. As a result, the global regulatory environment became stricter. However, Japan had already implemented stringent regulations, which proved effective. (*1) Therefore, Japan did not need to change its regulations even after these collapses. (*1) Even in the FTX Group's bankruptcy, the assets of FTX Japan's customers were all preserved because the regulations required 100% of users' assets to be segregated.
June 2023	Stablecoin regulation was enforced.
May 2024	DMM Bitcoin was hacked, resulting in a loss of approximately JPY 48.2 billion worth of Bitcoin. However, we have not seen any regulatory tightening in response to this incident at this stage.

II. Cryptoasset, NFT, and Stablecoin Regulation

1. Definition of Cryptoassets

The PSA defines cryptoassets as property value with the following elements:

(i) which is recorded by electronic means and can be transferred by using an electronic data processing system,
(ii) which can be used in relation to unspecified persons for the purpose of paying consideration for the purchase or leasing of goods, etc. or the receipt of provision of services and can also be purchased from and sold to unspecified persons acting as counterparties, and
(iii) excluding the Japanese currency, foreign currencies, currency-denominated assets, and Electronic Payment Instruments.

Electronic property value, which can be mutually exchanged with the above assets, also falls under the category of cryptoassets.

2. Cryptoasset Exchange Services

(1) Definition

Under the PSA, the Cryptoasset Exchange Service means any of the following acts carried out in the course of trade:

(i) sale and purchase of cryptoassets (i.e., exchange between cryptoassets and fiat currency) or exchange of cryptoassets into other cryptoassets;

[1] The web3 White Paper 2024 (English translation) https://www.taira-m.jp/The%20web3%20White%20Paper%202024%EF%BC%88English%2Cver%29.pdf

(ii) intermediary, brokerage, or agency service for the acts described above (i);
(iii) management (custody) of fiat currency on behalf of the users/recipients in relation to the acts described above in (i) and (ii) and
(iv) management (custody) of cryptoassets on behalf of the users/recipients.

We hereafter call a cryptoasset exchange service provider as "CESP".

(2) Meaning of "in the course of trade"

Sales and purchases of cryptoassets to Japanese residents are not subject to the regulation unless they are conducted "in the course of trade (*gyo to shite*)". An act in the course of trade is generally understood to be a repetitive and continuous act vis-à-vis the public. For example, trading in cryptoassets for one's own investment purposes or taking custody of cryptoassets of a wholly owned subsidiary are not considered acts in the course of trade.

It should be noted that just because your clients are only institutional investors is not considered as it is not in the course of trade.

(3) Solicitation to Japanese Residents

Whether or not a CESP solicits Japanese residents is also considered an important factor in determining the regulation's application. The determination of whether solicitation towards residents of Japan is being conducted is made on a case-by-case basis. For instance, actions such as not blocking access to a website from Japan, providing information in Japanese, or introducing products at events in Japan could be considered factors that indicate solicitation towards residents of Japan.

(4) Management of Cryptoassets

The custodian of cryptoassets shall take the CESP license. According to the FSA guidelines, whether each service constitutes the management of cryptoassets should be determined based on its actual circumstances. Generally, if a service provider can technically transfer its users' cryptoassets, it falls under the category of the management of cryptoassets. If a service provider does not possess any of the private keys necessary to transfer its users' cryptoassets, the service provider is basically not considered to manage cryptoassets.

Accordingly, wallet services, such as non-custodial wallets, where the users manage the private key on their own, are not considered to constitute the management of cryptoassets.

(5) Intermediary, Brokerage, or Agency Service

An intermediary generally means a factual act that involves efforts to conclude a legal act between two others. Brokerage or agency service means to perform a legal act in one's own name and for the account or on behalf of another person.

With respect to a purchase and sale agreement of cryptoassets between third parties, the acts of (i) soliciting the signing of the agreement, (ii)explaining the product for the purpose of solicitation, and (iii) negotiating the terms and conditions fall, in principle, under the category of an intermediary.

The mere distribution of product information papers, etc., may not fall under the category of an intermediary and should be considered on a case-by-case basis.

(6) Requirements for the License and Cost

The PSA requires minimum capital, financial requirements, a physical office, a sufficient number of personnel on staff, segregation of assets, an annual audit, a customer identity verification system, accountability to users, protection of person/s' information, including sensitive information, and, if outsourced, must retain authority. The service provider must be equipped with the systems for adequate operation and legal compliance deemed necessary to operate a Cryptoasset Exchange Service appropriately and securely. Although the applicant must have a minimum capital base of at least JPY 10 million, and it must not be in negative assets, from our experience, the cost of obtaining the license and starting the internet exchange business can be more than JPY 1 billion.

(7) Exchange M&A

We are often asked by companies interested in entering the Japanese crypto market whether they can start their business by acquiring an already licensed CESP rather than obtaining a new license. The answer is Yes. Regulatory speaking, change of major shareholders is done just ex-post notification and you can start your business after purchasing the already licensed CESP.

The major issue here is that the purchased CESP shall satisfy the governance and compliance levels, which are similar to those a new licensed exchange shall achieve. If one purchases a cheap CESP, which is just having a license but has not done a business actively, to reach these levels might be difficult and time-consuming. Furthermore, if you wish to change the business model or system of the purchased CESP, you must provide an explanation to and obtain approval from the FSA. The cost of purchasing the licensed CESP, combined with this additional expense, can sometimes be comparable to the cost of obtaining a new license. Therefore, careful

consideration is necessary.

3. Crypto Exchange's Obligations

(1) Management of Users' Property

The PSA requires the users' cryptoassets to be segregated from the CESP. Further, the CESP shall keep (i) at least 95% of the users' cryptoassets in cold wallets and (ii) equivalent to 100% minus those kept in the left column of its own cryptoassets in cold wallets. Thus, as a consequence, the CESP shall hold the equivalent of 100% of users' cryptoassets in cold wallets.

With respect to fiat currency, the CESP shall deposit its users' fiat currency in a bank account under a different name from where the CESP deposits its own funds.

A CESP must undergo an annual audit of its financial statements and segregation of assets.

(2) Anti Money laundering

Anti Money Laundering law requires CESPs to conduct a know-your-customer of users. 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 user, the receiving and sending CESPs must share information about the users. The lack of interoperability in such information-sharing systems has prevented users from sending and receiving cryptoassets between some CESPs.

4. DEX

The regulations applicable to decentralized exchanges (DEX) are not clear. There is an argument that the regulations do not apply to exchanges that are completely decentralized and have no administrator at all, as there is no entity subject to crypto regulations. However, it is necessary to carefully consider whether there is truly no administrator. Further, entities that provide access software to a DEX may be subject to the regulations for being intermediaries.

As stated later in section III. 1, the sale of cryptoassets issued by oneself is subject to crypto regulations. Providing liquidity to a DEX for cryptoassets issued by oneself may also be considered as engaging in the sales of the cryptoassets.

5. NFT

Pure NFTs, such as trading cards and in-game items recorded on blockchains that do not function as payment instruments, are not considered cryptoassets. The FSA states that the distinction between cryptoassets and pure NFTs is as follows:

(i) the issuer of the NFTs prohibits its use as a payment instrument by technical feature or by agreement
(ii) the quantity and price of the NFTs are not suitable as a payment instrument (specifically, one NFT costs more than ¥1,000 or the total number of the NFTs issued is less than 1 million).

Generally speaking, pure NFTs are not regulated in Japan. Please, however, note that whether NFTs are considered as "pure" NFTs needs careful discussion. For example, if an NFT gives some dividend or economic benefit, it might be considered as a security. Further, an NFT, which is linked to real-world assets, might require a discussion of whether regulation of real assets may apply.

6. Stablecoins

Japan was one of the first countries in the world to establish stablecoin regulations. Stablecoins pegged to fiat currency are defined as electronic payment instruments and require a license different from CESP to offer the related service.
Other stablecoins that adjust their value through algorithms could be regulated as cryptoassets or securities. Stablecoins classified as cryptoassets are subject to crypto regulations, while stablecoins classified as securities are subject to securities regulations (FIEA).

III. Crypto Financing

1. ICO, IEO

ICO (Initial Coin Offering) is an act of issuing and selling tokens to raise fiat currency or crypto assets from the public. ICO is regulated in Japan. The applicable regulations depend on the legal nature of the issued tokens. If the tokens are considered securities, the token issuance will be regulated by the FIEA. If the tokens are considered cryptoassets, the token issuance will be regulated by the PSA.
The issuance of new cryptoasset-type tokens in Japan is generally done by IEO (Initial Exchange Offering). IEO is an act of raising fiat currency or cryptoassets by an entity

entrusting the sales of tokens to a licensed CESP. In the case of IEO, if the issuer itself does not conduct sales activity, the issuer does not need to take the crypto exchange license. If, however, the issuer itself wants to conduct sales activity for its new tokens, it needs to have a crypto exchange license, which requires significant cost and time compared to IEO. Several IEO projects have already been launched in Japan.

The IEO process requires examinations by the exchange, JVCEA, a Japanese self-regulatory organization, and the FSA. The examination checks the feasibility of the project for which the funds will be used, the financial soundness of the issuer, and other factors.

2. SAFT, SAFE

SAFT (Simple Agreement for Future Tokens) is a way to raise funds in exchange for the right to purchase tokens to be issued in the future. SFAT targeting Japanese residents is considered to be subject to fund regulation or crypto regulation, depending on the legal nature of the agreement. However, both regulations do not apply unless the act is done in the course of trade, so we may argue that entering into a SAFT with limited numbers of specific persons, such as business partners who will contribute to developing projects, should not be regulated.

SAFE (Simple Agreement for Future Equity) with token warrant is subject to general equity investment regulations, depending on the attributes of involved entities and investors.

Japanese entities sometimes use J-KISS, a Japanese convertible equity, with a side letter that provides tokens.

IV. Crypto Staking

Generally speaking, we believe staking service for POS tokens is not regulated in Japan. For example, staking one's own cryptoassets or becoming a validator for ETH is not regulated in Japan.

Not all staking services, however, are exempted from the regulation. If service providers manage the private keys of users' cryptoassets (we understand some exchanges provide those services), custody regulation may apply. In addition to managing private keys, if the service providers distribute rewards as well as slashing penalties to the users, fund regulations might apply.

We understand that there are some NFT projects that say that they sell NFTs for crypto, and purchasers can stake NFTs, and can get rewards. We understand fund regulation might

apply to such cases, especially in cases where staking does not have any actual usage for providing security.

V. Crypto Lending

In crypto lending services, a service provider borrows cryptoassets from users for a certain period of time and pays a lending fee in exchange. No regulation applies to that lending because the Money Lending Business Act regulates money lending, but it does not deem cryptoassets as money.[2]

It should be noted that crypto custody regulations may apply in cases where the service is considered as custody, not lending, even if a service is titled as crypto lending. One factor that distinguishes lending and custody is whether users can withdraw their assets at any time (deposit) or whether there is a specific required time of non-withdrawal (lending).

VI. Crypto Mining

Mining cryptoassets requires large amounts of electricity. Thus, mining appears to be regulated in some countries, such as Kazakhstan[3]. Regulation of mining in certain areas in Russia is also being discussed[4]. In Japan, mining itself is not regulated.

A business that collects money from the public to conduct mining operations and then distributes the proceeds from mining to the customers may be regulated under the FIEA as a fund.

Schemes that one sell mining machines, accept deposits of the machines, and promise to pay fees for the mining results may also be regulated under the Act on Deposit Transactions. If the Act on Deposit Transactions is applied, the business must obtain confirmation from the Prime Minister, but it is said that to get such confirmation is nearly impossible. Creating a scheme to avoid such regulation is important.

VII. Crypto Taxation

1. Tax on Individuals

Profits generated by cryptoassets transactions are subject to income taxation and, in

[2] FSA Comments on April 3rd, 2020, No.36
https://www.fsa.go.jp/news/r1/sonota/20200403/01.pdf
[3] Shigenobu Masujima "Kazakhstan stricter crypto mining from April ", JETRO、
https://www.jetro.go.jp/biznews/2023/02/b3bf3bcc5cee230d.html
[4] Sergio Goschenko, Potential Ban on Cryptocurrency Mining in Certain Regions Disrupts Regulatory Efforts in Russia, Bitcoin.com News, https://news.bitcoin.com/potential-ban-on-cryptocurrency-mining-in-certain-regions-disrupts-regulatory-efforts-in-russia/

principle, classified as miscellaneous income. Miscellaneous income is income that is neither interest income, dividend income, real estate income, business income, employment income, retirement income, forestry income, transfer income, or temporary income. The tax rate for miscellaneous income ranges from 5% to 45%, depending on the amount of total income. The maximum tax rate is about 55% when we calculate income tax as well as residential tax and special reconstruction income tax.

2. Tax on Corporations

Profit generated by cryptoassets transactions is subject to corporate tax which is about 30% depending on the amount of income and how big a company is.
Cryptoassets for which there is an active market must be valued using the mark-to-market method at the end of the fiscal year and are taxable even if companies do not sell them.
This unrealized gain tax treatment became a huge issue in Japan, and many Web3 companies left Japan.
In 2022, the Japanese government decided to reform this unrealized gain tax, and now the tax is not levied if an issuing company of tokens continues to hold its tokens with certain technical transfer restrictions.
In 2023, another tax reform was proposed and approved by the government. Under the reform, an unrealized gain tax is not applied if a company holds tokens with a certain transfer restriction, even in the case that tokens are issued by other entities (including Bitcoin and Ether etc.)

EOD