

THIS IS FOR GENERAL INFORMATION purposes **only**. It does **not** constitute legal **advice** thus may **not** be relied upon regarding a specific legal issue or problem.

July 20, 2017

Guidance Note on the Japanese Virtual Currency Legislation and Overview on Registration Requirement thereunder

So Saito
So Law Office

1. Virtual Currency Legislation

1.1 History and statutory framework:

As Japan's regulatory response to the MtGox failure and the Financial Action Task Force (FATF) guidance in 2015 recommending all virtual currency ("VC") exchangers be registered or licensed and under the same scrutiny as financial institutions, amendments to the "Act on Settlement of Funds" and the "Act on Prevention of Transfer of Criminal Proceeds" (together with the ancillary amendments to the relevant orders for enforcement, cabinet office ordinances, etc., the "**VC Act**" or the "**Act**" hereunder) came into effect as of 1 April 2017 (the "**Effective Date**").

1.2 Definition of Virtual Currency

Under the VC Act, the definitions of VC are in two-fold.

Under the VC Act the term "**Virtual Currency**" means;

- (i) financial value (recorded by way of electronic means in the electronic devices etc., excluding any fiat currency/ currencies (of Japan or otherwise) and assets denominated in any such fiat currency) which may be used to pay the price in exchange for the goods purchased or rent or the services received to/ against unspecified person/ persons for such goods or services and which may be purchased from and/or sold to the unspecified person/ persons (the "**Type I VC**").
- (ii) financial value (recorded by way of electronic means in the electronic devices etc., excluding any fiat currency/ currencies (of Japan or otherwise) and assets denominated in any such fiat currency) which may be exchanged, as against unspecified person/ persons, with any such financial value as set out in paragraph (i) above and which may be transferred via electronic data processing system (the "**Type II VC**").

THIS IS FOR GENERAL INFORMATION purposes **only**. It does **not** constitute legal **advice** thus may **not** be relied upon regarding a specific legal issue or problem.

The Type I VC includes Bitcoin, Litecoin and other VCs which can be used as a payment method.

The Type II VC may include Ether and other VCs which cannot be used as a payment method at this moment but can be exchanged with Bitcoin. A token which can only be exchanged with Type II VC does not fall under the definition of the Type II VC.

Both definitions exclude an instrument which pegs to a fiat currency. Thus even if they use blockchain technology, a coin such as MUFG coin in Japan and Tether will not be regarded as VC.

1.3 Definition of Virtual Currency Exchange Business

The definitions of the VC Exchange Business is as follows:

Under the VC Act, the virtual currency exchange business (the “**VC Exchange Business**”) means any of the following acts carried out on a regular basis:

- (i) Sale and purchase of VC (i.e. exchange between VC and a fiat currency), or exchange of a VC into another VC;
- (ii) an intermediary, brokerage or agency service for the acts described in above (i); and
- (iii) management (custody) of a fiat currency or VC on behalf of the users/ recipient in relation to the acts described in above (i) and (ii).

Below are some examples of business which might be deemed as conducting VC Exchange Business

- (a) Exchange in which its users can sell and/or purchase VC from other users
- (b) Shop which sells and/or purchase VC
- (c) Operator of Bitcoin ATM
- (d) Operator of ICO (initial coin offering)
- (e) Brokerage firm which intermediates sales or purchase of VC

Below are some examples of business which does not fall under VC Exchange Business

- (a) Person who trades VC for its own investment purpose
- (b) Mining firm

THIS IS FOR GENERAL INFORMATION purposes **only**. It does **not** constitute legal **advice** thus may **not** be relied upon regarding a specific legal issue or problem.

- (c) Software developer
- (d) Wallet service provider who does not engage in VC sales/purchase

1.4 **VC Act in a nutshell - Regulatory Scope**

The Act requires operators of VC Exchange Business (the “**VC Exchange Business Operators**”) to get registered with the Japanese Financial Services Agency (the “**JFSA**”). VC Exchange Business Operators are under such duty, pursuant to the Act, as (i) customer identity verification, (ii) accountability to the customers, (iii) segregation of customers’ assets from the proprietary assets, (iv) bookkeeping, (v) compliance, (vi) internal audit, etc.

No person shall, without getting so registered with the JFSA, engage in the VC Exchange Business. Foreign exchange without the registration is also prohibited from conducting VC exchange business to Japanese residents.

1.5 **Regulator’s attitude is friendly to VC Exchange**

Japanese government wants to promote Fintech and new businesses. Rest assured generally speaking the VC businesses in Japan and JFSA are in good friendly terms.

The Act and the surrounding regulations have been set up after JFSA's series of discussions over the year with VC exchanges that were themselves starting up. The rules included are generally fairly reasonable (or they are by far the lenient rules than bitLicence in New York).

2. **Registration Overview**

2.1 **Transition period**

The Act avails certain interim measures for those VC Exchanges that started their business by no later than 31 March 2017 (before the Effective Date). Such early entrant VC Exchanges may continue their business for six (6) months from the Effective Date without the requisite registration. Further, such VC exchanges for which the application for registration has been made within the said six-month grace period may continue their business during the time such application is pending.

Once the grace period of 6 months (or otherwise) expires, doing VC Exchange Business without being registered is patently illegal.

THIS IS FOR GENERAL INFORMATION purposes **only**. It does **not** constitute legal **advice** thus may **not** be relied upon regarding a specific legal issue or problem.

2.2 Substantial work expected

The regulations on license and registration under VC Act generally are reasonable. Having said that the rules require some level of paperwork for that and subsequent continuous monitoring and control of observance thereof.

2.3 Registration of Foreign VC Exchange

Foreign VC exchange has two ways for its business to get registered in Japan i.e. offshore company itself gets registered or affiliate/ subsidiary located in Japan registered. To take the first way, VC Act requires the foreign VC exchange has a VC license in foreign jurisdictions. If it does not have it, the only possible way is to set up joint-stock company (*Kabushiki Kaisha*) in Japan.

2.4 Prohibition of Business Non-registered applies also to Foreign VC Exchanges

As written in item 1.4 above, VC Act prohibits VC exchange business operation in Japan without VC Exchange registration. Theoretically, an offshore VC exchange may transact with Japanese residents who voluntarily approach it without being solicited by it. However, the term "solicitation" in the context of "Internet," is broadly interpreted. If any offshore VC exchange does not intend to get registered in Japan, it is safer that such offshore exchange shut out all Japanese residents from transactions on its site.

2.5 Timeline

It is said to take three (3) to four (4) months from the start of the discussion with the regulator to file the official application for registration. The applicants are expected to hear from the regulator in a month or two.

3 Requirements

3.1 Minimum capital requirement and minimum financial status requirement

The Act requires VC Exchange has at least JPY 10 million capital and not in the state of insolvency (i.e. liability should not exceed asset plus capital).

From our experience, the capital amount (JPY 10Mln.) is never enough for the necessary setup. Even though the Act allows startup companies to enter into this market, such startups virtually need to be injected capital by way of certain

THIS IS FOR GENERAL INFORMATION purposes **only**. It does **not** constitute legal **advice** thus may **not** be relied upon regarding a specific legal issue or problem.

reliable/stable financing such as early-stage investment to avoid insolvency.

3.2 Attachment documents to be submitted with registration application:

- 3.2.1. Oath declaring that none of the Grounds for Refusal of Registration apply.
- 3.2.2. Directors' Certificate of Residence
- 3.2.3. Paper concerning use by director of original family name
- 3.2.4. Certificate that directors are under no adult guardianship and there is no pending bankruptcy of directors.
- 3.2.5. Directors' resume/ CV
- 3.2.6. Shareholders Register (top 20), Articles of Incorporation, Certificate of Registration,
- 3.2.7. For foreign VC Exchanges: Certificate of Registration in the country of incorporation
- 3.2.8. Latest Balance Sheet and Profit Loss Statement
- 3.2.9. For companies with Accounting Auditor: Report of Accounting Auditor
- 3.2.10. Prospect of profit and loss for three fiscal years from the startup
- 3.2.11. Description of VC to be dealt in
- 3.2.12. Organization Chart (describing department in charge of Internal Control function)
- 3.2.13. Resume/ CV of a person responsible for the management of VC Exchange Business
- 3.2.14. Internal Rules concerning VC Exchange Business
- 3.2.15. Contract forms for execution of VC Exchange Business
- 3.2.16. Outsourcing Agreement if any part of VC Exchange Business is being outsourced
- 3.2.17. Name of the designated Dispute Resolution Organization, if any, or complaint resolution /dispute resolution
- 3.2.18. Miscellaneous

With respect to the item 3.2.14, VC Exchanges are generally required to submit more than 20 rules and manuals.

3.3 Local director

The Act requires Foreign VC exchange which operates business thorough

THIS IS FOR GENERAL INFORMATION purposes **only**. It does **not** constitute legal **advice** thus may **not** be relied upon regarding a specific legal issue or problem.

Japanese branch to have a local representative who resides in Japan.

The Act is silent as regards Japanese VC exchange, but we understand that the regulator will require Japanese VC exchange has at least one director who resides in Japan.

3.4 Local compliance officer to be stationed in the office

A VC exchange would need to retain a compliance officer and an internal controller who understands Japanese laws (cf. alternatively both functions may well be served by one person single-handedly.)

3.5 Physical office requirement

JFSA requires a VC exchange to have a physical office, not just an office address in Japan.

3.6 Segregation of assets

The Act requires a VC exchange to segregate its assets from its users' assets. The VC exchange needs to deposit users' fiat currency in a bank account under its name that is different from the bank account it deposits its operating money. The VC Exchange must segregate its users' VC from its proprietary VC on the blockchain. The VC Exchange must ensure that each user's fiat currency/ VC is immediately identifiable.

3.7 Audit

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

3.8 Customer identity verification

A VC exchange is obliged under the Act on Prevention of Transfer of Criminal Proceeds to verify customer's identity before opening an account (Such authentication is primarily made by sending a restricted delivery mail to the customer.) and set up a robust internal control for anti-money laundering.

3.9 Accountability to users:

A VC exchange must provide adequate explanation to its users for user protection, e.g.;

THIS IS FOR GENERAL INFORMATION purposes **only**. It does **not** constitute legal **advice** thus may **not** be relied upon regarding a specific legal issue or problem.

- Unlike fiat currency, virtual currency is not guaranteed to be convertible to fiat currency
- Any user must be fully informed of its transaction, the handling fees charged, where it can file complaints
- Users must be provided receipts by the VC where they deposit money, etc. with the VC exchanges.

3.10 Information security

The VC exchanges must securely control their electronic information system so that their VC and records are protected against constant cyber attacks.

3.11 Protection of personal information

The VC exchanges must ensure the protection of personal information they obtained.

3.12 Sensitive information

Sensitive information, amongst others, must be securely controlled thus should be handled with extra care.

3.13 Outsourcing

Certain operations may be outsourced to other VC exchanges. Still, the responsibility remains with the principal thus the VC exchanges must retain authority to inspect and supervise such outsourced.

3.14 Bookkeeping

Each VC exchange must prepare books and keep the record regarding its business. It should also file the business report with JFSA.

4 Conclusion

The setup is not without pains as has been discussed above. However, The Act and the surrounding regulations have been set up after JFSA's series of discussions over the year with VC exchanges that were themselves starting up. The rules included are generally fairly reasonable

EOD