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

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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 or currencies (of Japan or otherwise) and assets denominated in any such fiat currency) that may be used to pay for the goods purchased or rent or the services received to/ as against unspecified person or persons therefor and which may in itself be purchased from and/or sold to the unspecified person or persons (the "**Type I VC**").

(ii) financial value (recorded by way of electronic means in the electronic devices

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etc. excluding any fiat currency or currencies (of Japan or otherwise) and assets denominated in any such fiat currency) that may be exchanged as against unspecified person or persons with any such financial value as set out in paragraph (i) above and that may be transported using an electronic data processing system (the "**Type II VC**").

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

The Type II VC may include the vast majority of altcoins, which cannot be used as a payment method at this moment but can be exchanged with Type I VC. A token that can only be exchanged with Type II VC will not fall under the definition of the Type II VC.

The definitions and their interpretation since December 2017 are the topmost focal points among the ICO token practitioners.

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

1.3 Definition of Virtual Currency Exchange Business

The definitions of the VC Exchange Business are 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 above (i);

and

- (iii) Management (custody) of a fiat currency or VC on behalf of the users/recipients in relation to the acts described above in (i) and (ii).

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

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

Below are some examples of businesses that do not fall under VC Exchange Business:

- (a) Person who trades VC for his or her own investment purposes
- (b) Mining firm
- (c) Software developer
- (d) Wallet service provider who does not engage in VC sales/purchases

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 to VC Exchange

Japanese government has long wanted to promote Fintech and new businesses. 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. Recently there seems to be a hardening of the attitudes of JFSA in operation of the VC Acts which is somewhat in line with, or presumably reflecting, the surge in price and the change in the global regulatory climate re ICO.

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1.6 No arbitrary power

Rest assured the law is clear what it takes to get registered as VC exchange business operators and JFSA has no arbitrary power groundlessly to refuse an application.

The regulatory environment in Japan is seen to be, and in fact is, a robust one and more entrepreneurs are swarming. Currently, there are sixteen licensees, and ninety more prospective applicants are said to have approached JFSA to apply next in a queue.

2 Registration Overview

2.1 Transition period

The Act availed certain interim measures for those VC Exchanges that started their business no later than 31 March 2017 (before the Effective Date). Since such grace period (of 6 months or otherwise) expired, unless the business operator applied for, and such application was officially received by JFSA on or before 30 September 2017, doing VC Exchange Business without being registered is patently illegal. Other early entrants must have filed with JFSA the Notification for Discontinuance of Services/ Business.

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 and subsequent continuous monitoring and control of observance thereof.

2.3 Registration of foreign VC exchange

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

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2.4 Prohibition of Business Non-registered also applies 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. Any offshore VC exchange that does not intend to get registered in Japan must effectively prevent all Japanese residents from transacting at its website.

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 this market, such startups virtually need to be injected capital by way of certain 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 have no pending bankruptcy.
- 3.2.5 Directors' resume/CV

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- 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 the 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 through Japanese branches 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 the Japanese VC exchange to have at least one director who resides in Japan.

3.4 Local compliance officer to be stationed in the office

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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 such VC exchange that accepts deposit (in fiat or VC) 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 into which 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 customers' 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.;

- 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,

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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 Procedure for Registration

4.1 Procedure Overview

Generally the registration process would proceed in the following order: (i) discussion with a lawyer, (ii) first meeting with the JFSA, (iii) preparation and submission of draft application documents including internal rules, (iv) comments are received from JFSA, applicants revise such drafts and submit them for further review and comment by the JFSA (the stage (iv) is repeated several times), (v) official submission

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of the application documents, (vi) further comments from JFSA are received and the application documents are revised accordingly, (vii) The application is officially accepted and registration is made.

4.2 First JFSA meeting

Amongst others, the JFSA requires an exchange to submit the below-listed information at the first meeting.

4.2.1 General Information about the Company

Names of shareholders, the names of directors, the expected number of staff, the expected organizational structure, the name of the accounting firm, the capital amount, the net assets, and the estimated income are required.

4.2.2 Intended Business

The kind of business that is contemplated to be conducted (such as Internet Exchange, OTC, ATM)

Whether there is a leveraged transaction

Names of virtual currencies to be handled

Whether the company will accept deposits of money/VC from users

Intended start time for exchange business

Nature of target users (such as individuals, institutional investors, Japanese residents, etc.)

4.2.3 Background of the Main Shareholder

Example background: "AAA Company is established in year BBBB, located in country CCC and operates DDD business. Net asset of AAA is EEE. The capital of AAA is EEE. AAA would like to set up a VC exchange because [reasons to be described]...."

4.2.4 Background of Directors and Important Officers

4.2.5 Information on the Virtual Currencies to be handled

Name of the virtual currency, unit, presence or absence of the trading market, supplying method, authentication method, usage, total supplied amount, market capitalization, max supply, current market price per unit, the existence of an issuer, risk related to such VC.

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5 Conclusion

The setup is not without pains as discussed above. However, the regulatory environment in Japan is seen to be, and in fact still is, a robust one, and more entrepreneurs are swarming. Currently, there are 16 licensees and 90 more prospective applicants said to have approached JFSA to apply next in queue.

The Act and the surrounding regulations have not been set up, except for JFSA's series of discussions over the year with VC exchanges that were starting up. For further development of VC, business self-regulation is being awaited across the globe where public vs. private discussion alone would foster such workable self-regulation in the industry.

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