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Cryptocurrency Regulatory Framework in Japan

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Introduction

Japan has one of the largest cryptocurrency markets in the world. It is the first country to enact a law regulating cryptocurrencies in the world. In Japan, cryptocurrencies are neither treated as money, nor are equated with fiat currency. However, bitcoin has been recognized as a legal tender in Japan. Japanese regulation requires an entity to register as a cryptoasset exchange provider ("**CAEP**") if it wishes to provide cryptoasset exchange services to Japanese residents. The object of this regulation is to:

1. protect customers of cryptoasset exchanges; and
2. prevent cryptoasset related terrorist financing and money laundering.

The need for this regulation can be connected with arguably crypto world's largest case, the Mt. Gox civil rehabilitation proceedings in February 2014, which was the world's largest cryptoasset exchange at that time providing convertible cryptoasset exchange services between cryptoassets and fiat currencies[1]. Although, the regulatory framework initially fuelled the growth of the Japanese crypto market, it started going south post January 2018 after one of the largest cryptoasset exchanges in the world reported missing cryptocurrencies of approximately USD 530 million due to a cyberattack on its network[2]. This attack started raising concerns regarding the existing regulatory framework, that along with the increasing use of cryptoassets for speculative reasons led to establishment of the Japan Virtual Currency Exchange Association (JVCEA) in April 2018 to strengthen local exchanges. JVCEA is a self-regulatory body that formulates self governance rules, assists its members in compliance with regulations, and addresses and communicated users' concerns.

In March 2018, to assess the efficiency and adequacy of the regulatory measures in dealing with cryptoasset exchange services, Financial Services Agency of Japan ("**FSA**") established a "Study Group on Virtual Currency Exchange Business". The study group published its report on December 21, 2018 proposing a new legal framework for dealing with cryptoassets which led to introduction of a bill for revision of certain legislation governing cryptoassets[3]. The bill mainly proposed amendments in the Payment Services Act, 2009 ("**PSA**") and the Financial Instruments and Exchange Act, 1948 ("**FIEA**"). These revisions came into the force on May 1, 2020.

The PSA revisions include:

1. revise the term "virtual currency" to "cryptoasset";
2. enhancement of regulation of cryptoasset custody services;
3. Tightening of regulations governing CAESPs, such as they are required to keep user funds with third party, preferably in "cold wallets", if user funds are kept in "hot wallets", the exchange is required to hold assets of a similar value.

The FIEA revisions include:

1. establish electronically recorded transferrable rights and regulations applicable thereto;
2. introduction of regulations governing cryptoasset derivative transactions;
3. introduction of regulations governing unfair acts in cryptoasset or cryptoasset derivative transactions.

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Regulation of exchanges

Cryptoasset definition

The term "cryptoasset" is defined in the PSA as:

1. proprietary value that may be used to pay an unspecified person the price of any goods purchased or borrowed or any services provided and which may be:
    1. sold to or purchased from an unspecified person (provided that recorded on electronic devices or other objects by electronic means excluding currency denominated assets (such as Japanese Yen or US Dollar); and
    2. that may be transferred using an electronic data processing system; or
2. proprietary value that may be exchanged reciprocally for proprietary value specified in the (i) with an unspecified person and that may be transferred using an electronic data processing system[4].

Cryptoasset exchange services provider (CAESP)

The PSA and Act on Prevention of Transfer of Criminal Proceeds ("**APTCP**") were intended to be the primary regulators of the cryptoasset exchange services. Article 2 of PSA defines exchange services as engagement in any of the following as a business[5]:

1. sale and purchase of cryptoasset or exchange of cryptoasset for other cryptoasset;
2. intermediary, brokerage, or delegation for the acts listed in (i) above; or
3. management of users' money in connection with the acts listed in (i) or (ii) above;
4. management of users' cryptoassets for the benefits of another person (custodian services).

The activities under (iv) point were added with the amendments in the PSA as the cryptoasset custody providers share common risks with the exchange providers and to address those risks management of cryptoasset for the benefits of other will amount to an exchange service.

The PSA requires any entity who is providing exchange services to be registered with the FSA and the local finance bureau[6]. Non registration of an exchange provider exposes the entity carrying such activities to criminal proceedings. Only a stock company or a foreign CAESP with a business office in Japan can apply for such registration[7]. Among other things, the applicants are also required to have:

1. a sufficient financial basis with a minimum capital amount of JPY10 million and net assets with a positive value;
2. a satisfactory organisational structure and systems to provide the exchange services appropriately and properly; and
3. certain systems to ensure compliance with the applicable laws and regulations.

The applicant is required to submit an application containing:

1. its trading name and address;
2. capital amount;
3. director's name and address;
4. the name of the cryptoassets to be handled;
5. contents and means of CAES;
6. name of outsourcee (if any) and its address; and
7. method of segregation management and other particulars[8].

The registration application must be accompanied by documents including:

1. a document pledging that there are no circumstances constituting grounds for refusal of registration;
2. extract of the certificate of residence of its directors, etc.;
3. a resume of the directors, etc.;
4. a list of shareholders;
5. financial documents;
6. documents containing particulars regarding the establishment of a system for ensuring the proper, secure provision/performance of CAES;
7. an organisational chart;
8. internal rules; and
9. a form of the contract to be entered into with users.

FSA requests applicants to fill approximately 400 questions checklist to confirm that the applicants have proper established systems to conduct exchange services. Moreover, FSA also prepares a detailed progress chart ensuing above. The registration process is a kind of due diligence by FSA. In substance, it is like issuing a license. After the registration is complete, the registry of the CAESP is made publicly available.

Regulatory obligations on the CAESPs

The exchange providers are required to take necessary measures for information security management[9], management of entrusted parties[10], customer protection[11], and management of users' property[12]. All the CAESPs are also obligated to establish the provision of an internal management system to make fair and appropriate responses to customer complaints and enforce measures to resolve any disputes through financial alternate disputes resolution proceedings[13].

For supervisory purposes, CAESPs are required to maintain books and documents on their services[14], various written reports accompanied by financial documents and a certified public accountant's or audit firm's audit report on such documents[15]. FSA also has the authority to order a CAESP to take necessary measures to improve its operations as necessary for supervision[16].

PSA Revisions

Virtual currency to cryptoasset: To align with the terminology used in international meetings such as in the G20 and to avoid confusion and make it easier for users to distinguish between crypto-assets and fiat currencies, the basic legal terminology was changed from "virtual currency" to "cryptoasset" when referring to digital assets.

Enhanced security: PSA revisions now require an in-depth investigation of the CAESP's security and compliance with global AML/CFT measures like the FATF's Recommendation 16.

Separation of users' funds: CAESP's are required to separate users' funds separately from its own funds and they are also required to use third-party operators (such as trust company or custodian service) to store users' assets as per the provisions of the new Cabinet Office

Ordinance. Moreover, the CAESP's are also required to store the entrusted cryptoassets in cold wallets (offline wallets), however, if it interferes in smooth functioning of their operations, they can keep them in the hot wallets, but then they will be obligated to hold "the same kind and the same quantities of cryptoassets" to repay their users if the hot wallet is compromised. There is another option as well to use other methods by taking technical safety management measures equivalent to a cold wallet. Although in that case, whether the measure are equivalent to a totally offline wallet will be identified on a case by case basis.

Stringent regulations for CAESPs: With PSA revisions, additional grounds on which a CAESP application can be rejected are introduced. There are also regulations for advertisement and solicitation of CAESP and further disclosure requirements for credit transactions.

FIEA Revisions

The Financial Instruments and Exchange Act, 1948 is deals with the issuance of securities and transactions related to other financial instruments in Japan. Recently with the FIEA revisions, the term "cryptoasset" has been included in the definition of "financial instruments" and other aspects of cryptoassets such as its prices and interest rates have been incorporated under the ambit of "financial indicators".

ERTRs and Tokenized securities

Broadly, securities under FIEA are classified as Paragraph 1 and Paragraph 2 securities. Paragraph 1 securities, among many others include financial instruments such as shares of capital stock companies, bonds, units of investment trusts, shares of investment corporations, warrants and commercial paper[17]. They are also called as liquid securities and are subject to relatively stringent requirements than the Paragraph 2 securities.

Paragraph 2 securities include beneficial interests of a trust (excluding units of investment trusts), interests in limited partnerships, limited liability partnerships and limited liability companies[18]. They are less liquid and are subject to lenient requirements as compared to Paragraph 1 securities.

As the securities transferred through electronic data processing units are even more liquid than the Paragraph 1 securities, the FIEA revisions introduced a fresh regulatory framework for securities transferred using electronic data processing systems called as electronically recorded transferrable rights ("**ERTR**s"). The concept of ERTR clarifies the scope of token governed by the FIEA.

Electronically Recorded Transferrable Rights: ERTRs are the rights set forth in Article 2, Paragraph 2 of the FIEA that are represented by the proprietary value transferrable by means of an electronic data processing system that are recorded in electronic devices or by electronic means excluding the rights specified in the relevant Cabinet Office Ordinance.
Under the FIEA revisions, the securities which are transferrable by electronic data processing systems are classified into three types:

1. **Tokenized Paragraph 1 Securities:** Securities under Paragraph 1 such as shares and bonds which are transferrable through electronic data processing systems;
2. **ERTRs:** Paragraph 2 securities such as contractual rights including trust beneficiary interests and collective investment scheme interests which are transferable by using electronic data processing systems;
3. **Non-ERTR Tokenized Paragraph 2 Securities:** Paragraph 2 securities such as contractual rights including trust beneficiary interests and interests in collective investment schemes, which are transferable by using electronic data processing systems. However, non-ERTR tokenized paragraph 2 securities are different than ERTRs in the sense that their negotiability is restricted to a certain extent.

The key purpose for the amendments in the FIEA was to make ERTRs subject to stringent requirements as are applicable for the Paragraph 1 securities.
In order for a right to constitute as ERTR, there has to be an electronic book entry of the transfer of the proprietary value and almost at the same time, the transfer of right should take place. Moreover, at the time of transfer, the intermediary or the party should be aware of the correct possession status of the seller.
After the revisions in the FIEA, (a) Tokenized Paragraph 1 Securities and (b) ERTRs are treated as Paragraph 1 securities, however, the rights under (c) Non-ERTR Tokenized Paragraph 2 Securities are treated as Paragraph 2 securities. Due to this, there is a substantial difference amongst their treatment in disclosure and licensing (registration) requirements.

Regulations for cryptoasset derivative transactions
The report dated December 21, 2018, issued by the study group which was established by FSA stated that cryptoasset derivative trading accounted for around 80% of all the crypto trades in Japan for the year 2017[19]. To put derivative transactions under the supervision of FIEA and subject them to certain regulations, “cryptoassets” were inserted under the definition of financial instruments under the FIEA revisions.
As cryptoassets will fall under the definition of financial instruments, cryptoasset derivate transactions will fall under the definition of Over the Counter Derivative Transactions[20].

Prohibition of “unfair acts”
The FIEA revisions introduced prohibitions against certain unfair acts with respect to cryptoasset spot transactions and cryptoasset derivative transaction (without limits as to the violating party) as crypto asset transactions were not subject to any prohibition or penalties with regards to unfair acts under the existing provisions of the FIEA or PSA.
The FIEA revisions contained prohibitions against:

- Wrongful acts;
- Fraudulence;
- Assault or intimidation;
- Dissemination of rumours;
- Market manipulation.

The prohibitions are intended to enhance user protection and prevent illicit gains. Although, due to issues with the identification of undisclosed material facts, insider trading is not regulated under the FIEA Revisions.

AML and KYC requirements

To prevent money laundering, terrorist financing and other nefarious uses of cryptocurrencies, APTCP requires specified business operators, including CAESPs registered with PSA and a Type 1 or Type 2 financial business operator under the FIEA to put in place KYC and other preventive measures. The regulated entities are required to:

- KYC – to record and verify the identity of customers;
- Recording and verification of transactions;
- Report suspicion transactions to the FSA;
- PEP monitoring;
- Other appropriate measures to ensure

Taxation

A very important issue with regards to cryptoassets in Japan has been its treatment concerning consumption tax. Earlier, sale of cryptoassets was subject to consumption tax to the extent that the office of the transferor was located in Japan. However, the same has been repealed in 2017 with amendments in Japanese tax laws[21].

The National Tax Agency of Japan repealed the inclusion of cryptoassets within the consumption tax regime and held that gains realised from the sale or use of cryptoassets will be treated as miscellaneous income, which means that taxpayers will not be permitted to utilise their losses elsewhere if they want to offset gains which they realised from the sale or use of crypto-assets. Moreover, inheritance tax will be imposed upon cryptoassets in the estate of a deceased person.

Conclusion

Japan has been at the forefront in regulating cryptoassets. With revision in PSA and FIEA, CAESPs now have stricter regulatory burden, though it is expected that this new regulatory framework will drastically enhance user protection. Also, this new framework is clearly sending a message that cryptoassets are here to stay.

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