Bill to Revise Regulations on Virtual Currencies (Crypto-Assets) and ICOs in Japan

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In brief

On March 15, 2019, the Financial Services Agency (the “FSA”) submitted to the 198th Session of the Diet a bill (the “Bill”) to amend, among others, the Payment Services Act (the “PSA”) in Japan. The Bill includes a change in terminology from ‘virtual currencies’ to ‘crypto-assets’, the development of regulations of crypto-asset exchange service providers (“CAESPs”), and the establishment of regulations for derivatives transactions using crypto-assets and ICOs (Initial Coin Offering). As social interest in crypto-assets and ICOs is growing, in this newsletter we will explain the content of the Bill relating to those two topics.

In addition, the “Study Group on Virtual Currency Exchange Services” (established by the FSA) published its report (the “Report”) on December 21, 2018, prior to the submission of the Bill. As the Bill conforms to the content proposed in the Report, we will explain the relevant content of the Report in this newsletter.

In detail

1. Terminology Change from “Virtual Currencies” to “Crypto-Assets”

The Report proposed renaming “virtual currencies” to “crypto-assets”. This is because (i) the term "crypto-assets" is being used in recent international discussions, and (ii) the term "virtual currencies" is likely to cause misunderstanding although, under the PSA, virtual currency exchange service providers (“VCESPs”) are obliged to explain to users the nature of the assets in order to prevent misidentification of virtual currencies as statutory currencies.

The Bill proposes changing the term from "virtual currencies" to "crypto-assets" in Article 2, paragraph 5 of the amended PSA. The terms "virtual currency exchange services" and "virtual currency exchange service providers" are also renamed "crypto-asset exchange services" and "crypto-asset exchange service providers" (Article 2, paragraphs 7 and 8 of the amended PSA). In this newsletter, we use the term "crypto-assets" in relation to the content of the Bill and use the term "virtual currencies" in relation to other matters.
2. Regulations for Exchanges and Management of Crypto-Assets

(1) Addressing Risk of Crypto-Assets Outflows

There were cases in which virtual currencies, which had been managed by VCESPs for users through hot wallets\(^1\), were leaked\(^2\). Consequently, the Bill newly imposes the following obligations on CAESPs (Articles 63-11 and 63-11-2 of the amended PSA). Details of these matters are delegated to the Cabinet Office Ordinance (the “COO”).

| (i) | To manage users’ crypto-assets using reliable methods (e.g. through cold wallets) except when necessary for the smooth execution of operations |
| (ii) | To maintain funds (the same type and amount of crypto-assets) for repayment of crypto-assets of users managed through hot wallets |

(2) Regulations on Excessive Advertising and Solicitation

In the Report, it was noted that, through advertisement by VCESPs, speculative transactions are encouraged in expectation of gains of virtual currencies, and that some users of such transactions are not sufficiently aware of the risks of virtual currencies. Therefore, with the aim of preventing misunderstanding of risks by users and facilitating speculative transactions, the Report suggested that excessive advertising and solicitation be prohibited (page 8 of the Report).

To this point, the Bill provides for regulations on advertising and solicitation by CAESPs, such as the prohibition of false representations and exaggerated advertisements and the prohibition of advertisements and solicitations that encourage speculation (Articles 63-9-2 and 63-9-3 of the amended PSA). Details of these matters are delegated to the COO.

(3) Regulations on Custody Services (Definition of Crypto-Asset Exchange Services)

The Report discussed services that do not sell, purchase, or exchange virtual currencies, but only manage virtual currencies and transfer virtual currencies to designated addresses based on users’ instructions (“Custody Services” or wallet services). It was noted that these Custody Services do not fall under the definition of “virtual currency exchange services” prior to the amendment of the PSA by the Bill because selling, purchasing, and exchanging virtual currencies are not involved\(^3\). However, it was also noted that these Custody Services should be required to be properly and reliably performed by establishing certain regulations as services related to settlement for the following reasons (page 14 of the Report).

- Custody Services share risks in common with the “virtual currency exchange services” (prior to the amendment by the Bill), such as the risk of outflow of users’ virtual currencies due to cyberattacks, the risk of VCESPs’ collapse, and the risk of money laundering and terrorist financing.

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\(^1\) To transfer (use) virtual currencies from a virtual currency address, a private key (multiple-digit alphanumeric) corresponding to the address is required. The software (wallet) which manages this private key and which is connected to an external network, is called a “hot wallet.” Key-management software which is not connected to an external network is called a “cold wallet” (page 3 of the Report).

\(^2\) Coin Check, Inc. managed secret keys using a hot wallet for the entire amount of virtual currencies (XEM) of their users. Virtual currencies with an equivalent value of approximately 58 billion yen outflowed due to unauthorised access in January 2018. Tech Bureau, Corp. managed secret keys using a hot wallet for many of virtual currencies (e.g., Bitcoin) of users. Virtual currencies with an equivalent value of approximately 7 billion yen (4.5 billion yen for virtual currencies of users) outflowed due to unauthorised access in September 2018 (page 4 of the Report).

\(^3\) The current definition of “virtual currency exchange services” as provided in Article 2, paragraph 7 of the current PSA includes “the management of virtual currencies of users in connection with the acts listed in the preceding two items [i.e., selling, purchasing, or exchanging of virtual currencies],” however, it does not include management of virtual currencies in a way that does not involve selling, purchasing, or exchanging of virtual currencies.
Since virtual currencies can easily be transferred cross-border via the Internet, it is important to take an internationally coordinated approach. In October 2018, the revised Recommendations of the Financial Action Task Force (FATF) were adopted to urge countries to impose restrictions on providers of Custody Services relating to money laundering and terrorist financing.

The Bill adds the management of crypto-assets (Custody Services) which are not related to selling, purchasing, or exchanging of crypto-asset to the definition of "crypto-asset exchange services" (Article 2, paragraph 7, subparagraph 4 of the amended PSA). Post-amendment, providers engaged only in Custody Services are also required to be registered as CAESPs, and they are required to develop internal control systems, implement segregated management, and address anti-money laundering. Details of these matters are delegated to the COO.

3. Measures to Ensure Proper Transactions Involving Crypto-Assets

(1) Addressing Problematic Crypto-Assets

Crypto-assets which are highly likely to be used for money laundering due to the closure of transfer records and the difficulty of tracing, and which are vulnerable to the maintenance and updating of transfer records, were discussed in the Report. However, it was noted that it is likely to be difficult to clearly identify virtual currencies with such problems in advance and address them through laws and regulations. Therefore, the Report suggested that it is important for administrative authorities and self-regulatory organizations to cooperate and implement flexible measures with respect to such virtual currencies (page 10 of the Report).

As such, the Bill stipulates that the authorities must be notified in advance of any changes to crypto-assets handled by CAESPs (Article 63-6, paragraph 1 of the amended PSA), and the authorities will cooperate with self-regulatory organizations in examining crypto-assets handled by CAESPs.

(2) Addressing Unfair Practices Using Crypto-Assets

There have been cases in which a person who obtained non-public information concerning the commencement of transactions of virtual currencies had benefited from the transaction of the new virtual currencies. In one case, a speculator group sold out a certain virtual currency after raising the price by designating a time and specific trading place and encouraging followers of social networking sites to purchase the virtual currency (page 11 of the Report).

In response to such cases, the Bill prohibits unfair practices such as rumour spreading and price manipulation regarding transactions of crypto-assets and crypto-asset-based derivatives (Article 185-22 to Article 185-24 of the Financial Instruments and Exchange Act (the "FIEA") after the amendment) and establishes penal provisions for such actions (Article 197, paragraph 1, subparagraph 6 and paragraph 2, subparagraph 2 of the amended FIEA). On the other hand, with regard to regulations on insider trading, it was pointed out in the Report that it is difficult to clearly stipulate acts that are necessary to be prohibited under laws and regulations (page 12 of the Report), thus, regulations have not been introduced.

(3) Addressing Bankruptcy Risk of CAESPs / Preferential Payment Regarding Rights to Return Entrusted Crypto-Assets

The Report noted that, although the legal nature of virtual currencies is unclear, from the viewpoint of facilitating the refund of entrusted virtual currencies to users in the event of a VCESP collapse, it would be an option that users are entitled to receive preferential payment from the VCESPs regarding the right to return entrusted virtual currencies (pages 6 of the Report). In addition, the Report highlighted the necessity of considering the relationship with other creditors when making the preferential payment. Thus, the objective property of the preferential payment should not be the total assets of the VCESPs, but (i) the entrusted crypto-assets of users, which would not normally be property available to creditors,
and (ii) the funds for repayment (the same type and amount of crypto-assets) required to be maintained for the users in order to mitigate the risk of the outflow of virtual currencies (page 7 of the Report).

The Bill requires CAESPs to manage users’ money separately from the CAESPs’ own money and to entrust users’ money to a trust company (Article 63-11 of the amended PSA). In addition, the Bill prescribes that users are entitled to receive preferential payment from the following crypto-assets regarding the right to return entrusted crypto-assets (Article 63-19-2 of the amended PSA). Details of the execution of preferential repayment are delegated to the Cabinet Order (the “CO”) (Article 63-19-2, paragraph 3 of the amended PSA).

<table>
<thead>
<tr>
<th>(i)</th>
<th>Crypto-assets managed by CAESPs separately from their own crypto-assets</th>
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<tr>
<td>(ii)</td>
<td>Funds (the same type and amount of crypto-assets) which are required to be maintained when CAESPs manage users’ crypto-assets through hot wallets (see 2.(1) above)</td>
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(1) Crypto-Asset-Based Derivatives

The Report pointed out that, while derivatives transactions with virtual currencies as underlying assets (“Virtual Currency-Based Derivatives”), such as margin transactions of virtual currencies, account for about 80% of all virtual currency transactions in Japan through VCESPs, the FSA has received a considerable number of consultations from users due to system deficiencies and uncertainties regarding the services of VCESPs. In addition, it was noted that Virtual Currency-Based Derivatives are not subject to financial regulations in Japan although many major countries have financial regulations related to such transactions (page 16 of the Report).

Under the Bill, the crypto-assets defined in Article 2, paragraph 5 of the amended PSA are included in "Financial Instruments", which is a definition of the underlying assets of derivatives transactions (Article 2, paragraph 24, subparagraph 3-2 of the amended FIEA). Likewise, derivatives transactions with crypto-assets as underlying assets (“Crypto-Assets-Based Derivatives”) are subject to regulations such as sales and solicitation regulations under the FIEA, as well as foreign exchange margin transactions (so-called ‘FX’ transactions). Therefore, CAESPs handling Crypto-Assets-Based Derivatives will be required to register as operators engaged in Type I Financial Instruments Business (“Type I FIB”), and the CAESPs will not be able to continue Crypto-Assets-Based Derivatives with customers without such registration. In addition, regulations on derivatives transactions under the FIEA, such as the prohibition of unsolicited solicitations and the loss-cut regulation, will be imposed in relation to Crypto-Assets-Based Derivatives.

The Report also noted that Virtual Currency-Based Derivatives have common problems with spot transactions of virtual currencies, such as risks of problematic virtual currencies and lack of user awareness of the characteristics of virtual currencies (page 17 of the Report).

To this point, the Bill imposes an obligation to explain business related to Crypto-Assets-Based Derivatives (Article 43-6 of the amended FIEA). Details of these matters are delegated to the COO.

(2) ICO (Initial Coin Offering)

Although there are no clear definitions of ICOs, an ICO is generally recognized as fund raising from investors of statutory currencies or virtual currencies by companies issuing electronic records/symbols called "Tokens". In addition, although there are various types of ICOs due to their high degree of freedom in structuring, it is possible to categorise ICOs into the following three types (page 19 of the Report).
While the Report acknowledged that with ICOs there are possibilities which existing means of financing do not provide, such as the ability to raise funds globally, the ability of small- and medium-sized enterprises to raise funds at low cost, and the ability to generate liquidity, there are the following problems related to ICOs (pages 19 of the Report).

| (i) The issuers have an obligation to distribute business earnings in the future (Investment Type) |
| (ii) The issuers have obligations other than that mentioned above, such as obligations to provide goods and/or services in the future (Other Obligation Type) |
| (iii) The issuers have no obligation (No Obligation Type) |

Under current laws, ICOs are subject to the regulations of the FIEA or the PSA depending on the structure of the ICO. If Tokens issued in an ICO fall under the definition of “virtual currencies” as provided in Article 2, paragraph 5 of the PSA, that ICO is subject to the regulations of the PSA. If purchasers of Tokens in an ICO expect the distribution of business profits from issuers (Investment Type) and the rights which Tokens represent (“Token Rights”) are purchased in statutory currencies, or are substantially deemed to be purchased in statutory currencies though Token Rights are actually purchased in virtual currencies, Token Rights fall under the definition of “Interest of Collective Investment Schemes” as provided in Article 2, paragraph 2, subparagraph 5 of the FIEA and thus are deemed to be “Securities” under the FIEA, and, therefore, that ICO is subject to the regulations of the FIEA (page 21 of the Report). On the other hand, under current laws, (a) if Tokens do not fall under the definition of “virtual currencies”, (b) if purchasers of Tokens do not expect the distribution of business profits from issuers (Other Obligation Type or No Obligation Type), or (c) if Token Rights are not purchased in statutory currencies actually and substantially, then that ICO is not necessarily subject to the regulations of the PSA or the FIEA (page 23 of the Report).

5 Interest of Collective Investment Schemes is defined as ‘among rights based on a partnership contract … or other rights …, rights for which the holders thereof (hereinafter referred to as an “Equity Investor” in this item) can receive dividend of profits arising from the business conducted by using money (including those specified by a Cabinet Order as being similar to money) invested or contributed by the Equity Investors (such business is hereinafter referred to as the “Invested Business” in this item) or distribution of the assets of the Invested Business’ and which does not fall under statutory exclusion. If an ICO is not categorised as Investment Type or if the Token Rights are purchased in virtual currencies (not in statutory currencies), there is doubt regarding whether or not the Token Rights fall under the definition of Interest of Collective Investment Schemes.
"Electronically Recorded Transfer Rights" and are included in "Paragraph 1 Securities" (Article 2, paragraph 3 of the amended FIEA). Therefore, in cases where Token Rights fall under the definitions of Interest of Collective Investment Schemes and Electronically Recorded Transfer Rights, those Token Rights are subject to the disclosure regulations of corporate affairs, as in the case of shares and corporate bonds, and trading of such Electronically Recorded Transfer Rights (the Token Rights) in the course of trade is subject to the regulations on Type I FIB. Details of these matters are delegated to the COO.

In addition, the Bill excludes Electronically Recorded Transfer Rights as provided in Article 2, paragraph 3 of the amended FIEA from the definition of "crypto-assets" under Article 2, subparagraph 5 of the amended PSA. Therefore, if Token Rights of Investment Type ICOs fall under the definition of Electronically Recorded Transfer Rights, those Token Rights will be subject to the regulations of the FIEA or the PSA after the amendment even though they fall under the current definition of "virtual currencies" under Article 2, subparagraph 5 of the current PSA. On the other hand, Electronically Recorded Transfer Rights of Other Obligation Type or No Obligation Type ICOs will continue to be subject to the regulations of the PSA if they fall under the definition of "crypto-assets" under Article 2, subparagraph 5 of the PSA.

5. Effective Date and Transitional Measures

The Bill will come into force as from the date (the “Effective Date”) specified by the CO within a period not exceeding one year from the date of promulgation (Article 1 of the Supplementary Provisions). In addition, for persons who only provide Custody Services for which registrations as crypto-asset exchange services are newly required, and for VCESPs who conduct Crypto-Assets-Based Derivatives for which registration as operators of Type I FIB are newly required, business may be continued until the date on which registration is accepted or refused by the FSA if such persons or VCESPs apply for the registration by the date on which six months have elapsed from the Effective Date (Article 2, paragraphs 2, 3, 10, paragraphs 1 and 2 of the Supplementary Provisions). However, due to criticism of the fact that business operators could continue business for a long period of time as transitional measures in relation to the former virtual currency exchange services, it is necessary to note that these transitional measures will not apply when one year and six months have elapsed from the date of the Effective Date (proviso to Article 2, paragraph 3 and Article 10, paragraph 2 of the Supplementary Provisions). Therefore, persons currently engaged only in Custody Services without registering as VCESPs, or VCESPs dealing in Crypto-Assets-Based Derivatives, will not be allowed to continue business unless the registration required by the amended law has been completed by the expiration of the transitional measures.

6. Closure

In this newsletter, we have explained the content of the Bill relating to crypto-assets and ICOs. However, under the Bill, only texts of the laws have been published and subordinate legislation such as that to be enacted by the COO have not been published at present. As many of the details of the new regulations of the amended PSA and FIEA are delegated to such subordinate legislation, it is necessary to analyse the details after subordinate legislation is published.

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6 If Token Rights of Investment Type ICOs fall under both of Interest of Collective Investment Schemes and Electronically Recorded Transfer Rights, such Token Rights are technically regarded as ‘deemed Securities’ under the relevant items of Article 2, paragraph 2 of the FIEA. Although ‘deemed Securities’ are, in general, excepted from what is subject to the disclosure regulations of corporate affairs and the regulations on Type I FIB, under the Bill, Electronically Recorded Transfer Rights are not included in such exception and are, therefore, subject to these regulations (Article 3, subparagraph 3, item (b) and Article 28, paragraph 1, subparagraph 1 of the amended FIEA).
Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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