JAPAN'S NEW CRYPTO REGULATION: 2019 AMENDMENTS TO PAYMENT SERVICES ACT AND FINANCIAL INSTRUMENTS AND EXCHANGE ACT OF JAPAN

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On May 31, 2019, the National Diet, the Japanese national legislature, passed an amendment bill to the Payment Services Act (the "PSA") and the Financial Instruments and Exchange Act (the "FIEA"), which was promulgated on June 7, 2019 (the "2019 Amendment"). The 2019 Amendment will become effective within one year from promulgation, following further rulemaking by the Japan Financial Services Agency (the "JFSA") to implement the 2019 Amendment, which is anticipated sometime soon and includes public comment process.

KEY TAKEAWAYS - WHAT DOES THIS MEAN TO CRYPTO INDUSTRY PARTICIPANTS?

The 2019 Amendment, coming into force within one year of the promulgation, will bring certain significant and fundamental changes to how crypto assets are regulated in Japan. Key takeaways from the 2019 Amendment include the following.

- Crypto asset margin trading and other crypto asset derivative transactions will become subject to Japanese regulations on derivative transactions generally. Broker-dealers and exchanges will likely need to revisit and update their registration status and policies and procedures. While it may be possible to rely on a limited grandfathering provision for six months after the "Effective Date," [1] a notification must be submitted to a relevant local Finance Bureau within two weeks after the Effective Date of the 2019 Amendment.
- Certain crypto assets distributed through distributed ledger technologies ("DLT") (such as blockchain) will be expressly regulated as Type I securities. Consequently, solicitation and offering of such crypto assets, including Initial Coin Offerings ("ICOs"), to Japanese investors will require careful review and structuring to avoid any regulatory pitfalls.
- Crypto asset-related custodial activities will be subject to licensing.
- Crypto asset trading activities will be subject to various prohibitions on unfair trading and practices.
- A detailed rulemaking process will follow and involve opportunities to submit comments during the public consultation process.

BACKGROUND LEADING TO THE 2019 AMENDMENT

In Japan, the first major regulatory development involving virtual currency and crypto assets took place in April 2017, when the registration requirement for virtual currency exchanges under the PSA and the KYC (verification of customers' identification) requirement under the Act on Prevention of Transfer of Profits from Criminal Activities (Japanese anti-money laundering law) were introduced.

However, in January 2018, a large virtual currency exchange was hacked and a significant amount of clients' virtual currencies under the exchange's custody were lost. This event led a program of on-site investigations by the JFSA. These investigations revealed that many exchanges' internal management and operational systems were insufficient. Separately, there were growing concerns that, while virtual currency in and of itself was not regulated, the value of virtual currency is highly volatile, and that virtual currencies had become a subject of speculation and investment, rather than a means of payment, and thus should be regulated as investment products. In this regard, the JFSA had previously issued a release on October 27, 2017 to alert the Japanese investment public that investments in ICOs can be highly volatile, that fraudulent activities may be involved in some of ICOs, and that engaging in ICOs, which can be viewed as the equivalent to investments by fiat currency, may be subject to the then existing regulations under the PSA or the FIEA. Further, new types of transactions, including the rapid growth of ICOs and virtual currency margin trading, have emerged, adding the needs for updating the regulatory framework in this space.

To better respond to these developments, in March 2018, the JFSA organized a special study group. In December 2018, the study group, after a series of meetings, published a report that included a number of important recommendations to reform crypto asset-related regulations (the "December 2018 Report"). Following the December 2018 Report, the 2019 Amendment was proposed and passed the National Diet.

2019 AMENDMENT

The 2019 Amendment includes certain significant and fundamental changes to the PSA and FIEA. Key changes under the 2019 Amendment are set out below:

Renaming from "virtual currency" to "crypto assets"

The PSA previously used the term "virtual currency" to refer to crypto currencies. Under the 2019 Amendment, the term "virtual currency" under the PSA is renamed as "crypto assets (*ango shisan*)" to use a more internationally accepted terminology.

Introduction of new regulations governing crypto asset margin trading and crypto asset derivative transactions generally

Currently, approximately a half of the registered crypto asset exchanges in Japan allow customers to engage in margin trading of crypto assets. JFSA views such trading as derivative transactions that reference crypto assets as underlying assets, and further expects that new types of derivative transactions may emerge and transaction volume may also increase. Under the current FIEA (before the 2019 Amendment), crypto currency derivative transactions were not subject to derivative regulations under the FIEA because crypto assets were not included in the definition of underlying assets to which the derivative regulations apply. The 2019 Amendment added crypto assets to the term "financial instruments" for the purposes of defining underlying assets of the derivative transactions subject to derivative regulations under the FIEA, and therefore the same regulations applicable to

other derivative transactions under the FIEA will apply to crypto asset derivative transactions. These regulations include certain conduct regulations, such as the notice requirement prior to trading, and prohibitions on making false statements, providing conclusive judgements, and engaging in uninvited solicitation.

For the purpose of "on-market derivative transaction" and "OTC derivative transactions," each of which requires settlement by "cash," the 2019 Amendment provides that crypto assets are deemed as "cash." As such, under the 2019 Amendment, the derivative regulations under the FIEA will apply to crypto derivative transactions including those to settle in crypto assets.

In addition, to ensure that a crypto asset exchange has the proper human resources and operational system to provide derivative transaction-related services in an appropriate manner, each crypto asset exchange applicant that intends to enable its customers to trade crypto asset derivatives will be required to describe such intention in its application so that the regulator may review the application in this regard. Similarly, a financial instruments broker-dealer will also be required to state its intention to deal with crypto asset derivatives in its broker-dealer registration application, or if it is already registered, notify the regulator of such intention.

Under the 2019 Amendment, broker-dealers will also be required to disclose to customers the nature of crypto assets in a manner to be specified by the JFSA's further rulemaking. Broker-dealers will also be prohibited from making misleading representations when soliciting crypto asset derivative transactions. Further, it is expected that certain minimum margin requirements will be introduced by the JFSA's rulemaking to protect retail customers from risks associated with speculative trading.

New ICO regulations

Under the 2019 Amendment, ICO-related activities will expressly be regulated under the FIEA, Japan's securities law. The 2019 Amendment introduced a new category of securities, "electronic recording transfer rights (*denshi kiroku iten kenri*)," intended to capture the rights (representing so-called "Type II Securities" [2]) recorded or transferred through DLT. Given the possibility of wide distribution enabled by DLT, "electronic recording transfer rights" themselves are classified as so-called "Type I Securities."

That said, unless exempted or structured as a private placement, going forward, offering of ICOs to investors in Japan will likely be subject to the registration requirement and extensive continuous public disclosure requirement under the FIEA, details of which will be determined through the JFSA's rulemaking process.

Furthermore, to engage in brokerage activities for electronic recoding transfer rights, a broker-dealer will need to be registered as a Type I financial instrument broker-dealer. JFSA officials, however, noted that the agency may consider introducing exemptions from this requirement through the agency's rulemaking for certain rights that are recorded or transferred through DLT, but that are not to be widely distributed.

For an ICO offered on a self-solicitation basis (*jiko boshu*) that issues "electronic recording transfer rights" and is structured as "collective investment scheme" (e.g., a limited partnership interest), an exemption for brokerage licensing under Article 63 may be available. Generally, offering of a "collective investment scheme" on a self-solicitation basis (*jiko boshu*) requires Type II financial instruments broker-dealer registration. However, an exemption is available if the offering satisfies requirements under Article 63 of the FIEA, including submission of a short-form notification with a local Finance Bureau. While the 2019 Amendment does not change the Article 63 framework, it expanded the scope of "collective investment scheme" by including "collective investment scheme' interests acquired through contribution of crypto assets. To that end, an ICO in the form of "collective investment

scheme" may rely on the exemption under Article 63, regardless of whether investors invest cash or crypto assets.

Custody business

With respect to the custody of crypto assets, holding electronic recording transfer rights on behalf of clients for trading purposes falls under the custody business (*yuka shoken tou kanri gyomu*), which requires Type I financial instrument broker-dealer registration under the FIEA.

Further, the 2019 Amendment expanded the scope of crypto asset exchange business under the PSA to include holding crypto assets on behalf of clients, and requires crypto asset custodians to register as a crypto currency exchange.

Prohibitions on unfair trading practices

The 2019 Amendment created a new chapter in the FIEA that prohibits various unfair trading practices involving crypto asset-related transactions and crypto asset derivative transactions. Prohibited practices include manipulative trading activities that generally follow the same categories of prohibited trading practices applicable to trading of other securities. Notably, the 2019 Amendment did not include an insider trading-like prohibition because, JFSA officials noted that, given the difficulty of identifying the issuer of a crypto asset, and that it is not yet clear what causes fluctuations in pricing of crypto assets, it is difficult to identify the type of information that is material for the investment decision of investors at this stage.

GRANDFATHERING

As noted above, the 2019 Amendment will come into effect within one year of the promulgation (i.e., by June 7, 2020) (Effective Date). [3] The 2019 Amendment provides a grandfathering provision for market participants already engaged in a business related to crypto assets that will require licensing under the 2019 Amendment. However, the grandfathering is limited to the activities and the types of products with which one in fact engages and deals as of the Effective Date, and is limited to the six months after the Effective Date. Market participants who intend to rely on the grandfathering provision must notify the regulator within two weeks from the Effective Date and complete registration within one and a half years, or they will be prohibited from continuing the grandfathered business.

CONCLUSION AND NEXT STEPS

As described above, the 2019 Amendment introduces a significantly different regulatory landscape for Japan's crypto asset industry and ICO market. More specifically, with respect to ICOs, offering/placement agent services will require involvement of a Type I financial instruments broker-dealer, while self-offering or self-solicitation of crypto assets may require Type II financial instruments broker-dealer registration, unless an exception or exemption is available. Consequently, crypto asset-related offering and ICOs involving investors in Japan will require more careful structuring and planning to avoid any regulatory pitfalls.

The JFSA is expected to propose implementing regulations of the 2019 Amendment soon. The implementing regulations will provide more details of the new regulatory landscape and the JFSA's expectations of industry participants. In addition, JFSA's rulemaking process will provide interested parties an opportunity to comment on the proposed regulations, thereby potentially influencing how the 2019 Amendment is implemented.

We also expect that certain developments outside of the JSFA's rulemaking process will impact Japan's crypto asset industry. For example, the December 2018 Report recommended restriction of offering an ICO to nonqualified institutional investors, which is similar to the restriction for unlisted stocks. We expect that this issue will likely be addressed through rulemaking by a self-regulatory organization, rather than the FIEA or regulations thereunder. As such, we expect further developments and opportunities involving Japan's new crypto regulations in the near future that should be closely monitored by interested parties.

NOTES

[1] The 2019 Amendment will come into effect within one year of the promulgation (i.e., by June 7, 2020) (the "Effective Date").

[2] "Type I Securities" are securities of liquid nature such as stocks and bonds; "Type II Securities" are certain rights of illiquid nature that are deemed to be securities for the FIEA purposes. Most notably, Type II Securities include a so-called "collective investment scheme," which is essentially interest of a partnership type fund. §2(1)(2) of the FIEA.

[3] If an application for license is filed within the six month period, the grandfathering period will be extended until completion or rejection of such application, provided that such extended period cannot be longer than one and a half year after the Effective Date of the 2019 Amendment.

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