

Cryptocurrencies as a Challenge for Securities Regulation?: Japan

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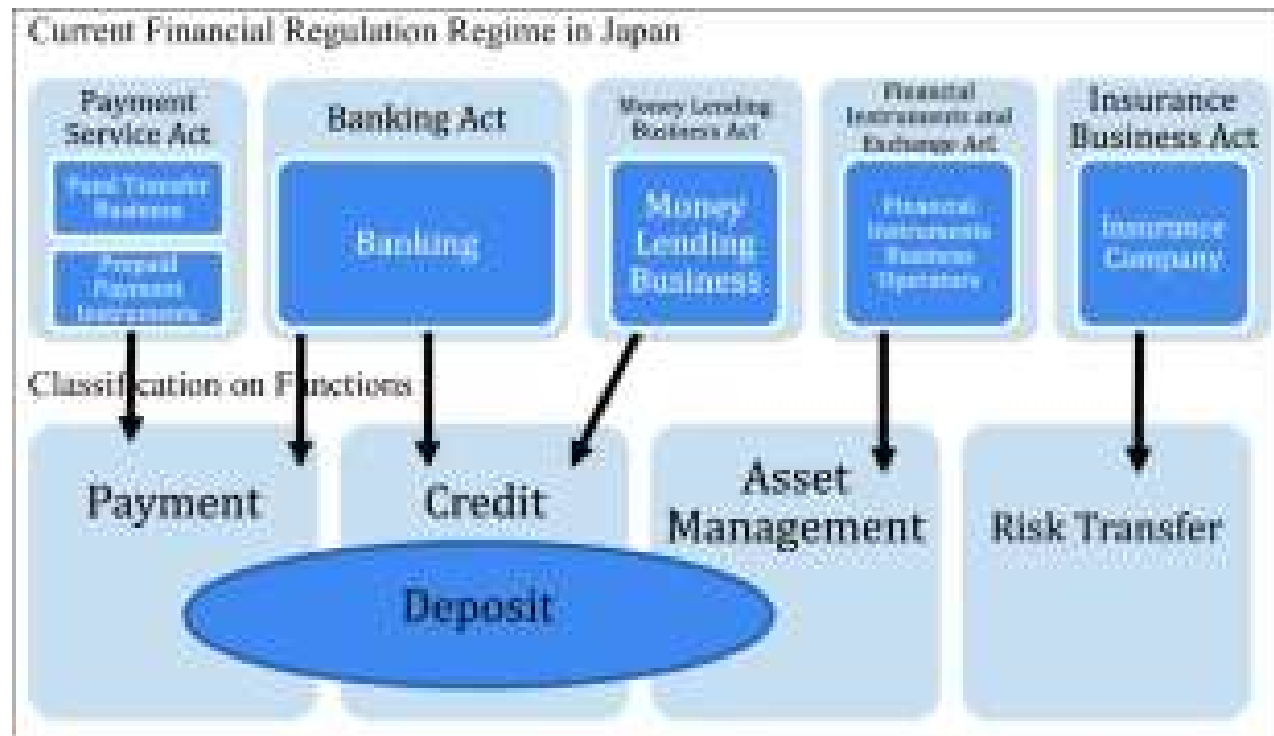
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Structure of Financial Regulation in Japan

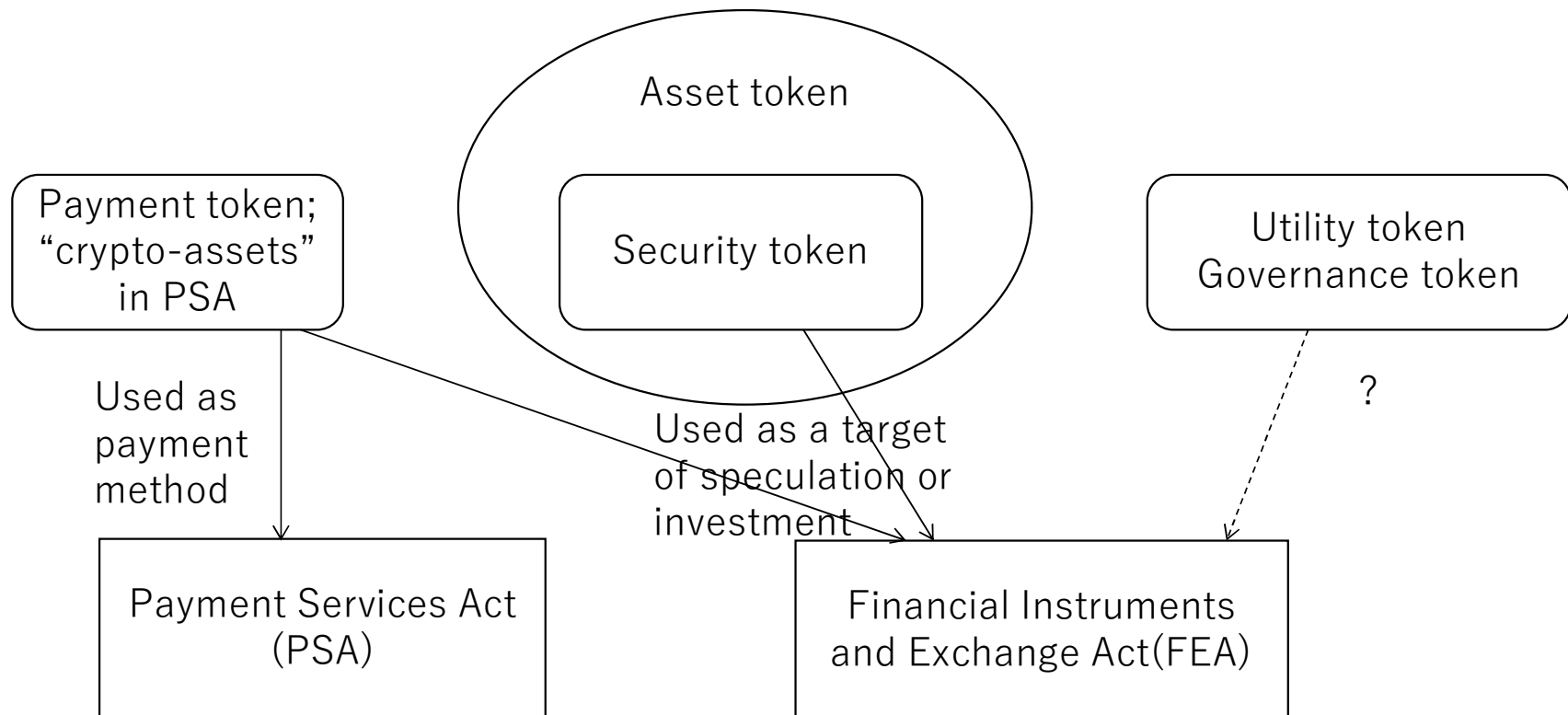


Akira Tokutsu, "The 'Independence Day' of Payments Law? Fintech's Impact on Financial Regulation in Japan" in Mark Fenwick et al. ed., "Regulating FinTech in Asia" (Springer, 2020)

History of regulation on cryptocurrencies in Japan

- 2014 Collapse of Mt.Gox
- 2015 FATF guidance
- 2016 Amendments to Payment Services Act (PSA)
 - Regulations on “virtual currency exchange services”
- 2019 Amendments to PSA
 - Improved regulation on “crypto-assets exchange services” (former “virtual currency exchange services”)Amendments to Financial Instruments and Exchange Act (FEA)
 - Regulations on ① crypto-assets derivatives, ② ICO, and ③ unfair transactions of crypto-assets
- 2022 Amendments to PSA
 - Regulations on stable coins (“electronic payment method”)

Regulation on cryptocurrency according to its function

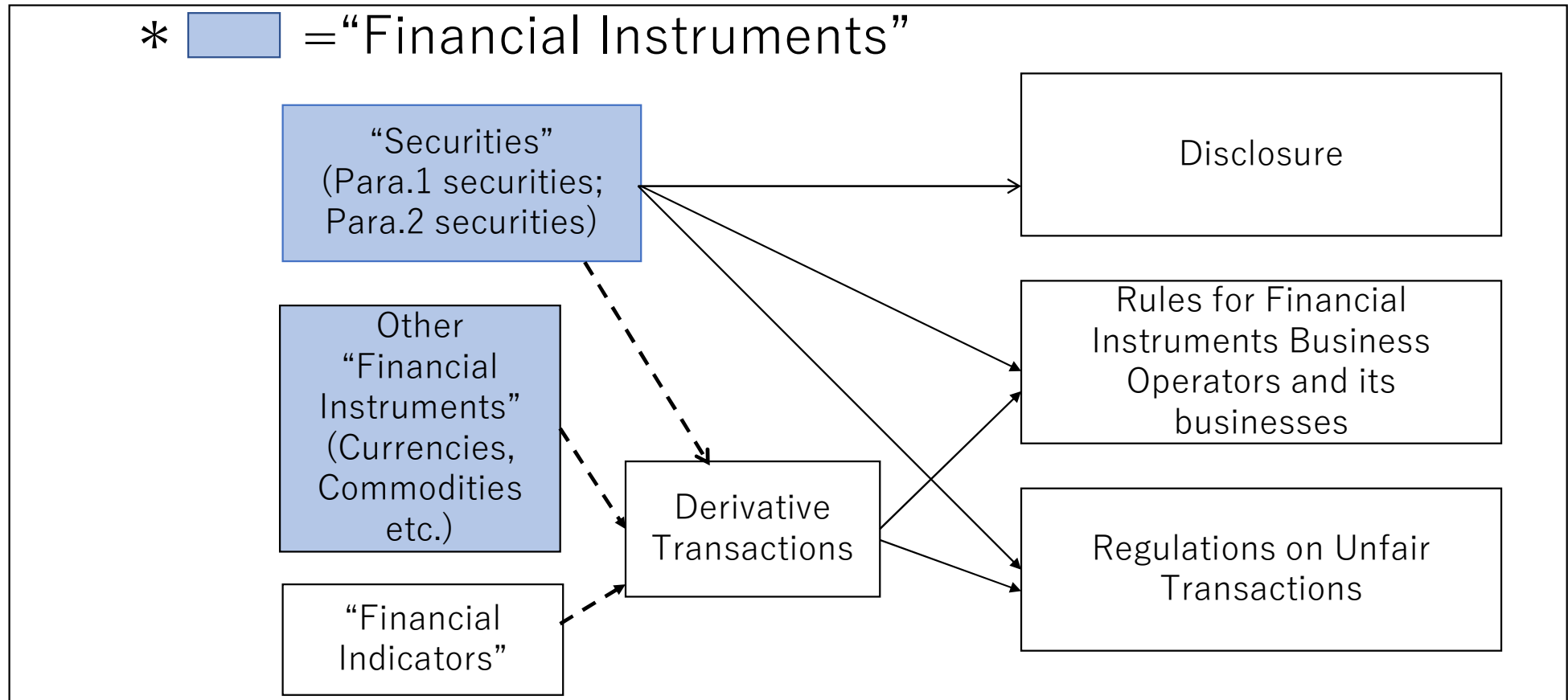


“Crypto-assets” in PSA Art. 2 para.14 (after 2022 amendments)

- i. property value (limited to that which is recorded on an electronic device or any other object by electronic means, and excluding the Japanese currency, foreign currencies, currency-denominated assets and electronic payment method (excluding those falling under currency-denominated assets); the same applies in the following item) which can be used in relation to unspecified persons for the purpose of paying consideration for the purchase or leasing of goods or the receipt of provision of services and can also be purchased from and sold to unspecified persons acting as counterparties, and which can be transferred by means of an electronic data processing system
- ii. property value which can be mutually exchanged with what is set forth in the preceding item with unspecified persons acting as counterparties, and which can be transferred by means of an electronic data processing system

* Security tokens (“Electronically Recorded Transferable Rights” in FEA) are excluded from “Crypto-assets”

Structure of FEA (before 2019)



“Securities” in FEA

- “Para. 1 securities”; “securities” in its origin
 - listed in FEA Art.2 para.1
 - ex. Share certificates, bond certificates
 - paper-based certificates on which rights are indicated (Cf. “Wertpapier” in German Law)
 - high transferability and tradability → high-level disclosure requirement and strict rules for financial instruments business operators
 - * rights indicated in para.1. securities are also deemed to be para.1 securities even if they are paperless
- “Para. 2 securities”
 - listed in FEA Art.2 para. 2 item 1~7
 - ex. Beneficial interests in trusts, membership rights in LLC etc., membership rights in ‘collective investment schemes’
 - deemed to be “securities”, but low transferability and tradability → lower-level disclosure requirement and relatively lax rules for financial instruments business operators

Collective investment schemes (FEA Art.2 para.2 item 5)

- ① The rights in a partnership, a silent partnership (“stille Gesellschaft”), a LP, a LLP etc., and other rights *catch-all provision
- ② The holder can receive dividends of profits arising from business that is conducted using the invested or contributed by the equity holder or a distribution of the assets of the invested business
- ③ Exemption from collective investment schemes;
 - (a) rights of an equity holder in cases specified as those in which all of the equity holders participate in the invested business
 - (b) rights of an equity holder, if it is provided that equity holders will not receive dividends of profits or a distribution of the assets of the invested business in an amount exceeding the amount invested or contributed by themetc.

Security token in FEA

- Tokenization can render rights more transferability and tradability
 - 3 categories of security token and the application of FEA
 - ① tokenized “Para. 1 securities” (ex. tokenized shares, tokenized bonds)
 - ⇒ regulations applicable to Para. 1 securities apply
 - ② tokenized “Para. 2 securities” (ex. tokenized partnership rights) ; “electronically recorded transferable records” (“ERTR”)
 - ⇒ regulations applicable to Para. 1 securities apply
 - ③ tokenized “Para. 2 securities” excluded from “ERTR”
 - ⇒ regulations applicable to Para. 2 securities apply
- * Additional regulations apply to “Electronically Recorded Transferable Rights to Be Indicated on Securities, etc.” (①~③) due to its characteristics as security tokens

Definition of “ERTR”

- the rights set forth in the items of [Art.2 para.2] (but only if they are indicated as a financial value (limited to one that is recorded on an electronic device or any other such object by electronic means) which can be transferred by using an electronic data processing system (excluding the cases that are specified by Cabinet Office Order in consideration of transferability and other circumstances)

Transferability of security token

- If it is ensured that the security token has low transferability, such a token is excluded from the ERTR → ③
 - technical measures to make it impossible to transfer the token to persons other than professional investors (Qualified Investors)
 - technical measures to make it impossible to transfer the token without the holder's offer and the issuer's acceptance
- What is "tokenization"? → interpreted according to whether it is likely to be distributed to a large number of investors
 - a. The transfer of the token and the transfer of rights must be carried out as a series of events
 - b. The parties to the transaction or the intermediary are in a position to know whether the seller has rights, such as having access to records

Does utility token fall on “ERTR”?

- Utility token as “ERTR”? → Utility tokens constitute rights in collective investment schemes in Japan?
- Utility token holders can receive “dividends of profits” or “distribution of assets”?
 - Utility token holders can receive gains from increase in value of the token, but such capital gains do not constitute “dividends of profits” in Japan → regulatory “vacuum” in utility token

Cf. Howey test about ‘investment contracts’ in US and utility token

① An investment of money, ② in a common enterprise, ③ with the expectation of profit, ④ to be derived from the efforts of others

→ expectation of capital gains can constitute expectation of profit

(③)

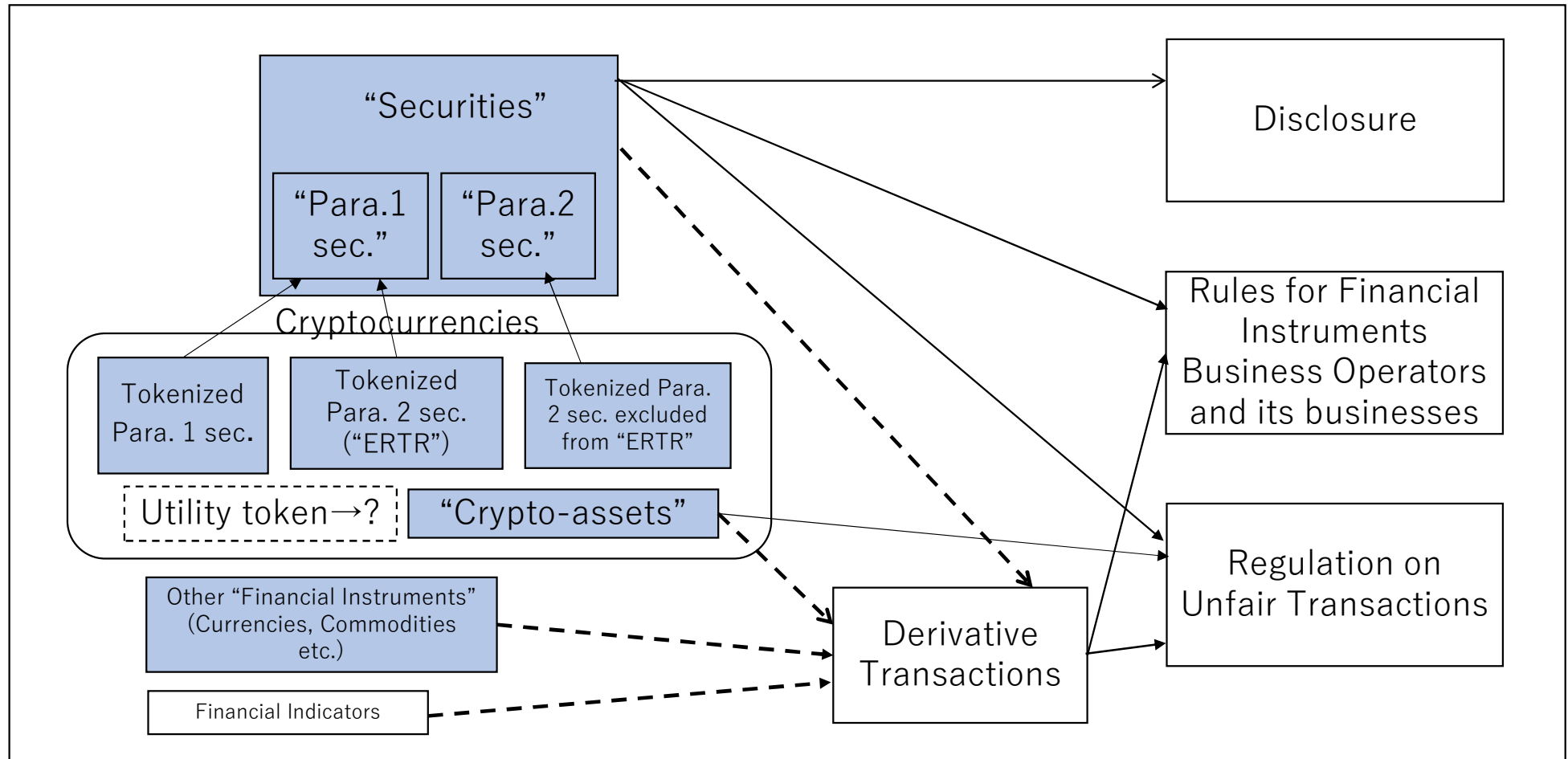
Regulations to crypto-assets derivatives

- “Crypto-assets” under the FSA were included as one of the “financial instruments” under the FEA→the same regulations as other financial instrument derivatives
- Registration as a Type 1 Financial Instrument Business operator is required to offer OTC crypto-assets derivative products
- Regulation on advertising, solicitation etc.
 - * Additional statements are required to crypto-assets derivative advertising in light of the novelty and complexity of crypto-asset derivatives
- Regulations on unfair transactions

Regulations on unfair transactions of cryptocurrencies in FEA

- Security tokens deemed as “securities” in FEA and crypto-asset derivatives are subject to the same regulations on unfair transactions as other securities or derivatives
- Regulations on unfair transactions of cryptoassets were introduced (prohibition on wrongful acts, such as false representation; prohibition on spreading rumors etc.; prohibition on market manipulation)
 - * No regulation on insider trading
- For securities or other derivatives, the need to promote their markets by forming fair market rules is widely recognized. How about crypto-assets as a target of speculation?

Structure of FEA (after 2019)



Disclosure regulation to security token

- Tokenized “para. 1 securities” and “ERTR”
 - same disclosure regulations as para.1 securities apply
 - ex. prospectus and securities registration statement required as securities offering disclosure
 - * In order for private offering exemption from disclosure requirements to be applied, technical measures are required to make it impossible ① to transfer the token to persons other than professional investors (Qualified Investors) and ② to solicit persons more than 50 people
 - * additional disclosure requirement of information on technology or platform used for tokenization, provider of the technology or platform, matters relating to the management of tokens and the risk of being stolen
 - ⇒ A far higher level of disclosure is required than the former practice of white papers.
- Tokenized “para. 2 securities” → same disclosure regulations as para.2 securities apply

Regulation to Financial Instruments Business Operators and its security token businesses

- Tokenized “para. 1 securities” and “ERTR” → registration as “Type 1 Financial Instrument Business” operator is required
- Tokenized “para. 2 securities” excluded from “ERTR” → registration as Type 1 or Type 2 Financial Instrument Business operator is required
- * Special Provisions on Electronic Public Offering Services → simplified regulations on crowdfunding via internet

Regulation to Financial Instruments Business Operators and its security token businesses

- Same regulation on advertising and solicitation etc. as securities
- Additional statements are required to security token (“Electronically Recorded Transferable Rights to Be Indicated on Securities, etc.”) advertising in light of its specific risks
 - ① Expanded business regulations and supervisory guidelines apply, such as additional descriptions in the pre-contractual documentation, as there may be different risks than for other securities with regard to the holding, transfer and settlement of the security token
 - ② Security Management services operators are required segregation of security tokens using “cold wallets”

Future of (securities) regulations on cryptocurrencies?

- Japan has developed a set of securities regulations for cryptocurrencies, but the ICO boom has gone down and there are few examples in Japan → the future of securities regulation on cryptocurrencies is unclear
- How to address “regulatory vacuum” in utility token or governance token
- Accounting and tax of securities token
 - Accounting Standards Board of Japan is now discussing accounting for the issuance and holdings of ICO tokens.
 - * Should ICO tokens allocated by its issuer to itself be recognized as “assets”? Should they be measured at fair value or at cost?