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Development of Legal Framework for Virtual Currencies in Japan - Bill Submitted to the Diet

Takashi Nakazaki / Ken Kawai

On March 4, 2016, the first bill regarding virtual currencies (cryptocurrencies) was submitted to the Diet in Japan. This bill provides definitions of Virtual Currency and Virtual Currency Exchange Services, and requires registration of Virtual Currency Exchange Services. The bill also sets forth the regulations regarding the business of Virtual Currency Exchange Service Providers, supervision over them. In addition, the bill imposes certain obligations (including customer identification obligations) by designating Virtual Currency Exchange Service Providers as “specified business operator” within the meaning of the Act on Prevention of Transfer of Criminal Proceeds.

I. Circumstances leading to the submission of the bill

In Japan, the legal position of bitcoin and other virtual currencies (cryptocurrencies) was not entirely clear and there were no acts regulating them. However, as the world becomes more aware of risk of virtual currencies being used for money laundering or terrorist financing, in June, 2015, following the Leaders’ Declaration at the G7 Elmau Summit, the Financial Action Task Force (FATF) published the guidance that should require any virtual currency exchange to be registered and/or licensed, and to comply with regulations on money laundering and terrorist financing, including customer identification obligations. In the meanwhile, since the collapse of a leading bitcoin exchange in Japan led to circumstances where the funds and bitcoins of the customers were not returned, there was an increased need to protect users. In light of these circumstances, on March 4, 2016, after discussion in the meetings of “Working Group on Advanced Payment Services” of the Financial System Council, the bill to amend the Payment Services Act and the Act on Prevention of Transfer of Criminal Proceeds in order for regulating virtual currencies was submitted to the Diet. This Act will come into force as from the date specified by the Cabinet Order within a period not exceeding one year from the day of promulgation. Certain transitional measures are also to be specified by the Cabinet Order.

As explained above, this bill is mainly intended to impose certain regulations on virtual currency exchange services with the primary aim to forestall money laundering and terrorist financing and protect users, but not to comprehensively develop the legal framework for virtual currencies. For example, this bill does not cover the treatment of consumption tax on virtual currency transactions. It should also be noted that the bill does not, as reported by some media, proactively define virtual currency as “currency.”

II. Contents of the Proposed Amendments to the Payment Services Act regarding Virtual Currency

1. Definition of Virtual Currency

The term “Virtual Currency” is defined as:

- (i) proprietary value that may be used to pay an unspecified person the price of any goods purchased or borrowed or any services provided and may be sold to or purchased from an unspecified person (limited to that recorded on electronic or other devices by electronic means and excluding Japanese and other foreign currencies and currency denominated assets; the same applies in the following item) and that may be transferred using an electronic data processing system; or
- (ii) proprietary value that may be exchanged reciprocally for proprietary value specified in the preceding item with an unspecified person and that may be transferred using an electronic data processing system.

In short, “Virtual Currency” means (i) “proprietary value” electronically recorded that does not fall within the scope of “currencies” or “currency denominated assets”¹ and that can be used to settle payments for goods and/or services and be sold and purchased between unspecified persons, and can also be transferred using an electronic data processing system; or (ii) “proprietary value” that can be exchanged with another “Virtual Currency” and can also be transferred using an electronic data processing system. The important point with such definition is that it can be used to settle payments, sold and purchased, and exchanged between unspecified persons. As a consequence, if the scope of the use thereof is limited, the issue of whether or not it meets this definition may be likely to arise.

2. Introduction of registration system for Virtual Currency Exchange Services

(1) Virtual Currency Exchange Services

The term “Virtual Currency Exchange Services” means any of the following acts carried out as a business:

- (i) sale/purchase of Virtual Currency or exchange for other Virtual Currency;
- (ii) intermediary, agency or delegation for the acts listed in (i) above;² or
- (iii) management of users’ money or Virtual Currency in connection with its acts listed in (i) and (ii).

¹ The term “currency denominated assets” means any assets which are denominated in Japanese or other foreign currency, or with respect to which the performance of obligations, refund or any other equivalent act is to be implemented in Japanese or foreign currency.

² (i) and (ii) are collectively referred to as “exchange, etc. of Virtual Currency.”

The point with (i) is that the Virtual Currency Exchange Services cover not only sale/purchase of Virtual Currency in exchange for the Japanese or foreign currency but also exchange for other Virtual Currency. Pursuant to (ii), any acts that do not involve sale, purchase or exchange of Virtual Currency but do involve intermediary, agency or delegation therefor as a business are deemed as “Virtual Currency Exchange Services.” For example, if a person who does not run a Virtual Currency exchange solicits users to purchase Virtual Currency as a broker, such solicitation will be deemed as providing Virtual Currency Exchange Services. In addition, pursuant to (iii), the provision of Virtual Currency management services will be deemed as “Virtual Currency Exchange Services.” However, since the limitation (“in connection with its exchange, etc. of Virtual Currency”) is added, the provision of e-wallet services without involving exchange, etc. of Virtual Currency could be interpreted as not falling within the scope of “Virtual Currency Exchange Services.”

(2) Registration of Virtual Currency Exchange Services

In order to engage in Virtual Currency Exchange Services, a person must be registered with the Prime Minister (a person so registered will be referred to as a “Virtual Currency Exchange Service Provider”). A “Foreign Virtual Currency Exchange Service Provider”³ also must obtain the afore-mentioned registration. A foreign Virtual Currency Exchange Service Provider who does not obtain such registration is prohibited from making solicitations listed in items (i) through (iii) of (1) above to a person in Japan.

A person who intends to obtain registration must submit a registration application containing the name(s) of Virtual Currency(ies) to be handled, contents and means of virtual Currency Exchange Services, and other particulars. Such registration application must be accompanied by documents, including a document pledging that there are no circumstances constituting grounds for refusal of registration, financial documents and the documents containing particulars regarding the establishment of a system for ensuring the proper and secure provision/performance of Virtual Currency Exchange Services. With respect to registered providers, “the registry of Virtual Currency Exchange Service Providers” will be publicly made available.

The bill provides a list of grounds for refusal of registration. For example, a registration application is refused if the applicant:

- is not a stock company established under the laws of Japan or a Foreign Virtual Currency Exchange Service Provider (limited to a foreign company that has an office in Japan);
- in the case of a Foreign Virtual Currency Exchange Service Provider, is a corporation that does not have a representative person in Japan (who is domiciled in Japan);
- is a corporation lacking a sufficient financial basis necessary for the proper and secure provision/performance of Virtual Currency Exchange Services that conforms with certain criteria specified by the Cabinet Office Ordinance;
- is a corporation that has not established a system necessary for the proper and secure provision/performance of Virtual Currency Exchange Services; or

³ A person who engages in virtual currency exchange services with the registration, license, etc. —equivalent to the registration in Japan — that has been obtained pursuant to the applicable laws and regulations in a foreign country.

- is a corporation that has not established a system necessary for ensuring compliance with the provisions regarding Virtual Currency.

3. Regulations on the business of Virtual Currency Exchange Service Providers

Major regulations on the business of Virtual Currency Exchange Service Providers are as follows (details to be provided in the Cabinet Office Ordinance).

- A Virtual Currency Exchange Service Provider must take measures necessary to ensure the safe management of information.
- A Virtual Currency Exchange Service Provider must provide information to users and otherwise protect users, and take measures necessary for the proper and secure provision/performance of its services.
- A Virtual Currency Exchange Service Provider must segregate users' property from its own property, and regularly undergo an audit of the status of such segregated management by a public certified accountant or audit firm.
- In the event of any dispute with customers, a Virtual Currency Exchange Service Provider needs, in principle, to seek a resolution to such dispute through financial ADR proceedings.

4. Supervision over Virtual Currency Exchange Service Providers

Provisions for supervision (such as preparation of books, documents and reports, submission of such reports accompanied by a certified public accountant's or audit firm's audit report, on-site inspection, orders to improve business operations, etc.) are newly established for Virtual Currency Exchange Service Providers. Major provisions are as follows:

<Obligations of Virtual Currency Exchange Service Providers>

- To prepare and maintain the books and documents relating to Virtual Currency Exchange Services
- To prepare a report on its Virtual Currency Exchange Services for each business year and submit the same to the Prime Minister, which must be accompanied by financial documents and certified public accountant's or audit firm's audit report on such documents.
- In the event where a Virtual Currency Exchange Service Provider manages users' money or Virtual Currency, to prepare a report on the amount or quantity of users' money or Virtual Currency managed by it for a certain period in addition to the afore-mentioned report, and submit the same together with certain attachments to the Prime Minister.

<Powers of the Prime Minister>

- When the Prime Minister finds it necessary for the proper and secure provision/performance of Virtual Currency Exchange Services, the Prime Minister may (a) order the relevant Virtual Currency Exchange Service Provider to submit reports or materials, (b) have officials enter its office or other facilities, and (c) inquire about the status of its business or properties or inspect its books and documents. (The Prime Minister may, within the necessary limits, take the similar measures against those to whom a Virtual Currency Exchange Service Provider has entrusted its services (including subcontractors, sub-sub contractors and further subcontractors).)

- The Prime Minister may order a Virtual Currency Exchange Service Provider to take necessary measures to improve its business operation or financial conditions or other measures necessary for the purpose of supervision.
- If a Virtual Currency Exchange Service Provider (a) becomes subject to any of the afore-mentioned grounds for refusal of registration, (b) has obtained the registration through fraudulent means, or (c) has violated the Act or an order issued pursuant to the Act or a disposition given pursuant thereto, the Prime Minister may revoke the registration or order the Virtual Currency Exchange Service Provider to suspend all or part of its services for a specified period of not more than six months. When the Prime Minister renders such disposition, the Prime Minister must give public notice to that effect pursuant to the provisions of the Cabinet Office Ordinance.

5. Provisions regarding an association established by Virtual Currency Exchange Service Providers (“Certified Association for Payment Service Providers”)

Virtual Currency Exchange Service Provider may at their discretion establish an association, the purpose of which is to provide guidance, supervision and other services to its member companies. An association so established that satisfies certain requirements will be certified as Certified Association for Payment Service Providers.

6. Penal provisions applicable to Virtual Currency Exchange Service Providers

The existing penal provisions of the Payment Services Act will apply to Virtual Currency Exchange Service Providers. Major violations and penalties therefor are as follows:

- (i) imprisonment with required labor for not more than three years or a fine of not more than three million yen, or both;
 - (a) performing the Virtual Currency Exchange Services without registration, (b) registration through fraudulent means, or (c) name lending
- (ii) imprisonment with required labor for not more than two years or a fine of not more than three million yen, or both;
 - (a) violation of the obligation to segregate users' money and Virtual Currency, or (b) violation of the order to suspend the Virtual Currency Exchange Service
- (iii) Imprisonment with required labor for not more than one year or a fine of not more than three million yen, or both;
 - (a) failure to give public notice of business assignment, merger, demerger, company split or discontinuance of the business or dissolution with respect to the Virtual Currency Exchange Service or giving false public notice thereof, (b) violation of the obligation to prepare and maintain the books and documents or preparation of false books or documents, (c) failure to submit the report and attached documents for each business year that must be submitted to the Prime Minister or false statement therein, (d) failure to follow the Prime Minister's order to provide a report or submit materials, provision of a false report or submission of false materials,

- or (e) refusing to answer or giving false answer at an on-site inspection, or refusing to allow, hinder or avoid the inspection
- (iv) Imprisonment with required labor for not more than six months or a fine of not more than five hundred thousand yen, or both:
 - False statement in the registration application or attached documents
- (v) A fine of not more than one million yen
 - Violation of an order to improve business operations

III. Contents of the Proposed Amendments to the Act on Prevention of Transfer of Criminal Proceeds regarding Virtual Currency

The Act on Prevention of Transfer of Criminal Proceeds is amended to add Virtual Currency Exchange Service Providers to “Specified Business Operators” who assume obligations thereunder, thereby imposing on them the following obligations, etc. prescribed by the same Act:

1. Obligation to identify customers

Upon conducting a specified transaction with a customer in connection with the specified business affairs, a Virtual Currency Exchange Service Provider must verify the following:

- (a) customer identification data, (b) purpose of conducting the transaction, (c) occupation/lines of business, (d) customer identification data of a person who has substantial control of the business of the customer, and (e) (under certain circumstances) status of assets and income

2. Obligation to prepare and maintain verification records

A Virtual Currency Exchange Service Provider must, having conducted customer identification, immediately prepare customer identification records, and maintain such records for seven years from the day on which the contract for a specified transaction, etc. terminates.

3. Obligation to prepare and maintain transaction records

A Virtual Currency Exchange Service Provider must, having conducted a transaction in connection with the specified business affairs, immediately prepare transaction records, and maintain such records for seven years from the day on which the transaction is conducted.

4. Obligation to report suspicious transactions to the relevant authority

If a property accepted through its specified business affairs is suspected to be criminal proceeds or a customer is suspected to be engaged in money laundering in connection with specified business affairs, a Virtual Currency Exchange Service Provider must promptly report the same to the relevant authority.

5. Measures to appropriately conduct verification at the time of transaction

A Virtual Currency Exchange Service Provider must take measures to keep matters verified at the time of transaction up-to-date, and endeavor to improve education and training to its employees and other necessary systems.

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 - Authors:
Takashi Nakazaki (takashi.nakazaki@amt-law.com)
Ken Kawai (ken.kawai@amt-law.com)
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