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Publication of the Draft of Cabinet Office Ordinance concerning Virtual Currency Exchange Service Providers

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On December 28, 2016, the Financial Services Agency of Japan (the “FSA”) announced drafts of proposed amendments to the relevant Orders for the Enforcement and Cabinet Office Ordinances and a draft of a newly proposed Cabinet Office Ordinance in relation to the regulations on Virtual Currency Exchange Service Providers, which is expected to take effect after April 2017. The details of the regulations applicable to Virtual Currency Exchange Service Providers are specified by the proposed amendments and the newly proposed Cabinet Office Ordinance. This newsletter outlines these proposed regulations.

I. Background

In Japan, the legal position of bitcoin and other virtual currencies was not entirely clear and there have been no acts regulating them. With the aim of imposing certain regulations on virtual currency exchange services, the Payment Services Act (Act No.59 of 2009) (“PSA”) and the Act on Prevention of Transfer of Criminal Proceeds (Act No. 22 of 2007) (“APTCP”) etc. (collectively, the “Amendment Acts”) were amended on May 25, 2016. The Amendment Acts (i) provide definitions of Virtual Currency and Virtual Currency Exchange Services, (ii) require registration of Virtual Currency Exchange Services Providers, (iii) set forth the regulations regarding the business of Virtual Currency Exchange Service Providers, and (iv) impose certain obligations such as customer identification obligations (or know your customer obligations) by designating Virtual Currency Exchange Service Providers as “Specified Business Operator”¹. On December 28, 2016, in order to substantiate the details of the Amendment Acts, the FSA published relevant regulations, including a draft of the Cabinet Office Ordinance concerning Virtual Currency Exchange Service Provider (“VC COO”) and a draft of the amendments to the Order for the Enforcement and Cabinet Office Ordinance of the

¹ For further details, please see our newsletter titled “Development of Legal Framework for Virtual Currencies in Japan - Bill Submitted to the Diet” dated April 25, 2016:
http://www.amt-law.com/pdf/bulletins2_pdf/160425.pdf

APTCP (each as “APTCP OE” and “APTCP COO”) (collectively, “Virtual Currency Regulations”)². The details of the regulations applicable to Virtual Currency Exchange Services are specified by the Virtual Currency Regulations. The Amendment Act as well as Virtual Currency Regulations will come into force as from the date specified by the Cabinet Order of the Amendment Act (which is expected to come into force after April 2017).

II. Introduction of Registration System for Virtual Currency Exchange Services Providers

The term “Virtual Currency Exchange Services” means any of the following acts carried out as a business, and in order to engage in Virtual Currency Exchange Services, an entity must be registered with the Prime Minister (an entity so registered is referred to as a “Virtual Currency Exchange Service Provider”):

- (i) sale/purchase of Virtual Currency or exchange for other Virtual Currency;
- (ii) intermediary, agency or delegation for the acts listed in item (i) above³; or
- (iii) management of users’ money or Virtual Currency in connection with the acts listed in items (i) and (ii) above.

III. Regulations on Virtual Currency Exchange Service Provider

(1) Outline of the Registration Requirement

Under the PSA, any entity wishing to register as a Virtual Currency Exchange Service Provider will be required to fulfill certain conditions provided under Article 63-5 of the PSA, the most significant of which are described below.

The applicant must be (i) a stock company (Kabushiki Kaisha, “KK”), or (ii) a Foreign Virtual Currency Exchange Service Provider⁴ which has an office(s) and representative in Japan. Accordingly, any foreign entity wishing to register as a Virtual Currency Exchange Service Provider must establish either a subsidiary (in the form of a KK) or a branch in Japan.

In addition, the PSA requires the applicant to have (a) a sufficient financial basis (please see section III.(3) below), (b) a satisfactory organizational structure and certain systems to conduct the Virtual Currency Exchange Service appropriately and properly, and (c) certain systems to ensure compliance with relevant laws and regulations.

(2) Registration Application and Accompanying Documents

The applicant must submit a registration application containing its trading name and address, capital amount, director’s name, the name of the Virtual Currency(ies) to be handled, contents and means of

² The public consultation period for the Virtual Currency Regulations closed on January 27, 2017. Please note that each Article number and contents may be changed, as the case may be, pursuant to the result of public comments.

³ Items (i) and (ii) are collectively referred to as “Exchange, etc. of Virtual Currency”.

⁴ An entity who engages in virtual currency exchange services with a registration, license, etc. equivalent to the registration in Japan that has been obtained pursuant to the applicable laws and regulations in a foreign country.

Virtual Currency Exchange Services, outsourcees' name and address (if any), method of segregation management and other particulars⁵. Such registration application must be accompanied by documents, including document pledging that there are no circumstances constituting grounds for refusal of registration, extract of the certificate of residence of its directors, etc., a resume of the directors etc., a list of shareholders, financial documents and documents containing particulars regarding the establishment of a system for ensuring the proper, secure provision/performance of Virtual Currency Exchange Services, organization chart, internal rules, and a form of the contract to be entered into with users⁶.

(3) Financial Requirements

- minimum capital amount: 10 million JPY⁷
- minimum net assets amount: a positive net amount⁸

(4) Safe Management of System

A Virtual Currency Exchange Service Provider must take measures for the sufficient management of IT systems relating to its Virtual Currency Exchange Services, and measures to prevent the leakage, loss and/or damage of personal information relating to its Virtual Currency Exchange Services⁹.

(5) Supervision of Outsourcees

If a Virtual Currency Exchange Service Provider outsources a part of its Virtual Currency Exchange Services to a third party, the Virtual Currency Exchange Service Provider is required to ensure the appropriate and proper implementation of such outsourced services¹⁰. As part of this requirement, a Virtual Currency Exchange Service Provider must carry out the necessary and appropriate supervisory actions regarding the outsourcees, such as (a) examining periodically, or as necessary, whether the outsourcees are appropriately and properly implementing the outsourced services, and (b) requiring the outsourcees to make improvements when necessary. In addition, a Virtual Currency Exchange Service Provider must take necessary measures, such as amendment or termination of the agreement with the relevant outsourcee, to ensure the appropriate and proper implementation of the outsourced services or for the Virtual Currency Exchange Service Provider's users' protection.

(6) Measures for Protection of Users

(i) Explanation for Prevention of False Recognition

A Virtual Currency Exchange Service Provider is required to explain certain matters (such as the fact that Virtual Currency is considered to be neither Japanese currency nor foreign currencies) to users in advance when they conduct an Exchange, etc. of Virtual Currency with users¹¹.

⁵ Article 63-3, Paragraph 1 of the PSA, Article 5 of the VC COO

⁶ Article 63-3, Paragraph 2 of the PSA, Article 6 of the VC COO

⁷ Article 9, Item 1 of the VC COO

⁸ Article 9, Item 2 of the VC COO

⁹ Article 63-8 of the PSA, Articles 12 and 13 of the VC COO

¹⁰ Article 63-9 of the PSA, Article 15 of the VC COO

¹¹ Article 16 of the VC COO

(ii) Provision of Information to Users

A Virtual Currency Exchange Service Provider is required to provide certain information to users such as (a) its trading name and address, (b) registration number, (c) a content of transactions, (d) an outline of each Virtual Currency that the provider handles, or (e) fees, remunerations or costs in advance when they conduct transactions relating to a Virtual Currency Exchange Services with users¹².

Also, when a Virtual Currency Exchange Service Provider receives cash or Virtual Currency from its users, it must provide the users with the following information without delay¹³: (a) its trading name, registration number; (b) the amount of cash or Virtual Currency which it has received; and (c) the date of receipt. In addition, when a Virtual Currency Exchange Service Provider conducts transactions of Virtual Currency with users on an on-going basis, it must provide users with information regarding (a) the transaction record with users, and (b) the balances of the user's cash and Virtual Currency which it manages at least every three months¹⁴.

(iii) Establishment of Internal Rules etc.

In order to ensure the protection of users and the proper and secure provision/conduct of the Virtual Currency Exchange Services, a Virtual Currency Exchange Service Provider is required to establish its internal rules¹⁵.

Also, a Virtual Currency Exchange Service Provider is required to establish a system for providing training to employees, a system for providing guidance to outsourcees, and other systems sufficient to ensure that the business is operated based on said internal rules, etc.¹⁶.

(iv) Other Measures to Ensure the Protection of Users

A Virtual Currency Exchange Service Provider is required to take, among others, the following measures¹⁷:

- to establish a system necessary for the protection of users based on the characteristics of Virtual Currency, the contents of transactions etc.;
- to suspend the transactions relating to the Virtual Currency Exchange Service, etc., if a Virtual Currency Exchange Service Provider finds a possibility that a criminal act has been committed with regard to the transactions relating to the Virtual Currency Exchange after considering any provision of information by the investigative authority, etc. to the effect that said transactions were used for the purpose of committing a fraud or other criminal acts and other circumstances; and
- in case where a Virtual Currency Exchange Service Provider carries out Virtual Currency transactions with users by using a computer connected with electric telecommunication lines, to take appropriate measures to prevent said users from mistaking the Virtual Currency Exchange Service Provider for another person.

¹² Article 17, Paragraph 1 of the VC COO

¹³ Article 17, Paragraph 3 of the VC COO

¹⁴ Article 17, Paragraph 4 of the VC COO

¹⁵ Article 19 of the VC COO

¹⁶ Article 19 of the VC COO

¹⁷ Article 18 of the VC COO

(7) Segregation and Audit Requirements

- A Virtual Currency Exchange Service Provider must segregate user's cash from its own cash by the following methods¹⁸:
 - (a) deposit of cash at bank etc.; or
 - (b) placement of cash in a certain trust.
- A Virtual Currency Exchange Service Provider must segregate user's Virtual Currency from its own Virtual Currency by the following methods¹⁹:
 - (a) If the Virtual Currency Exchange Service Provider manages Virtual Currency:

It must make a clear distinction between the user's Virtual Currency and its own Virtual Currency in a manner such that the user's Virtual Currency is immediately identifiable; and
 - (b) If a Virtual Currency Exchange Service Provider outsources the management of Virtual Currency to a third party:

It must ensure that the third party makes a clear distinction between the user's Virtual Currency and the provider's own Virtual Currency in a manner such that the user's Virtual Currency is immediately identifiable.
- A Virtual Currency Exchange Service Provider must regularly undergo an audit of the status of the segregated management by a public certified accountant or audit firm at least once a year²⁰.

(8) Regulations regarding Responses to Complaints and Financial ADR System

A Virtual Currency Exchange Service Provider should establish internal management systems in order to make fair and appropriate responses to client complaints²¹.

A Virtual Currency Exchange Service Provider should take measures to resolve disputes in a financial ADR (i.e., measures to handle complaints and measures to resolve disputes)²².

(9) Books and Record Keeping

The PSA imposes on a Virtual Currency Exchange Service Provider an obligation to prepare and preserve the books and records related to its Virtual Currency Exchange Services²³.

(10) Ongoing Reporting Requirements

A Virtual Currency Exchange Service Provider is required to prepare and submit to the relevant authority (i) an annual business report in respect of its Virtual Currency Exchange Services, and (ii) a periodic report on the amount or quantity of users' money and Virtual Currency which the Virtual Currency Exchange Service Provider manages, each in the specified forms provided by the Cabinet Office Ordinance²⁴.

¹⁸ Article 63-11, Paragraph 1 of the PSA, Article 20, Paragraph 1 of the VC COO

¹⁹ Article 63-11, Paragraph 1 of the PSA, Article 20, Paragraph 2 of the VC COO

²⁰ Article 63-11, Paragraph 2 of the PSA

²¹ Article 25, Paragraph 1 of the VC COO

²² Article 25, Paragraph 2 of the VC COO

²³ Article 63-13 of the PSA, Articles 26 through 28 of the VC COO

²⁴ Article 63-14 of the PSA, Articles 29 and 30 of the VC COO

IV. Proposed Amendments to the Order for the Enforcement and Cabinet Office Ordinance of Act on Prevention of Transfer of Criminal Proceeds

The APTCP is amended to add Virtual Currency Exchange Service Providers to the definition of “Specified Business Operators”²⁵, and APTCP OE will be amended to add a business pertaining to the Virtual Currency Exchange Services to the definition of “Special Business”²⁶.

As a result, when a Virtual Currency Exchange Service Provider carries out any of the following²⁷, it must verify the identity data (i.e., name and location of the head office or main office), purpose and intended nature of the transaction, type of business and the beneficial owner of the customer:

- executes a master agreement with a customer for repeatedly providing such customer with Exchange, etc. of Virtual Currency or management services of the user’s money or Virtual currency in respect of the Virtual Currency Exchange Services;
- an Exchange, etc. of Virtual Currency resulting in receipt and payment of Virtual Currency amounting to the equivalent of more than JPY 200,000; or
- (x) transfers a user’s Virtual Currency managed by the Virtual Currency Exchange Service Provider pursuant to a request by the user; and (y) such transfer amounts to the equivalent of more than JPY 100,000 or the equivalent thereof.

V. Contents of Guidelines concerning Virtual Currency Exchange Service Provider

Guidelines concerning Virtual Currency Exchange Service Provider set out the following guidelines:

- Future transactions which are not physically settled do not fall within the definition of an Exchange, etc. of Virtual Currency.
- In respect of margin transactions of Virtual Currency, if a Virtual Currency Exchange Service Provider lends money to users, the Virtual Exchange Service Provider must obtain registration as a money lending business.
- When a Virtual Currency Exchange Service Provider provides leverage transactions, the Virtual Currency Exchange Service Provider needs to explain the risks associated with the transactions to users appropriately and establish appropriate leverage ratio and loss cut rules etc.

End

²⁵ Article 2, Paragraph 2, Item 31 of the APTCP

²⁶ Article 6, Item 14 of the APTCP OE

²⁷ Article 7, Paragraph 1 of the APTCP OE

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