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Outline of the Report by the Financial System Council's "Working Group on Payment Services" (Introduction of Regulations on Stablecoins and the Tightening of Regulations on Prepaid Payment Instruments)[1]

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The Financial System Council's Working Group on Payment Services (the "WG"), which began conducting discussions in October, 2021 in response to a request from the Minister of State for Financial Services "to conduct a review on an ideal system for sound and efficient financial settlements in view of international demands for measures against money laundering and terrorist financing, and for progress in digitization," announced on January 11, 2022 that it had compiled a report (the "Report") after holding five rounds of discussions.

The Report recommends the amendment of the *Payment Services Act* and the *Act on Prevention of Transfer of Criminal Proceeds, etc.*, which recommendation was approved by the Cabinet and submitted as a bill to the Diet on March 4, 2022. If the said bill is enacted within the ordinary session of the Diet, it is expected to come into effect as early as the first half of 2023.

This newsletter provides an outline of the contents of the Report by focusing on (1) the regulations on stablecoins, and (2) the proposed strengthening of regulations on prepaid payment instruments from the viewpoint of Anti-money laundering and countering the financing of terrorism (AML/CFT).

1 Regulation of Stablecoins

1-1 Background of the WG's discussions

Stablecoins, USDT (Tether) and USDC (USD Coin) in particular, are widely distributed overseas as

[1] AMT issued a newsletter about this topic in Japanese. It can be found on our website (see below link). This newsletter is not a translation thereof.
https://www.amt-law.com/asset/pdf/bulletins2_pdf/220228.pdf

payment methods for cryptoassets and other digital assets. For example, the daily trading volume of USDT has expanded to far exceed that of BTC (bitcoins).

On the other hand, under the current law in Japan, stablecoins, which can be redeemed in currency, fall under the category of assets denominated in currencies as stipulated in Article 2, Paragraph 6 of the *Payment Services Act*, and the business of transferring stablecoins by request from users is considered to fall under the category of a fund transfer service. However, partly because the current *Banking Act* and *Payment Services Act* do not have a legal framework to properly regulate stablecoins, which are blockchain tokens, virtually no stablecoins are currently being circulated in Japan.

With the rapid development of the digital economy, the virtual unavailability in Japan of stablecoins, which are the primary means of payment in the blockchain economy or token economy, is posing a major impediment to the domestic development of blockchain technology and the digital economy, and there has for many years been a demand for a legal framework to enable the circulation of stablecoins in Japan.

On the other hand, following the announcement of the Libra initiative by Meta (formerly known as Facebook), national authorities have expressed concerns about global stability, both in terms of monetary sovereignty and stability of the financial order, and the Financial Stability Board (FSB) published ten recommendations on stablecoins in October, 2020. In addition, the Financial Action Task Force (FATF) pointed out the risk of money laundering with regard to stablecoins in its "Updated Guidance: A Risk-Based Approach To Virtual Assets And Virtual Asset Service Providers", published in October, 2021, and discussions have been held, mainly in Europe and the United States, toward imposing stricter regulations on stablecoins.

In response to this trend, the "Interim Summary of Issues" presented in November, 2021 by the "Study Group on Digital and Decentralized-Finance," which was established at the Financial Services Agency of Japan in July, 2021, indicated the need for prompt institutional responses to stablecoins. In response to this, the WG has discussed questions of specific institutional design, and their Report presents the details a future regulatory regime in concrete terms with a view to amending the existing laws.

1-2 Outline of the regulations proposed by the Report[2]

1-2-1 Classification and definition of stablecoins

In the Report, stablecoins are divided roughly into the following two types (p. 17 of the Report):

(i) Digital money type stablecoins: those issued at a price linked to the value of a legal currency (e.g., 1 coin = 1 yen) and promised to be redeemed in the same amount as its issue price (and those equivalent to the same).

[2] https://www.fsa.go.jp/singi/singi_kinyu/tosin/20220111/houkoku.pdf (available only in Japanese)

(ii) Crypto-asset type stablecoins: those other than digital money type stablecoins (e.g., those that aim to stabilize value by algorithms).

Under the current system, digital money type stablecoins fall under the category of "currency-denominated assets," while crypto-asset type stablecoins fall under the category of "cryptoassets."

On the basis of the above classification, the Report proposes to establish a definition of "electronic payment instruments" under the *Payment Services Act*, which means "those among 'currency-denominated assets' that can be used for remittance and settlement to unspecified persons (limited to those that are recorded by electronic means and transferable by means of an electronic data processing system)," and based on this definition, to develop separate regulatory frameworks for issuers and intermediaries, respectively (p. 20 of the Report).

Among currency-denominated assets, digital money type stablecoins and existing electronic money (issued by banks or fund transfer service providers) are classified as "electronic payment instruments." On the other hand, currency-denominated assets that are not seen as widely available for remittance and settlement (e.g., government bonds, corporate bonds, electronically recorded monetary claims, prepaid payment instruments, etc.) are, in principle, excluded from the definition of "electronic payment instruments."

It should be noted, however, that as indicated in footnote 70 of the Report, "prepaid payment instruments do not fall under the category of electronic payment instruments in principle, but may fall under the category of electronic payment instruments if they are issued by the issuer in a permissionless distributed ledger with specifications that can be distributed to unspecified persons and used as a means of remittance and settlement to unspecified persons other than the issuer or member stores." Accordingly, even if an instrument falls under the category of prepaid payment instruments, those that freely circulate through a permissionless chain can fall under the category of electronic payment instruments.[3]

On the other hand, crypto-asset-type stablecoins (e.g., DAI) do not fall under the category of electronic payment instruments because they fall under the category of crypto-assets.

1-2-2 Regulation of issuers of electronic payment instruments

The Report indicates that, unlike existing digital money (PayPay, etc.), issuers and intermediaries can be separated for digital money type stablecoins, and thus a legal system for this purpose needs to be established (p. 21 and below of the Report). The following legal framework is provided for issuers.

First, the act of issuing or redeeming electronic payment instruments basically falls under the category

[3] Issuers and intermediaries of electronic payment means are required to refrain from issuing and circulating such prepaid payment instruments (footnotes 88 and 95 of the Report), and it is assumed that such prepaid payment instruments will be substantially excluded after the amendment of the existing laws.

of a fund transfer service under the current law, and for this a banking license or a fund transfer service registration is required. As far as fund transfer services are concerned, the Report points out that, regarding the issuer's responsibilities, "It is important [for issuers to ensure] that redemption claims made by users against issuers are clearly secured and that redemption claims made by users are appropriately protected in the event of failure of the issuer or intermediary" (p. 23 of the Report). On the above basis, the Report proposes that the following mechanisms be implemented to ensure that the issuers satisfy the above requirements (p. 23 of the Report):

(1) Based on the current practice of banks regarding the creation and extinguishment of deposit claims at the time of an account transfer, a mechanism can be opted for whereby an intermediary has been granted the authority by a bank to manage each individual customer's deposit balance and transfer such deposit balance between customers (the bank, as an issuer, only manages the total amount of the deposit);
(2) A mechanism can be opted for under which an intermediary has been granted the authority by a fund transfer service provider to manage and transfer each user's outstanding claims (the fund transfer service provider, as an issuer, only manages the total amount of the outstanding claims); or
(3) A mechanism can be opted for that applies the applicable Japanese trust legislation where an intermediary sells and transfers trust beneficiary rights in a beneficiary certificate issuing trust, the trust assets of which are managed in the form of deposits with banks.

All of the above mechanisms assume that there will at all times be a contractual relationship between the issuer and the intermediary.[4] In order to establish such a contractual relationship, it is implied that the use of a permissioned chain is assumed in practice. On the other hand, since major digital money type stablecoins (USDT, USDC, BUSD (Binance USD) and TUSD (True USD), etc.) currently on the market are tokens on a permissionless chain, anyone can be an intermediary, and a contract is not necessarily envisaged to be concluded between the issuer and the intermediary. Therefore, we are of the view that the Report: (a) presents an approach that, rather than proposing the regulation of issuers based on the actual situation of major stablecoins currently circulating overseas, proposes certain ideal legal frameworks for stablecoins to be issued in Japan in the future, and (b) indicates that if stablecoins are to be issued in accordance with such legal frameworks, the issuance and circulation of stablecoins as an electronic payment instrument would be permitted.

The Report states that the methods (1) to (3) above protect users as follows:

i Under the mechanism of using deposits ((1) above), deposits are protected as general deposits, etc. or deposits for settlement purposes in the event of failure of the bank as the issuer, as is the case under the current deposit insurance regime.
ii Under the mechanism of using outstanding obligations in the process of funds transfers ((2)

[4] In addition, from the viewpoint of clarifying the roles and responsibilities of issuers and intermediaries, the Report states that, with respect to matters concerning the allocation of responsibility between issuers and intermediaries in the event of damage to users, it is mandatory for issuers and intermediaries to conclude a contract (p. 30 of the Report).

above), in the event of failure of the funds transfer service provider as the issuer, user assets are deemed to be secured through deposited assets with statutory deposit office, etc.

iii Under the framework of using trust beneficiary interests ((3) above), in the event of failure of the trust company as the issuer, user assets are bankruptcy-remote by the trust.

As for electronic payment instruments in the form of trust beneficiary rights ((3) above), since a trust beneficiary right is deemed to be a security under the current *Financial Instruments and Exchange Act*, the Report proposes to amend the structure to exclude the application of disclosure regulations and business regulations under the *Financial Instruments and Exchange Act* if certain requirements are satisfied, such as the requirement that the management of the entire value of the trust property be in the form of a deposit in JPY.

If method (2) above is adopted, a fund transfer service provider would also be able to issue electronic payment instruments, but this is not a realistic option for realizing stablecoin transactions in Japan in the form currently and widely used overseas. This is because the fund transfer service, which is subject to limits on the amount of money to be remitted (1 million yen for a Type 2 funds transfer service and 50,000 yen for a Type 3 funds transfer service) and regulations on the retention of customer funds (in principle, the retention of funds is not allowed in a Type 1 funds transfer business) (footnote 81 of the Report), is inconsistent with the actual use of such existing stablecoins, as follows:
(i) the amounts to be paid with stablecoins can become relatively large because the principal use of stablecoins is to settle transactions of cryptocurrency and digital assets; and
(ii) it is customary for stablecoin holders (customers) to retain their stable coins in their own account until the stablecoins are used to settle transactions.

1-2-3 Regulation of intermediaries

The Report proposes imposing new business restrictions on intermediaries of electronic payment instruments. The acts that would be subject to the restrictions are as follows (pp. 25-26 of the Report):

(i) Act of creating and extinguishing deposit claims on behalf of a bank;
(ii) Act of creating and extinguishing claims pertaining to outstanding obligations in the process of funds transfers on behalf of a funds transfer service provider; and
(iii) Sale and exchange, management, and intermediation of sale and exchange, etc. of electronic payment instruments such as trust beneficiary rights, etc. for which the trust property is a demand deposit.

These actions respectively correspond to the mechanisms (1), (2) and (3) described in 1-2-2 above. The Report does not clearly indicate what kind of acts are regarded as acts subject to business regulations when the intermediation is conducted by a method that does not fall under the above types (it is presumed that the acts in (i) to (iii) above are not normally performed in the intermediation of USDT, or USDC, etc.), nor is it clear whether it envisages establishing a legal system based on the premise that intermediation by other methods is substantially eliminated.

The Report suggests that the business regulations for intermediaries will be similar to those applicable to crypto asset exchange service providers, and the main contents of such regulations are as follows (pp. 27-29 of the Report):

- Financial requirement
- Implementation of measures for the protection, etc. of users
  - ✓ Provision of information to users (basic information, transaction details, fees, etc. of the issuer who assumes reimbursement obligations)
  - ✓ Measures necessary to avoid dealing with electronic payment instruments that have user protection problems
  - ✓ Formulation of a compensation policy in the event of unauthorized use
  - ✓ Information security management (system security measures and secure management of personal information)
- Preservation of deposited user assets
  - ✓ In principle, accepting a deposit of legal currency from a user is prohibited
  - ✓ Separate management of electronic means of payment deposited by users
- AML/CFT
  - ✓ Measures under the *Act on Prevention of Transfer of Criminal Proceeds* (the "*Criminal Proceeds Act*") (duty to verify the identities of customers at the time of transaction, duty to report suspicious transactions, duty to give notice, etc.)
- Requests for reports, inspections, orders for business improvement or suspension, cancellation of registration, etc. by authorities

Of the above regulations, however, the prohibition on intermediaries receiving money from users in principle is significantly different from the current regulations on cryptocurrency exchanges. Furthermore, this regulation is not consistent with the actual use of stablecoins overseas, and would have a significant impact on practice, since overseas stablecoins are mainly used as an instrument for settling transactions of cryptoassets and digital assets, and such stablecoins are treated as being analogous to the lineup of cryptoassets at cryptocurrency exchanges and can be purchased by using money deposited at cryptocurrency exchanges. We recommend that a close eye be kept on what would be the exceptions to the acts prohibited in principle.

1-2-4 Regulation of the relationship between issuer and intermediary

The Report indicates that, in addition to the safety and resilience of the system, the following (1) to (3) are generally required for stablecoin-related businesses, because it is important to establish appropriate governance for the whole system to provide appropriate financial services in the context of the separation of issuers and intermediaries:

(1) There must be clear rules concerning the transfer of rights (procedures, timing).
(2) Business operators must ensure that AML/CFT requirements are met.

(3) The rights of users must be appropriately protected, such as in the cancellation of transactions and compensation for losses in the event of failure of issuers or intermediaries, or in the event of technical failures or other such problems.

In particular, from the viewpoint of AML/CFT in (2), it is considered that an effective response will be possible by “implementing technical measures by setting system specifications, etc.”

The Report indicates, “By reference to the discussions at the FATF, it may be possible to establish a framework that includes, for example, a requirement that issuers and intermediaries establish systems, including by setting their system specifications, to ensure the following:

- The prevention of transfers to unidentified users; and
- The freezing of balances transferred to unidentified users”

(p. 30 of the Report).

If the issuer or an intermediary is legally obligated to assume such measures to prevent transfers to users whose identities have not been verified and to freeze balances that have been transferred to the same, it would be extremely difficult to handle permissionless type stablecoins in Japan, regardless of whether the issuer has a license for a banking business or a fund transfer service, etc. in Japan.

Given that most of the stablecoins currently handled in Europe, the United States, and many other countries around the world are permissionless, if Japan were to take legal measures which are essentially equivalent to a de facto inability to deal with such permissionless type stablecoins, this would be of great significance because, while Japan would have a robust regulatory system from the perspective of AML/CFT, it would risk being left behind from the perspective of innovation in digital asset transactions using stablecoins.

1-2-5 Stablecoins issued overseas

The Report points out the following with regard to digital money type stablecoins issued overseas.

“Under the current law, an issuer is required to obtain a banking license or register as a fund transfer service provider if the issuer circulates in Japan stablecoins issued overseas (for example, when the issuer solicits users via a website in Japanese, etc.)” (Footnote 74 of the Report).

“With regard to stablecoins currently in circulation in the United States [...] based on the actual situation of transactions, it cannot be said that under Japanese legislation, users can smoothly exercise their reimbursement claims against the issuers in the event of failure of an intermediary” (Footnote 77 of the Report).

“With regard to remittance and settlement methods that can be widely used in society, it is important that user assets are appropriately protected and that users can receive reimbursement in the event of the failure of the issuer. In practice, from the viewpoint of whether the cross-border exercise of

reimbursement claims by users can be carried out smoothly in the event of failure of an issuer located overseas, an issuer may basically be required to establish its presence and preserve its assets in the respective jurisdiction" (Footnote 87 of the Report).

"The introduction of legal framework on intermediaries raises the question of whether, under such framework, persons other than issuers can handle electronic payment instruments issued by persons located abroad. In this regard, in light of the nature of electronic payment instruments, which promise redemption, etc. at the same price as the issue price, it is important that user assets are appropriately protected in the event of failure of the issuer and that users can smoothly receive redemption proceeds in practice. In this regard, the FSB's recommendation also calls for ensuring legal clarity regarding the legal enforceability of reimbursement claims of users and for the process that allows for said enforceability. From this point of view, it is considered necessary at present to in principle require the issuers to establish their presence in and preserve user assets in Japan. With regard to other measures, it is conceivable that we will continue to examine whether intermediary activities will be evaluated at the same level of user protection, etc. as in (6) (1) (a) to (c) above (Author's note: 1-2-2, (i) to (iii) in this paper), taking into account the state of development of regulatory and supervisory systems in foreign countries and practical perspectives" (pp. 26-27 of the Report).

In light of the above, foreign issuers of digital money type stablecoins must, in principle, establish a presence in Japan and obtain a Japanese banking license in order to distribute them directly in Japan. In addition, even if foreign issuers are not deemed to solicit residents of Japan[5] and are subsequently not required to obtain banking licenses, in principle, such foreign issuers would be required to preserve the proceeds from the issuance of such stablecoins in Japan. If such regulations were to be introduced, at the very least, the major stablecoins currently issued overseas could not be distributed in Japan unless they were redesigned to require issuers to establish a presence in Japan, and to preserve assets in Japan. In addition, even if such requirements are satisfied, as described in 1-2-4 above, there still remains the problem that the current permissionless distributed ledger system cannot be automatically applied to stablecoins for use in Japan. Consequently, under the proposed legislation, it can be said that the authorities have accepted future conditions of their use in Japan that would make it virtually impossible for major stablecoins issued overseas to be handled here.

1-3 Summary

If regulations are introduced in accordance with the Report, a clear regulatory framework will pave the way for the issuance and distribution of permissioned stablecoins issued by domestic banks and trust companies. The key point in the future would be to find out new usage scenarios for stablecoins in contrast to bank transfers and conventional digital money. For example, whether it is possible to introduce a permissioned stablecoin as a means for settling digital securities (security tokens).

[5] In relation to the contractual relationships with intermediaries, it is questionable whether it can be concluded that there is no solicitation of residents in Japan even where foreign issuers entrust the solicitation of residents in Japan to intermediaries.

On the other hand, companies that intend to issue permissionless stablecoins and to distribute existing overseas stablecoins would face a difficult challenge. In other words, it can be said that the authorities have expressed a negative view towards implementing the existing overseas business model for issuing and intermediating stablecoins, which is mainly used to settle transactions of cryptocurrency and digital assets, in relation to Japanese residents.

2 Regulations on prepaid payment instruments

2-1 Outline of the regulations proposed in the Report

2-1-1 Types of prepaid payment instruments

The Report analyzed IC type and server type prepaid payment instruments as follows by taking into account the actual use of third-party prepaid payment instruments (pp. 36, 37 of the Report):

- Small sum payment type prepaid payment instruments (e.g., transportation IC cards, etc. in which the value cannot be transferred or assigned electronically and which are used for small payments under a small charge limit)
  → In light of the risks involved, these are not seen as requiring any special measures (Footnote 127 of the Report)
- Electronically transferable type prepaid payment instruments
  → (1) a balance assignment type and (2) a number notification type are given in the Report as examples of instruments the value of which can be electronically assigned and transferred (see below for more details). Among these “electronically transferable types”, the Report also defines an instrument in terms of whether the amount of funds loadable to an account is a large sum or has no limit (e.g., is a service that allows customers to reload tens of millions of yen with an international brand prepaid card), referring to such as an “electronically transferable large sum type.”

Electronically transferable type prepaid payment instruments are further categorized as follows (pp.37, 38 of the Report), and discussions have developed on the need for new regulations based on this classification.

(1) **Balance transfer type**
A prepaid payment instrument which allows the transfer of the balance of the prepaid payment instrument’s value between accounts within a mechanism managed by an issuer.

(2) **Number notification type**
(2)-1 Number notification type prepaid payment instruments (in a narrow sense)
Prepaid payment instruments of which the value can be transferred electronically outside of the mechanism managed by the issuer through notification of numbers, etc.[6]. The following

[6] It is generally understood that numbered tickets (e.g., bar codes) issued by a dedicated terminal of a store prior to the

is given as an example of this instrument:

- Electronic gift certificates, etc. to be loaded to an account by using a prepaid payment instrument (ID number, etc.) that can be notified by e-mail, etc.

(2)-2 Instruments that are equivalent to number notification type prepaid payment instruments (in a narrow sense):

An instrument other than (1) and (2)-1 which will be separately prescribed by applicable laws as an instrument which other persons can easily use its account balance already loaded (i.e., the prepaid payment instrument) by notifying said other persons of the number, etc. granted by the issuer to connect said account balance to the right to use said account balance outside of a mechanism managed by the issuer, and where the scope of such use is numerous and extensive. At present, only the following are assumed to fall under this instrument:

- Prepaid cards (commonly known as branded prepaid cards) that can be used on the same payment infrastructure as international branded credit cards (VISA, MasterCard, JCB, etc.)

2-1-2 Obligation to develop a system for number notification type electronically transferable prepaid payment instruments

The Cabinet Office Ordinance, etc. has been revised and necessary measures have been taken that ensure balance transfer type prepaid payment instruments (item (1) above) from the viewpoint of preventing unauthorized use, pursuant to the report by the Financial System Council's "Working Group on Payment Legislation and Legislation for the Intermediation of Financial Services" dated December, 2019.[7] Specifically, issuers of balance transfer type prepaid payment instruments are required to set an upper limit on the amount of any unused balance that can be transferred, to establish a system to detect unnatural transactions such as identifying the recipients of repeated transfers, and to suspend the use of prepaid payment instruments for those who have engaged in suspicious transactions.

On the other hand, with respect to number notification type prepaid payment instruments (item (2) above), the current law does not impose an obligation on an issuer to establish the same system as is required for item (1) balance transfer type prepaid payment instruments. However, an amendment of the existing laws is being considered in order to impose said obligation on issuers of item (2) notification type prepaid payment instruments, because problems have been reported with the latter instruments being associated with cases of unauthorized use, including fraud and unauthorized use of resale sites, etc.. Moreover, problems are likely to occur with type (2)-1 instruments since said instruments are issued without conducting an identity verification of the user at the time of issuance and, thus, they can be easily transferred by e-mail, etc. outside the scope of the issuer's control. Specifically, the following requirements are being considered (pp. 39, 40 of the Report):

(i) Requiring issuers of prepaid payment instruments categorized as item (2) number notification

payment for charging an account specified in advance are not applicable to numbers, etc. that are prepaid payment instruments (p. 38 of the Report).

[7] https://www.fsa.go.jp/singi/singi_kinyu/tosin/20191220.html

type prepaid payment instruments to review the product design and their systems of the instrument so as to reduce the issued amounts from the viewpoint of providing services that can be used by the users with a sense of security, to formulate terms and conditions prohibiting resale, to monitor the status of usage including resale, etc., to freeze usage in the event of unauthorized resale, etc., and to develop a system to alert the users when unauthorized use is detected, etc.

(ii) Requiring confirmation by the regulators with issuers of prepaid payment instruments categorized as item (2) number notification type prepaid payment instruments, which are considered to have a relatively high risk of unauthorized used due to their product design, that they have established a monitoring system that is commensurate with the risk, and widely inform the service users to refrain from using resale sites.

2-1-3 Regulation of electronically transferable large sum type prepaid payment instruments from an AML/CFT perspective

(1) Change in AML/CFT approach to prepaid payment instruments

Under the *Criminal Proceeds Act*, specified business operators[8] are required to verify the identity of customers when conducting specified transactions and to report suspicious transactions. In this regard, to date, issuers of prepaid payment instruments have not been included in the definition of specified business operators and are not subject to the *Criminal Proceeds Act* because, in principle, refunds are not allowed on prepaid payment instruments and the risk of money laundering is relatively limited.

However, the above concept only applies to small sum prepaid payment instruments (e.g., transportation IC cards) that have values which cannot be transferred or assigned electronically and have a small load limit, and does not apply to other electronically transferable type prepaid payment instruments. Therefore, it is necessary for issuers to take measures commensurate with the risk of money laundering.[9] On the other hand, from the viewpoint of user convenience and in consideration of the role that prepaid payment instruments play in cashless payments and seeding innovation, discussions are being held on whether to impose an obligation to verify the identity of customers and to report suspicious transactions, etc. under the *Criminal Proceeds Act* only on issuers of electronically transferable type prepaid payment instruments in which their maximum loadable amount is a large sum or has no upper limit, i.e., electronically transferable large sum type prepaid payment instruments (pp. 42, 43 of the

[8] Deposit-taking institutions, insurance companies, etc., financial instruments business operators, etc., commodity futures business operators, trust companies, etc., money lenders, funds transfer service providers, crypto asset exchange service providers, money exchangers, finance lease business operators, credit card business operators, building lots and buildings business operators, jewels and precious metal business operators, mail receiving service providers, telephone acceptance service providers, telephone forwarding service providers, legal/accounting experts (lawyers, judicial scriveners, administrative scriveners, certified public accountants, and tax lawyers).

[9] In particular, the Report points out that the so-called international brand prepaid payment instruments (falling under the item (2)-2 number notification type prepaid payment instruments) pose at least the same risk from the viewpoint of money laundering and other risks because they utilize the payment infrastructure of credit cards of the same brand, they can be used at member stores of the same brand including online usage, and they provide the same service functions as credit cards (the difference between these prepaid payment instruments and these credit cards being only the time of payment (whether prepaid or postpaid)). In recent years, it has also been pointed out that international brand prepaid payment instruments, onto which can be loaded tens of millions of yen, are also being issued (p. 43, 44, Footnote 143 of the Report).

Report).

(2) Scope of "electronically transferable large sum type prepaid payment instruments" subject to application of the *Criminal Proceeds Act*

With regard to the scope of electronically transferable large sum type prepaid payment instruments (i.e., the threshold amount that is appropriate to determine electronically transferable prepaid payments which will be subject to the regulations under the Criminal Proceeds Act), from the viewpoint that the risk of misuse for money laundering, etc. is particularly high if this type of payment instrument is repeatedly and continuously electronically transferred and assigned, the Report recommended the following approaches for each type of electronically transferable type prepaid payment instrument (p. 45 of the Report):

(1) Balance transfer type prepaid payment instruments

In the case of item (1) balance transfer type prepaid payment instruments, both the transferor and the transferee create an account in advance in the issuer's system, and the value is transferred by a balance transfer within the mechanism managed by the issuer. The issuer therefore can monitor the value transferred. Accordingly, the threshold amount for this type should be determined based on the act of electronically transferring balances from one account to another.

(2) Number notification type prepaid payment instruments

In the case of item (2)-1 number notification type prepaid payment instruments (in a narrow sense), the value is transferred by notifying a person of the number outside of the mechanism managed by the issuer, because before loading the account, the number can be notified to such external person by e-mail, etc. without the involvement of the issuer.

In the case of item (2)-2 number notification type prepaid payment instruments (the so-called international brand prepaid payment instruments), the number associated with the right to use the loaded balance is in substance transferred by notifying a person of the number outside of the mechanism managed by the issuer.

Since the issuer of (2) number notification type prepaid payment instruments cannot monitor the transferred value itself, the threshold amount for this type should be determined based on the act of loading the account with the value electronically.

With regard to the specific threshold amount for an instrument to be deemed an electronically transferable large sum prepaid payment instrument, the Report suggests the following: (i) the amount to be transferred on any given instance and the amount to be loaded at any given instance shall be more than 100,000 yen. These amounts have been arrived at by following the approach of the *Criminal Proceeds Act* that requires identity verification at the time of transaction when transferring money of more than 100,000 yen when cash is transferred by bank transfer; and
(ii) the cumulative amount to be transferred and loaded per month shall be more than 300,000 yen. This

amount has been proposed based on the practices of systems operated by fund transfer service providers and credit card business operators that have functions similar to electronically transferable type prepaid payment instruments (p. 46 of the Report).

Based on the above, the Report has proposed that prepaid payment instruments that meet all of the following criteria be defined as "large sum electronically transferable type prepaid payment instruments" subject to the regulations under the *Criminal Proceeds Act* (pp. 47, 48 of the Report):

(a) They are third party type prepaid payment instruments (limited to those that are recorded in an electronic device and other objects by electronic or magnetic means);
(b) They are instruments which can assign or transfer value by using an electronic data processing system[10] [11];
(c) They are managed in an account (meaning the account in which the unused balance pertaining to the prepaid payment instrument is entered or recorded by the issuer);
(d) The account in (c) above is limited to an account that can be repeatedly reloaded with value[12];
(e) In accordance with the classifications in (aa) to (cc) below, they are instruments that meet the following criteria, where relevant:[13]
  (aa) In the case of item (1) balance transfer type instruments: the amount transferrable to another account exceeds certain threshold amounts.
    Specifically, the thresholds will be where the amount transferred per transfer exceeds 100,000 yen or the cumulative amount transferred per month exceeds 300,000 yen.
  (bb) In the case of item (2)-1 number notification type instruments (in a narrow sense): the amount to be loaded to the account through prepaid payment instruments that can be notified by e-mail, etc. (ID numbers, etc.) exceeds certain threshold amounts.
    Specifically, the thresholds will be where the amount loaded per transfer exceeds 100,000 yen or the cumulative amount loaded per month exceeds 300,000 yen.
  (cc) In case of item (2)-2 international brand prepaid payment instruments: the amount to be loaded to the account or amount of use exceeds certain threshold amounts.[14]

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[10] Meaning the prepaid payment instruments falling under the types described in (1), (2)-1 and (2)-2.
[11] Footnote 154 of the Report elaborates as follows: "Even where the terms and conditions of the contract, etc. pertaining to the services of prepaid payment instruments prohibit the assignment, etc. of prepaid payment instruments, if the user can in fact substantially make an assignment, etc. contrary to this prohibition, it will be deemed to satisfy the requirements of this (b)." Therefore, in order to not satisfy this requirement, it is insufficient to merely stipulate restrictions on assignment or transfer in the terms and conditions and, rather, it is necessary to render any such assignment or transfer technically impossible.
[12] Footnote 155 of the Report indicates that "A contract to open an account is a contract for continuous or repeated issuance of prepaid payment instruments," thus, the type of services where users charge prepaid payment instruments to accounts is considered to basically satisfy the requirements of (d). As a type excluded from the requirements of (d), on the other hand, are the so-called use-out electronically transferable prepaid payment instruments, as indicated in Footnote 156 of the Report.
[13] As footnote 157 of the Report indicates, "For example, in the case of a prepaid payment method that falls under both (a) balance transfer type and (b) number notification type (in a narrow sense), if the amount that can be transferred to another account is within a certain amount, and the amount that can be loaded to an account by prepaid payment means that can be notified by e-mail, etc. (ID number, etc.) is within a certain amount, then this condition (e) is not applicable,". Thus, if the instrument falls under all of (1), (2)-1, and (2)-2, then it is necessary to note that this condition (e) is satisfied unless measures are assumed to prevent each instrument from meeting all of the respectively corresponding criteria (aa) to (cc).
[14] Footnote 159 of the Report indicates an approach for international brand prepaid payment instrument falling under the

Specifically, the thresholds will be if both the accumulated monthly amount to be loaded to the account and the accumulated monthly amount that the user is able to use both exceed 300,000 yen.

* However, even if an instrument falls under any of (aa) through (cc) above, if an instrument in which the maximum amount of unused balance (meaning the maximum amount of money that can still be charged to so-called wallets, etc. exclusive of the amount actually used) of the relevant account is limited to a certain amount (which is expected to be no more than 300,000 yen), such instrument will be exempt from regulation under the *Criminal Proceeds Act* (i.e. such instrument is not applicable to electronically transferable large sum type prepaid payment instruments).

Concerning the regulator's approach to determining the thresholds for the "Amount to be loaded to the account through prepaid payment instruments that can be notified by e-mail, etc. (ID numbers, etc.)" in (bb) above, the amount loaded directly to the balance without using ID numbers, etc. that are prepaid payment instruments (e.g., payment from credit cards or bank accounts, receipt of resale market sales proceeds) is not included. On the other hand, such an amount is included in "the maximum amount of unused balance of an account is limited to a certain amount" in * above (Footnote 158).

(3) Contents of new legislation on "electronically transferable large sum type prepaid payment instruments"

It is expected that the following regulations will be newly imposed on issuers of electronically transferable large sum type prepaid payment instruments (p. 51 of the Report):

- Strengthening of monitoring by the authorities will be required by way of mandating the following matters to be stated in the application form for registration under the *Payment Services Act* and notification of business implementation plans.
  → This means that, from the viewpoint of user protection, the business implementation plan must state the product design, the operating parameters of the system, monitoring methods, and policies for dealing with users in the case of unauthorized use.
- Regulation of issuers of electronically transferable large sum type prepaid payment instruments such as by requiring them to verify the identities of customers at the time of the transactions and by mandating the reporting of suspicious transactions pursuant to the *Criminal Proceeds Act*.
  → This means that the regulators will designate issuers of "electronically transferable large sum type prepaid payment instruments" as specified business operators under the *Criminal Proceeds Act*; designate the opening of accounts for "electronically transferable large sum type prepaid payment instruments" as specified transactions under the *Criminal Proceeds Act*; designate any business pertaining to the issuance of "electronically transferable large sum type prepaid payment

item (2)-2 type whereby the amount actually used would serve as the criterion (and not only the amount that could be loaded into the account) in light of the fact that prepaid payment instruments themselves are not transferred electronically, that they utilize credit card's settlement infrastructure, and that the credit card controls the amount used.

instruments" as a specified business under the *Criminal Proceeds Act*; and prohibit the transfer of accounts for "electronically transferable large sum type prepaid payment instruments." As a result, it is expected that issuers of electronically transferable large sum type prepaid payment instruments would be required to perform user identity verification (KYC) at the time of opening an account and would be obligated to report suspicious transactions regarding transfers, etc. among the users of electronically transferable large sum type prepaid payment instruments even after their issuance.

The current issuers of electronically transferable large sum type prepaid payment instruments are expected to be given an appropriate grace period after the new regulations come into force because they will need to establish the necessary systems and inform current users accordingly.

2-1-4 Issues to be considered in the future

It is indicated on page 52 of the Report that the WG focused particularly on electronically transferable large sum type prepaid payment instruments because these are presently considered to have an especially high risk of being used for money laundering; however, this does not mean that there is a low risk of being used for money laundering for other types of prepaid payment instruments. The WG is committed to continuously reviewing the system and to acting in a timely and flexible manner in view of future changes in the risk environment related to money laundering and the status of the provision of services for prepaid payment instruments.

The Report sets out the following specific issues to be considered in the future. These issues are quite specific and are substantially focused on actual practice. Therefore, it will be necessary to pay close attention to future developments to see whether they will result in legislative changes.

(a) It is necessary to continuously review the scope of electronically transferable large sum type prepaid payment instruments in light of the actual use of prepaid payment instruments in the future and in light of changes in the risk environment related to money laundering, etc.

(b) The regulations under the current *Payment Services Act* do not apply to prepaid payment instruments that are valid for only six months or less.

In this regard, among the prepaid payment instruments that are valid for only six months or less, which are excluded from regulation under the *Payment Services Act*, those by which users can exchange or purchase other prepaid payment instruments could be said to be substantially equal to those that are valid for more than six months (which are not excluded from regulation under the *Payment Services Act*). Therefore, it is necessary to consider whether the former should in fact be excluded from such regulation. In addition, regarding prepaid payment instruments that are identified as being excluded from such regulation that can be used to transfer large sums of money, it is also necessary to consider whether or not the maximum period of validity for such instruments should be fixed at a term that is less than six months, in line with designating electronically

transferable large sum type prepaid payment instruments, given that they pose a particularly high risk of being used for money laundering.

(c) With respect to number notification type prepaid payment instruments that cannot be reloaded to an account (commonly known as one-use type electronically transferable prepaid payment instruments), such instruments are not considered as electronically transferable large sum type prepaid payment instruments because, in practice, it is difficult to perform a user identity verification (KYC) at convenience stores etc., where such instruments are sold. The Report presents an approach that, while proposing a review of the expansion of the scope of electronically transferable large sum type prepaid payment instruments mentioned above at (a), it also proposes the necessity of simultaneously conducting a review of prepaid payment instruments that are treated as having a lower risk of money laundering to determine whether any additional measures (e.g., strengthening an issuer's obligation to develop a system for monitoring number notification-type electronically transferable prepaid payment instruments (see 2-1-2 above)) are required. Examples of the additional measures might include requiring issuers to conduct simple identity verification measures or to make reports on suspicious transactions based on the *Criminal Proceeds Act*, and such measures might also take into account the status of the issuers' review of their product design and monitoring.

End

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