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Recent developments in blockchain-based digital bond offerings in Japan

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THIS ARTICLE PROVIDES AN OUTLINE OF SOME OF THE CENTRAL REGULATORY ISSUES REGARDING DIGITAL SECURITIES, THE DIGITAL BOND OFFERINGS CONDUCTED TO DATE, AND THE KEY LEGAL CONSIDERATIONS IN THE DEVELOPMENT OF DIGITAL SECURITIES IN JAPAN.

Introduction

In response to the emergence of fintech across the globe, an increasing number of major financial institutions in Japan are offering blockchain-based digital securities. In recent years, they have mainly focused on offerings of digital bonds and tokenised equity interests in real estate funds. This new trend has been boosted by the introduction of new regulations on digital securities under the Financial Instrument and Exchange Act of Japan (the “FIEA”) that came into effect on May 1, 2020.

The terms “digital securities” and “digital bonds” are not legislatively defined. However, “digital securities” is generally understood to mean securities issued based on blockchain technology that fall within any of three categories (as further described in below). “Digital bonds” is generally understood to mean bonds issued based on blockchain technology that constitute Tokenised Paragraph 1 Securities (as defined below).

Overview of the new digital securities regulatory framework in Japan

The FIEA has conventionally classified securities into: (i) traditional securities, such as shares and bonds

(“Paragraph 1 Securities”), and (ii) contractual rights, such as trust beneficiary interests and interests in collective investment schemes (“Paragraph 2 Securities”). Paragraph 1 Securities are subject to stricter disclosure and licensing/registration requirements because they are highly liquid. The requirements applicable to Paragraph 2 Securities, which are less liquid, are relatively less stringent. However, securities issued via electronic data processing systems, such as blockchain, are expected to be more liquid than securities issued via traditional methods, such as Paragraph 1 or Paragraph 2 Securities.

For this reason, a new regulatory framework has been introduced under the FIEA for securities that are transferable by electronic data processing systems. Under the new regulatory framework, such securities are classified into the following three categories:

- (1) paragraph 1 Securities (such as shares and bonds) that are transferable by electronic data processing systems (“Tokenised Paragraph 1 Securities”);
- (2) contractual rights (such as trust beneficiary interests and interests in collective investment schemes), conventionally categorised as Paragraph 2 Securities, which are transferable by electronic data processing systems (electronically recorded transferable rights (“ERTRs”)); and

- (3) contractual rights (such as trust beneficiary interests and interests in collective investment schemes), conventionally categorised as Paragraph 2 Securities, which are transferable by electronic data processing systems but the negotiability of which is limited (“Non-ERTR Tokenised Paragraph 2 Securities”).

An issuer of Tokenised Paragraph 1 Securities or ETRTs is in principle required, before making a public offering or secondary distribution of such securities, to file a securities registration statement, as is the case for traditional Paragraph 1 Securities, unless the private placement exemption applies. Any person who engages in the business of selling, purchasing or handling the offering of Tokenised Paragraph 1 Securities or ETRTs is required to undergo registration as a Type 1 Financial Instruments Business Operator (“Type 1 FIBO”).

In light of the higher degree of discretion involved in the design of Tokenised Paragraph 1 Securities or ETRTs, as well as the higher liquidity of these securities, a Type 1 FIBO that handles such digital securities will be required to take steps to control the risks associated with digital networks, such as the blockchain used for digital securities offerings.

Digital bonds offerings in Japan

Although not common, there have been two instances of digital bonds offerings in Japan.

Digital asset bonds and digital bonds issued by Nomura Research Institute

In March 2020, Nomura Research Institute, Ltd. (“NRI”) issued two series of bonds by private placement using block chain technology, naming them “digital asset bonds” and “digital bonds,” respectively. The technical infrastructure of these bonds, “ibet,” was provided by BOOSTRY Co., Ltd. (“BOOSTRY”).

The digital asset bonds were offered directly to investors by NRI itself. Under these bonds, instead of interest payments, digital assets in the form of coupons were distributed to investors through ibet. The distributed

digital assets were points with values equivalent to money and were usable for café products. NRI solicited investors for the digital asset bonds through a smartphone app connected to ibet.

The digital bonds, which were similar to traditional bonds in some ways, were underwritten and offered to investors by Nomura Securities Co., Ltd. (“Nomura”). As with traditional bonds, monetary payments of interest were made under the digital bonds.

The aforementioned bonds have already been redeemed as they had a term to maturity of three months from the date of their issuance. The number of people to which the bonds were sold was limited as the bonds were offered by private placement.

Although these bond issuances took place before the new regulatory framework on digital securities came into effect on May 1, 2020, they were the first blockchain-based bonds to be offered in Japan. If they had been issued under the current regulatory framework, they would constitute Tokenised Paragraph 1 Securities.

Security token bonds issued by SBI Securities

In April 2021, SBI SECURITIES Co., Ltd. (“SBI Securities”) issued blockchain-based bonds, called “security token bonds,” by way of a public offering. The security token bonds fall within the category of Tokenised Paragraph 1 Securities. The technical infrastructure of the bonds was “ibet for Fin,” which was also developed by BOOSTRY.

The security token bonds were offered directly to investors by SBI Securities itself. In addition to interest payments, holders of the security token bonds were also given crypto assets, called XRP, as rewards. The amount of such rewards depends on the amount of the bonds held. The security token bonds have a term to maturity of one year from the date of their issuance. Holders of the bonds (except for SBI Securities) are restricted from selling their bonds to any person other than SBI Securities, and all such sale have to be conducted through the ibet for Fin system.

This is the first public offering of digital bonds in Japan.

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No registration under book-entry transfer system

The aforementioned digital asset bonds, digital bonds and security token bonds have not been registered with the book-entry transfer system in Japan, operated by Japan Securities Depository Center, Inc. (“JASDEC”) in accordance with the Act on Book-Entry Transfer of Corporate Bond and Shares of Japan, which was enacted as a special legislation of the Companies Act of Japan (the “Companies Act”).

The book-entry transfer system is a “multi-layered” system under which bonds are registered with the book-entry transfer system, and issuances and transfers thereof are effected by way of book-entries. Only account management institutions, such as securities companies, banks and other financial institutions approved by JASDEC are able to engage in book-entry transfers of securities. Investors are required to open an account with approved account management institutions before they can hold securities under the book-entry transfer system. Accordingly, bond issuers would only have information on such account management institutions and not information on the actual investors themselves.

By contrast, under the Companies Act, transfers of bonds in respect of which certificates are not issued, are effected through agreements between sellers and buyers, with perfection carried out through a bond register. Issuers of bonds may maintain bond registration by electronic means as long as the relevant electronic records satisfy the requirements under the Companies Act. What this means is that if the relevant records of bonds on a blockchain platform satisfy such requirements, such records maintained by an issuer of bonds or bond register agent would be deemed effective bond registration under the Companies Act. This would enable perfection of bond transfers within the blockchain platform.

By maintaining a register of bonds by themselves, instead of registering with the book-entry transfer system, bond issuers would have access to information on the investors who have actually purchased the bonds. This would enable bond issuers to approach investors directly for solicitation and to provide them with marketing and other information.

In addition, bond issuers would also be able to provide investors with gifts of coupons or other rewards which cannot be provided through the book-entry transfer system, using the information in the bond registers, as SBI Securities had done in respect of its security token bonds.

Key legal considerations in the development of digital securities

To promote the practical utilisation of digital securities, it is necessary to increase the convenience of their usage by investors. This requires enhancement of the speed of transactions involving digital securities, and the lowering of costs for such transactions. To this end, infrastructure enabling investors to securely complete and perfect transactions within a blockchain platform (without the need for any procedures beyond the platform) would be ideal. This raises several issues, some of which are discussed below.

Restriction of transactions outside blockchain platform

As noted above, bonds are transferrable simply by agreement between sellers and buyers under the Companies Act. In the case of digital bonds, if a bond issuer does not restrict bond transfers outside a blockchain platform, the issuer (or bond register agent) would not be



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able to obtain and record information on all the bond transactions that have taken place. This would make it difficult to maintain an accurate perfection system. Accordingly, it is important to effectively restrict transactions outside the blockchain platform so as to provide security for investors. With that said, bond transfers outside the platform would be deemed legally valid under the Companies Act if the purchaser of the bonds, without having been grossly negligent, is unaware of the relevant transfer restriction. This is an issue that would require careful consideration as well.

Secondary market system

There is currently no secondary market system for digital securities in Japan. However, such a market system would be necessary to allow investors to monetise the digital securities they have acquired in the primary market, and thereby enable fundraising through offerings of digital securities. Utilisation of proprietary trading systems (PTS) is a possible solution to this.

Although discussions in this regard have started among some companies and self-regulating organisations, certain remain to be resolved, such as (i) the scope of digital securities to be covered in the secondary market system, (ii) the method by which the trading prices of digital securities would be determined, (iii) the extent to which laws and regulations (including self-regulatory rules) would be required, and (iv) the licence regime required for operators of the secondary market system.

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