THE VIRTUAL CURRENCY REGULATION REVIEW

SIXTH EDITION

Editor
Paul Anderson

THE LAWREVIEWS

Published in the United Kingdom
by Law Business Research Ltd
Holborn Gate, 330 High Holborn, London, WC1V 7QT, UK

www.thelawreviews.co.uk

Enquiries concerning reproduction should be sent to info@thelawreviews.co.uk.
Enquiries concerning editorial content should be directed to the Content Director,
Clare Bolton – clare.bolton@lbresearch.com.

ISBN 978-1-80449-200-0

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ANDERSON MŌRI & TOMOTSUNE

CHARLES RUSSELL SPEECHLYS

DENTONS

DE ROOS ADVOCATEN

DETAIL COMMERCIAL SOLICITORS

GERNANDT & DANIELSSON ADVOKATBYRÅ

GOLDMAN SACHS BANK EUROPE SE

GONZALEZ CALVILLO

HAN KUN LAW OFFICES

HENGELER MUELLER PARTNERSCHAFT VON RECHTSANWÄLTEN MBB

K&A

KGP LEGAL LLC

KRAMER LEVIN NAFTALIS & FRANKEL LLP

LENER & PARTNERS

LEXTERS

MARVAL O'FARREL MAIRAL

OPINIO LEGAL

PINHEIRO NETO ADVOGADOS

RAMPARTS, GIBRALTAR

RUSSELL MCVEAGH

SCHELLENBERG WITTMER LTD

SQUIRE PATTON BOGGS

STIKEMAN ELLIOTT LLP

URÍA MENÉNDEZ

VERTEQ CAPITAL

Chapter 12

JAPAN

Ken Kawai, Takeshi Nagase and Huan Lee Tan[1]

I INTRODUCTION TO THE LEGAL AND REGULATORY FRAMEWORK

Japanese law does not have a unified regime applicable to tokens issued or minted on a blockchain. The legal status of tokens under Japanese law is determined in accordance with their functions and uses. For example, cryptocurrency and utility tokens such as BTC and ETH are regulated as cryptoassets under the Payment Services Act (PSA). A business operator that engages in the business of buying, selling or exchanging cryptocurrencies or intermediating these activities, or managing cryptocurrencies for the benefit of others, is required to register as a cryptoasset exchange service provider (CAESP).

In contrast, 'security tokens', which represent shares, bonds or fund interests in tokens, are regulated under the Financial Instruments and Exchange Act (FIEA) as electronically recorded transferable rights to be indicated on securities (ERTRISs). Business operators that engage in the business of offering, handling the offering, buying, selling or exchanging ERTRISs, or intermediating these activities, are required to register as a Type I financial instruments business operator (a Type I FIBO).

In addition, if tokens constitute 'stablecoins', prices of which are pegged to the value of a fiat currency, the tokens are likely to be classified as either cryptoassets or means of funds remittance transactions, depending on whether the stablecoins are redeemable in fiat currency. In this regard, on 4 March 2022, the Bill for Partial Amendment to the Act on Payment Services Act, etc. for the Purpose of Establishing a Stable and Efficient Funds Settlement System was submitted to the Diet (the national legislature), which approved it on 3 June 2022 (the Amendment Act). The Amendment Act aims to establish a stable and efficient funds settlement system that can respond to the digitalisation of finance and other fields, against the following backdrop:

a the increasing issuance and circulation of stablecoins overseas;

b the growing need to further improve the effectiveness of transaction monitoring by banks, among other institutions; and

c the spread of prepayment instruments that enables payment by electronic means.

In addition, in response to item (a) above, the Amendment Act also introduces the concept of electronic payment instruments (EPI), which corresponds to the concept of stablecoins (Article 2, Paragraph 5 of the Amended Payment Services Act (the Amended PSA)).

1 Ken Kawai and Takeshi Nagase are partners and Huan Lee Tan is special counsel at Anderson Mōri & Tomotsune.

The Amendment Act also provides a new definition of intermediary activities in respect of the management of stablecoins that constitute EPIs. Specifically, the Amendment Act defines the management of stablecoins that constitute EPIs as 'electronic payment instruments exchange services' (EPIES). Furthermore, the Amendment Act introduces a registration system for businesses engaged in these activities. The Amendment Act came into effect on 1 June 2023.

Tokens other than those mentioned above (such as non-fungible tokens (NFTs), which serve no economic function as a means of payment because of their unique characteristics) will not be regulated under financial regulations in principle.

II SECURITIES AND INVESTMENT LAWS

i Electronically recorded transferable rights and tokenised securities

The FIEA has traditionally classified securities into: conventional securities, such as shares and bonds (Paragraph 1 Securities); and contractual rights, such as trust beneficiary interests and interests in collective investment schemes that are deemed securities (Paragraph 2 Securities). Paragraph 1 Securities, which are more liquid, have been subject to relatively more stringent disclosure and licensing (registration) requirements. Paragraph 2 Securities, being less liquid, have been subject to relatively more lenient requirements. Against this backdrop, securities issued using an electronic data processing system, such as a blockchain, are expected to be even more liquid than Paragraph 1 Securities. For this reason, under the FIEA, securities transferable by electronic data processing systems have been classified into the following three categories:

a Paragraph 1 Securities (such as shares and bonds) that are transferable through electronic data processing systems (tokenised Paragraph 1 Securities);

b contractual rights (such as trust beneficiary interests and interests in collective investment schemes) that are conventionally categorised as Paragraph 2 Securities and transferable through electronic data processing systems (also known as electronically recorded transferable rights (ERTRs)); and

c contractual rights (such as trust beneficiary interests and interests in collective investment schemes) that are conventionally categorised as Paragraph 2 Securities and are transferable through electronic data processing systems but whose negotiability is restricted to a certain extent (non-ERTR tokenised Paragraph 2 Securities).

Definition of ERTRs

ERTRs refer to the rights conventionally treated as Paragraph 2 Securities (such as trust beneficiary rights and interests in collective investment schemes) that 'are represented by proprietary value transferable by means of an electronic data processing system (but limited only to proprietary values recorded in electronic devices or otherwise by electronic means)', excluding 'those rights specified in the relevant Cabinet Office Ordinance in light of their negotiability and other factors'. In this connection, 'those rights specified in the relevant Cabinet Office Ordinance in light of their negotiability and other factors' are generally understood to mean rights in respect of which technical measures have been taken to prevent the transfer of the proprietary value of these rights to persons other than:

a qualified institutional investors; or

b investors eligible to conduct specially permitted businesses for qualified institutional investors (the Article 63 Exemption) such as:

- listed companies;
- corporations with capital or net assets of ¥50 million or more; and
- individuals with investment assets (including cryptoassets) of ¥100 million or more, who have maintained their securities accounts for more than one year.

Technical measures have been taken to prevent the proprietary value of these rights from being transferred without an offer from the owner and approval from the issuer for every transfer.

The key purpose of the FIEA is to subject ERTRs to the disclosure and licensing (registration) requirements applicable to Paragraph 1 Securities.

Definition of tokenised securities

Tokenised securities refer to dematerialised (paperless) securities that are 'represented by proprietary value transferable by means of an electronic data processing system (but limited only to proprietary values recorded in electronic devices or otherwise by electronic means)'. Tokenised securities can be classified into the following rights:

a tokenised Paragraph 1 Securities (such as tokenised shares and bonds);
b ERTRs; and
c non-ERTR tokenised Paragraph 2 Securities.

Under the FIEA, rights under points (a) and (b) above are deemed Paragraph 1 Securities, while rights under point (c) are treated as Paragraph 2 Securities. This classification creates a significant difference in the disclosure and licensing (registration) requirements applicable to the rights.[2]

Disclosure requirements

As a result of the application of disclosure requirements to ERTRs, issuers of ERTRs are (in principle) required, upon making a public offering or secondary distribution of ERTRs, to file a securities registration statement and issue a prospectus. A person who causes other persons to acquire ERTRs or who sells ERTRs to other persons through a public offering or secondary distribution must deliver a prospectus to the other persons in advance or at the time of the acquisition or sale.

Licensing (registration) requirements

As ERTRs constitute Paragraph 1 Securities, a person acting as a broker, agent or intermediary in respect of the sale or purchase of ERTRs or the handling of an offering of ERTRs in the course of a business is required to undergo registration as a Type I FIBO under the FIEA.

ii Regulations governing cryptoasset derivative transactions

Regulations governing cryptoasset derivative transactions have been introduced by the FIEA to protect users and to ensure that such transactions are appropriately conducted. More specifically, for the purposes of subjecting derivative transactions involving financial

2 Disclosure requirements do not apply to rights under point (c) unless these rights constitute rights in securities investment business and solicitation for interest in these rights has been conducted, as a result of which 500 persons or more come to hold the rights. Only Type II FIBOs, and not Type I FIBOs, are permitted to handle public offerings and private placements of rights under point (c).

instruments or financial indicators to certain entry regulations and rules of conduct issued under the FIEA, cryptoassets have been inserted in the definition of 'financial instruments' under the FIEA. Furthermore, the prices, interest rates and other aspects of cryptoassets have been incorporated into the definition of financial indicators.

As cryptoassets are now included in the definition of financial instruments, the conduct of over-the-counter derivative transactions related to cryptoassets or intermediary or brokerage activities in relation thereto will also constitute Type I financial instruments business under the FIEA.

iii Prohibitions against unfair acts in cryptoasset or cryptoasset derivative transactions

In respect of cryptoasset spot transactions and cryptoasset derivative transactions, the FIEA contains prohibitions against the following: wrongful acts; dissemination of rumours, fraudulence, assault or intimidation; and market manipulation. These prohibitions (which are without limit as to the violating party) are intended to enhance the protection of users and to prevent the obtainment of unjust benefits. Breach of these prohibitions is punishable by penalties.

Insider trading, however, is not regulated under the FIEA, owing to difficulties with both the formulation of a clear concept of cryptoasset issuers and the identification of undisclosed material facts.

III BANKING AND MONEY TRANSMISSION

i Approach of the central bank

Cryptoassets are neither deemed money nor equated with fiat currency. The Bank of Japan (BOJ) neither supports nor prohibits the use of cryptoassets.

It has also been reported that the BOJ has no plans to issue any central bank digital currency (CBDC) at this point in time. To ensure the stability and efficiency of the entire payment and settlement system, however, the BOJ has highlighted the importance of being well prepared to respond to changes. In line with this, the BOJ conducted 'Proof-of-Concept Phase 1' from April 2021 to March 2022 to establish an experimental environment using several design patterns for the CBDC ledger, which is the foundation of the CBDC system, and to verify whether the basic functions of CBDCs could be properly executed.

In 'Proof-of-Concept Phase 2', conducted from April 2022 to March 2023, following Phase 1, the BOJ added several peripheral functions to CBDCs, and particularly to functions related to the CBDC ledger verified in Phase 1, to check certain important processing performance and technical capabilities in respect of the CBDC ledger. In Phase 2, the BOJ also looked at the possibility of applying new technologies to data models and databases in respect of CBDCs.

The government of Japan has so far not decided whether to issue CBDCs in Japan, but discussions continue to be held in this regard. On its part, the BOJ believes it important to continue preparations for any future issuance of CBDCs, including the continued conduct of technical demonstration tests, so as to be able to respond in a timely manner to future changes in the external environment.

ii Money transmission

Only licensed banks or registered fund transfer business operators are permitted to engage in 'funds remittance transactions' regulated under the Banking Act or PSA as a business. The Supreme Court, in a case precedent, has defined funds remittance transactions to mean 'the planned or actual transfer of funds, as requested by customers, through utilisation of a funds transfer system without physical transportation of cash between physically distant parties'. As funds do not include cryptoassets, however, a cryptoasset remittance transaction is unlikely to be deemed a funds remittance transaction.

In addition, among the stablecoins that have been issued by private business operators, stablecoins whose prices are linked to the value of fiat currency would fall within the definition of currency denominated assets, which are excluded from the definition of cryptoassets. Accordingly, such fiat currency-backed stablecoins are unlikely to constitute cryptoassets. Conversely, the issuance of fiat currency-backed stablecoins will likely constitute a funds remittance transaction. In this connection, as noted in Section I above, under the Amendment Act, the management of stablecoins that constitute EPIs will constitute 'electronic payment instruments exchange services'.

IV ANTI-MONEY LAUNDERING

To prevent cryptoasset-related money laundering and terrorism financing, the Act on Prevention of Transfer of Criminal Proceeds (APTCP) requires CAESPs or Electronic Payment Instruments Exchange Service Providers (EPIESPs) to implement know-your-customer (KYC) and other preventative measures. The APTCP applies to registered exchange providers, and generally requires them to:

a verify and record the identity of customers when conducting certain transactions (that is, to implement the KYC process);

b record transactions with customers;

c report suspicious transactions to the Financial Services Agency (FSA); and

d take measures to keep information regarding customer verification up to date, provide education and training for employees, and develop other systems necessary for the proper conduct of the processes described in points (a) to (c).

Travel Rule

When a CAESP or an EPIESP transfers cryptoassets or EPIs to a customer of another CAESP (including any foreign CAESP and EPIESP) at the request of a customer, the CAESP or EPIESP must notify the receiving CAESP or EPIESP of the identification information, including the name and blockchain address, pertaining to the sender and the receiver (Travel Rule). However, transfers to a CAESP or an EPIEPS in countries that do not yet have any Travel Rule legislation are not subject to the rule. In addition, when a CAESP or an EPIESP transfers cryptoassets or EPIs to an unhosted wallet at the request of a customer, it is not subject to the Travel Rule. Nevertheless, even for transactions that are not subject to Travel Rules, information on the counterparty (name, blockchain address, etc.) must be obtained and recorded.

V REGULATION OF EXCHANGES

i Regulation of CAESPs

Definition of CAESPs

The PSA and APTCP were primarily intended to regulate CAESPs, with a particular focus on protecting customers and preventing cryptoasset-related money laundering and terrorism financing. Pursuant to the PSA, those wishing to provide exchange services have to be registered with the Prime Minister as exchange providers.[3] To qualify, applicants must be either a stock company or a foreign CAESP with an office and representative in Japan. Accordingly, a foreign applicant is required to establish either a subsidiary (in the form of a stock company) or a branch in Japan as a prerequisite to registration. In addition, applicants are required to have the following:

a at least ¥10 million in capital as well as net assets with a positive value;
b a satisfactory organisational structure and appropriate operational systems to enable the proper provision of exchange services; and
c appropriate systems to ensure compliance with applicable laws and regulations.

The PSA also provides legislative definitions of 'cryptoasset exchange services' and 'cryptoasset'. Article 2, Paragraph 15 of the PSA defines exchange services as engagement in any of the following activities as a business:

a sale or purchase of cryptoassets, or the exchange of a cryptoasset for another cryptoasset;
b intermediating, brokering or acting as an agent in respect of the activities listed in point (a);
c management of customers' money in connection with the activities listed in points (a) and (b); or
d management of customers' cryptoassets for the benefit of another person.

The PSA designates the activities under point (d) above as a type of CAESP. Consequently, management of cryptoassets without the sale and purchase thereof (cryptoasset custody services) is included in the scope of CAESPs. Therefore, a person engaging in cryptoasset custody services must be registered as a CAESP. In this context, the FSA Administration Guidelines (guidelines on cryptoassets) explain the meaning of 'management of customers' cryptoassets for the benefit of another person' as follows:

> *although whether or not each service constitutes the management of cryptoassets should be determined based on its actual circumstances, a service constitutes the management of cryptoassets if a service provider is in a position in which it may transfer its users' cryptoassets (for example, if such service provider owns a private key with which it may transfer users' cryptoassets solely or jointly with its related parties, without the users' involvement).*

Accordingly, it is understood that if a service provider merely provides its users with a cryptoasset wallet application (i.e., a non-custodial wallet) and private keys are managed by the users themselves, this service would not constitute a cryptoasset custody service.

3 The registration will be carried out through the FSA and the relevant local finance bureau, which act as the Prime Minister's delegate.

Definition of cryptoasset

A cryptoasset is defined in Article 2, Paragraph 14 of the PSA as:

a a proprietary value that may be used to pay an unspecified person the price of any goods, etc. purchased or borrowed or any services provided, where the proprietary value may be:
  - sold to or purchased from an unspecified person, provided the sale and purchase is recorded on electronic or other devices through electronic means; and
  - transferred through an electronic data processing system (Type I cryptoasset); or

b a proprietary value that may be exchanged reciprocally for the proprietary value specified in point (a) with an unspecified person, where the proprietary value may be transferred through an electronic data processing system (Type II cryptoasset).

Principal regulations applicable to the operation of exchange providers

CAESPs are required to:

a take the measures necessary to ensure the safe management of information available to them;

b provide sufficient information to customers;

c take the measures necessary for the protection of customers and the proper provision of services;

d segregate the property of customers from their own property and subject the segregation to regular audits by a certified public accountant or audit firm; and

e establish internal management systems to enable the provision of fair and appropriate responses to customer complaints, and implement measures for the resolution of disputes through financial alternative dispute resolution proceedings.

Additional regulations under the PSA

Under the PSA, the following changes have been made to the regulatory system governing CAESPs, both to enhance user protection and to clarify the rules relating to CAESPs:

a expansion of grounds on which applications for registration as a CAESP may be rejected;

b introduction of a system of advance notification for any proposed amendment to certain aspects of the relevant cryptoasset, such as its name;

c introduction of regulations governing advertisements and solicitation in respect of exchange services;

d introduction of disclosure requirements where cryptoassets are exchanged (or where certain similar transactions are undertaken) via the grant of credit to users;

e enhancement of the obligation on CAESPs to preserve users' assets; and

f grant of rights to users to enable their receipt of preferential payment when claiming for the return of cryptoassets.

With respect to point (e) above, a CAESP is required under the PSA both to manage the money of users separately from its own money and to entrust users' money to a trust company or any other similar entity in accordance with the provisions of the relevant Cabinet Office ordinance. In other words, a CAESP is required not only to manage the money of users in bank accounts separately from its own, but also to entrust the money to a trust company or trust bank, acting as trustee.

In addition, a CAESP is required to manage the entrusted cryptoassets, in principle, by using a cold wallet that has never been and will never be connected at any time to the internet (totally offline wallet) or through other methods by taking technical safety management measures equivalent to a totally offline wallet.[4] A CAESP may exceptionally manage cryptoassets through other methods, such as using multi-signature hot wallets, if these methods are necessary for ensuring users' convenience and smooth performance of cryptoasset exchange services. However, the yen equivalent of the entrusted cryptoassets managed by the other methods must not exceed 5 per cent of the yen equivalent of the total entrusted cryptoassets.

ii Regulation of EPIESPs

Definition of EPIs

As noted in Section I above, in response to the increasing issuance and circulation of stablecoins overseas, the Amendment PSA has introduced the concept of EPI, which corresponds to the concept of stablecoins. The Amended PSA stipulates four categories of EPIs, as follows (Article 2, Paragraph 5 of the PSA):

a currency-denominated assets that are recorded and transferred electronically, are usable for paying consideration to unspecified persons, and capable of being purchased from or sold to unspecified persons (Type I EPIs);

b a property value exchangeable with Type I EPIs with an unspecified counterparty, and transferable by means of an electronic information processing system (Type II EPIs);

c specified trust beneficiary rights (Type III EPIs); and

d those instruments specified by Cabinet Order as falling under the three preceding items (Type IV EPIs).

With regard to the definition of Type I EPIs, 'currency-denominated assets' are defined as assets denominated in Japanese yen or a foreign currency, or with respect to which the performance, repayment, or any other activity equivalent thereto will be carried out in Japanese yen or a foreign currency. Based on this definition, a digital coin whose value is pegged to the Japanese yen, US dollar or any other fiat currency (such as, for example, where the price of a digital coin is always fixed at one yen or dollar, or where a digital coin is redeemable at one yen or dollar) may fall within the definition of Type I EPIs, but would not constitute cryptoassets.

In view of the above, 'algorithmic stablecoins' that are not collateralised by fiat currency but whose values are linked to fiat currency through an algorithm are unlikely to qualify as currency-denominated assets. Such algorithmic stablecoins will likely constitute cryptoassets if they are transferable or tradeable with unspecified parties on the blockchain.

Type I EPIs and other currency denominated assets are distinguishable by the following: (1) whether it can be used as payment for consideration to unspecified persons and (2) whether it is capable of being purchased from or sold to unspecified persons. More specifically, a prepaid payment instrument (PPI) and electronic money that are issued by fund transfer service providers do not satisfy condition (1), as their issuers would centrally manage the balance of each user and the scope of accepting stores (member stores). Additionally, even though digital money is issued on a blockchain, it will not satisfy condition (2) if the issuer

4 The FSA Administration Guidelines provide that in determining whether measures equivalent to a totally offline wallet have been taken, each case will be judged based on its specific circumstances.

has imposed technical measures to allow the digital money to be transferred only to persons who have been verified at the time of transaction (i.e., KYC), and if the issuer's consent or other involvement is required for each transfer of the digital money. Consequently, only permissionless stablecoins (e.g., USD Tether issued by Tether Operations Limited or its affiliates (USDT) and USD Coin designed and issued by Centre Consortium, etc. (USDC)) would typically be considered as falling within the definition of Type I EPIs, as permissionless stablecoins generally do not require KYC of new stablecoin holders or any other involvement of the issuer when transferred.

Because EPIs must be property value denominated in a legal currency, and issuance and redemption of EPIs enable parties across long distances to pay and receive funds without directly delivering cash, the issuance and redemption of EPIs thus constitute 'fund remittance transactions'. Consequently, a banking licence or fund transfer business registration would in principle be required to issue and redeem EPIs. In addition, Trust companies and foreign trust companies are also permitted to issue EPIs, although they are only permitted to issue Type III EPIs (specified trust beneficiary rights)

Definition of EPIESP

It is also noteworthy that it is not possible for a CAESP to list EPIs on its exchange without being registered as an EPIESP. More specifically, a person who engages in activities including, but not limited to the following, is required to be registered as an EPIESP:

a sale and purchase of EPIs or exchange of EPIs for other EPIs;

b intermediary, brokerage or delegation activities in respect of such sale, purchase or exchange; and

c management of EPIs for the benefit of another person.

VI REGULATION OF MINERS

As the mining of cryptoassets does not fall within the definition of CAESPs, mining activities are not regulated under existing Japanese regulations. However, interests in mining schemes formulated as collective investment scheme interests or interests in cloud mining schemes may be deemed securities under the FIEA and could therefore be subject to its provisions.

VII REGULATION OF ISSUERS AND SPONSORS

i Regulation of initial coin offering tokens and token issuers

Tokens issued by way of an initial coin offering (ICO) take many forms, and the Japanese regulations applicable to a token vary depending on the ICO scheme involved.

Cryptoasset-type tokens

A token that falls within the definition of a cryptoasset will be subject to cryptoasset-related regulations under the PSA. A token that is subject to the PSA must be sold by or through a CAESP.

The Japan Virtual and Crypto Asset Exchange Association, a self-regulatory organisation established under the PSA, published a draft of self-regulatory rules and guidelines for ICOs of cryptoasset-type tokens entitled Rules for Selling New Crypto Assets (the ICO Rules). On the basis of the ICO Rules, ICOs may be categorised into two types:

a where a CAESP issues new tokens and sells these tokens by itself; and
b where a token issuer delegates the sale of newly issued tokens to CAESPs.

Generally, in addition to ensuring the security of newly issued tokens, including the blockchain, smart contract, wallet tool and other aspects thereof, the ICO Rules require that the following be satisfied for all ICOs:

a maintenance of a business structure that facilitates review of the business for which funds are raised via an ICO;
b disclosure of information on the token issuer, the token issued, the proposed use of proceeds raised and other matters;
c segregation of the management of ICO proceeds (both fiat currency and cryptoassets) from the management of the issuer's own funds;
d proper accounting treatment and financial disclosure of ICO proceeds; and
e proper valuation of newly issued tokens.

Securities-type tokens

As noted in Section II.i, where distributions are made to token holders on the profits of a token issuer's business and calculated based on the ratio of a token holder's token ownership, the token involved may constitute an ERTR and consequently subject the token issuer to the provisions of the FIEA.

As ERTRs are expected to constitute Paragraph 1 Securities, a broker, an agency or an intermediary selling or purchasing ERTRs or handling a public offering of ERTRs in the course of business will be required to undergo registration as a Type I FIBO.

In addition, any ERTR issuer that solicits the acquisition of ERTRs (i.e., undertaking a security token offering) will be required to undergo registration as a Type II FIBO, unless it qualifies as a specially permitted business for qualified institutional investors.

Prepaid card-type tokens

Tokens that are similar to prepaid cards, in the sense of being usable as consideration for goods or services provided by token issuers, may be regarded as prepaid payment instruments, and accordingly could be subject to applicable regulations under the PSA. (A token subject to the prepaid payment instrument regulations under the PSA would not simultaneously be subject to the PSA regulations applicable to cryptoassets (and vice versa)).

ii Regulation of sponsors

As one of the primary purposes of cryptoasset regulation in Japan is the protection of cryptoasset exchange customers, sponsors of ICO issuers are not regulated by the PSA or other laws in respect of cryptoassets.

VIII CRIMINAL AND CIVIL FRAUD AND ENFORCEMENT

i Penal provisions applicable to exchange providers

The existing penal provisions found in the PSA are applicable to CAESPs. The following is a summary of some of the major violations under the PSA, and the penalties applicable for these violations.

a Imprisonment with penal labour for a term not exceeding three years or a fine not exceeding ¥3 million, or both, can be imposed for:
- providing exchange services without registration;
- registration through fraudulent means; or
- name lending.

b Imprisonment with penal labour for a term not exceeding two years or a fine not exceeding ¥3 million, or both, can be imposed for:
- a violation of the obligation to segregate customers' funds and cryptoassets from an exchange provider's funds and cryptoassets; or
- a violation of any order for the suspension of exchange services.

c Imprisonment with penal labour for a term not exceeding one year or a fine not exceeding ¥3 million, or both, can be imposed for:
- failure to give public notice of a business assignment, merger, demerger, company split or discontinuance of business, or dissolution in respect of an exchange provider, or giving false public notice thereof;
- a violation of the obligation to prepare and maintain books and documents, or the preparation of false books or documents;
- failure to submit the required report (and any required attachment thereto) for each business year to the Prime Minister, or submission of a report containing false statements;
- failure to comply with an order of the Prime Minister to submit reports or materials, or the submission of false reports or materials; or
- refusal to respond to questions or provision of false responses at an on-site inspection, or refusing to provide cooperation in respect of the inspection.

d Imprisonment with penal labour for a term not exceeding six months or a fine not exceeding ¥500,000, or both, can be imposed for any false statement in a registration application or attachments thereto.

e A fine not exceeding ¥1 million can be imposed for violating an order for the improvement of business operations.

f Imprisonment for a term not exceeding six months or a fine not exceeding ¥500,000, or both, can be imposed for any failure to make the required disclosure regarding advertisement or solicitation in respect of CAESPs.

g Imprisonment for a term not exceeding one year or a fine not exceeding ¥3 million, or both, can be imposed for any misrepresentation or any representation under a cryptoasset exchange agreement that will likely lead to an inaccurate understanding of the nature or other aspects of a cryptoasset.

h Imprisonment for a term not exceeding six months or a fine not exceeding ¥500,000, or both, can be imposed for:
- any misrepresentation or representation in an advertisement concerning an exchange service that will likely lead to an inaccurate understanding of the nature or other aspects of a cryptoasset; or

- any representation under a cryptoasset exchange agreement or in an advertisement concerning an exchange service, to induce the sale or purchase of a cryptoasset or the exchange of a cryptoasset for another cryptoasset that is not for the purpose of enabling the use of the relevant cryptoasset as a means of payment but is instead for the exclusive purpose of promoting interest in a particular cryptoasset.

ii Civil fraud

The PSA contains no specific regulation for the prevention of unfair trading or sale of tokens. However, the Civil and Penal Codes of Japan, and certain consumer protection laws and regulations,[5] are applicable to activities of this kind, except where the relevant token is deemed a security under the FIEA, in which case the FIEA provisions regulating unfair trading of securities will apply.

In addition, the Act on Sales, etc. of Financial Instruments (ASFI) is applicable to acts that result in the acquisition of cryptoassets. Where the ASFI is not applicable, customers wishing to claim against CAESPs will be required to establish a claim in tort. To address this unsatisfactory situation, the ASFI expressly imposes accountability on exchange service providers, including presuming the amount of damages that such service providers would owe, to reduce the burden of proof on the part of service users.

IX TAX

The treatment of consumption tax in respect of cryptoassets has been a hot topic in Japan. In the past, sales of cryptoassets were subject to Japanese consumption tax to the extent that the office of the transferor was located in Japan. However, following amendments to applicable tax laws, as of 1 July 2017, consumption tax cannot be imposed on a sale of cryptoassets, if the relevant cryptoasset is deemed a cryptoasset under the PSA (such as Bitcoin). Additionally, it was announced by the National Tax Agency of Japan that gains from the sale or use of cryptoassets will be treated as miscellaneous income, such that gains from the sale or use of cryptoassets cannot be offset against losses incurred elsewhere.

Further, it was stated in the Japanese government's Ruling Party's Tax Reform Proposal published in December 2022, that year-end corporate taxation in respect of cryptoassets would not apply to cryptoassets held by a corporation at the end of a fiscal year if such cryptoassets are (1) subject to valuation gains or losses based on market valuation and (2) meet certain requirements, such as if they have been issued by the corporation and have been continuously held since their issuance. As a result, on 20 June 2023, the National Tax Administration issued a Partial Revision of the Basic Notification on Corporate Tax, etc. (Notification on Interpretation of Laws and Regulations), which officially excludes from the scope of market valuation cryptoassets held by a corporation at the end of its fiscal year that are issued by the corporation itself and meet the following conditions:

a the cryptoassets were issued by the corporation and have been continuously held since their issuance; and

b the cryptoassets have been continuously restricted from being transferred by any of the following means since the date of their issuance:

5 Such as the Act on Specified Commercial Transactions, the Consumer Contract Act and the Act against Unjustifiable Premiums and Misleading Representations.

- certain technical measures are taken to ensure that the cryptoassets cannot be transferred to another party; or
- the cryptoassets have been held in a trust that meets certain requirements.

X OTHER ISSUES

Recently, digital art and digital trading cards represented by NFTs, which are non-replaceable digital tokens issued on a blockchain, have been traded for considerable amounts. As a result, NFTs have been rapidly gaining attention in Japan. While digital data is inherently free and easy to copy, NFTs are considered innovative because they involve creation of unique, one-of-a-kind data based on blockchain technology.

From the perspective of financial regulations, if NFTs are non-fungible, not substitutable and not used as a means of payment, they would not be considered cryptoassets under the PSA.

In this regard, according to the CryptoAsset Guidelines dated 24 March 2023 issued by the FSA, one of the factors for determining whether a token constitutes a Type I cryptoasset is whether it is 'an asset capable of being purchased or sold with legal fiat currency or crypto assets under socially accepted norms. Specifically, a token that satisfies items (i) and (ii) below' generally will not constitute a Type I cryptoasset. The same applies to the determination of whether a token constitutes a Type II cryptoasset:

a the issuer, etc. has made it clear that the token is not intended to be used as payment for goods, etc. to unspecified parties. This can be achieved by, for example, stating clearly in the terms and conditions of the issuer or its business handling service provider, or in the product description, that use of the token as a means of payment to unspecified parties is prohibited, or that the token or related system is designed in a way that does not enable it to be used as a means of payment to unspecified parties); and

b (where use of the token as a means of payment for goods, etc. to unspecified parties is permitted) certain requirements on the price and quantity of the relevant goods, etc., and on the technical characteristics and specifications of the token must be met. For example, at least one of the following characteristics must be present:

- the minimum value per transaction must be sufficiently high (i.e., ¥1,000 or more); or
- the number of tokens issuable, in proportion to the aforementioned minimum value of a transaction, is limited (i.e., not exceeding 1 million).

XI LOOKING AHEAD

Recently, decentralised finance (DeFi) has emerged and is growing rapidly. This is a decentralised financial system consisting of blockchain-based applications (commonly referred to as decentralised applications, or Dapps). DeFi is an umbrella term for financial systems and projects that are accessible and transparent to everyone, but the nature and degree of decentralisation vary from project to project. DeFi is not only a market for exchanging tokens, but also an application that enables a variety of financial transactions, including token lending between anonymous users, fund management, derivatives trading, insurance, identity management infrastructure and credit information infrastructure.

At present, Japanese law does not regulate DeFi directly, and each function of DeFi needs to be examined individually to determine whether it is subject to any financial

regulations. For example, in DeFi, decentralised exchanges (DEXs) that enable users to buy and sell tokens without a centralised administrator may fall under the category of CAESPs. However, the regulator may encounter difficulty in identifying specific operators of such DEXs and enforcing Japanese regulations effectively.