



Japan Regulatory Update on Virtual Currency Business

Financial Regulatory Alert

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On 1 April, 2017, an amendment (Amendment) to the Payment Services Act of Japan (PSA) and relevant cabinet ordinances came into effect, introducing a regulatory regime for virtual currency (VC) businesses and making Japan the first developed country to do so.

Since the Amendment, fifteen VC business operators have registered under this new regime.

This article discusses three primary issues related to the VC business in Japan as a consequence of these recent legislative developments: (i) the regulatory framework for VC businesses, (ii) taxation on VC and (iii) Initial Coin Offerings.

I. Regulatory Framework for VC businesses

Background

Mt Gox, which was formerly one of the world's largest VC exchanges, collapsed in February of 2014 after a client of the company incurred a massive VC loss (Mt Gox former CEO has been accused of orchestrating an embezzlement scheme to defraud Mt Gox clients). As a result, the need for VC business regulations in order to protect consumers was recognized earlier in Japan than elsewhere.

In response to the Leaders' Declaration at the G7 Elmau Summit, Japan's Financial Action Task Force published guidelines in June of 2015 requiring registration or licensing for VC exchanges and the implementation of proactive measures to counter money-laundering activities and terrorist financing. Following this development, the Financial System Council's "Working Group on Advanced Payment Services" began discussing a basic regulatory framework and by March 2016, and the Amendment was submitted to the Japanese Diet.

Japan's VC regulations are considered a significant step forward in the legal development of FinTech. The hallmark features of the VC regulations which best signify this progress are threefold: (i) the definition of VC, (ii) the registration requirements and (iii) the restrictions on registered VC operators.

Definition of VC

Under the Amendment, "Virtual Currency" is classified further as Type 1 and Type 2 VCs. These classifications are respectively defined as a digital currencies which possess the following features:

Type 1 VCs:

- (i). Can be used to pay unspecified persons 1) for the purchase of goods, 2) for the lease of goods or 3) as

consideration for services rendered

- (ii). Can be purchased from and sold to unspecified persons
- (iii). Have financial value
- (iv). Are recorded by electromagnetic means in electronic devices
- (v). Are not Japanese currency, any foreign currency, or any asset denominated in any currency; and
- (vi). Can be transferred through electronic data processing systems

Type 2 VCs:

- (i). Can be mutually exchanged with Type 1 VCs and with unspecified persons; and
- (ii). Have the same features (iii) to (vi) as set forth for Type 1 VCs above

According to the foregoing definition, current major VCs such as Bitcoin, Ethereum or Litecoin would be considered "Type 1 VCs" while Counterparty coin (the so-called "XCP") or tokens which can be exchanged to Type 1 VCs would be considered "Type 2 VCs".

However, in-game monies or coupons which are typically available only in "specific areas" (e.g. stores, markets, online-games etc.) and tradeable only with "specific issuers" would fail to meet the definition for either Type 1 or Type 2 VCs.

Registration requirement

1. Overview

Under the Amendment, business operators dealing in "Virtual Currency Exchange Services"(VCE Services) must register with the Financial Services Agency(FSA). The VCE Services are categorized as follows:

- (i) Purchase and sale of VCs, or exchange for other VCs
- (ii) Intermediary, brokerage or agency for (i)
- (iii) Management of cash or VCs in relation to (i) and (ii)

Typically, operating an exchange where customers can trade VCs would fall under category (i) above while operating a matching platform for purchasing, selling or exchanging VCs would fall under category (ii) above.

2. Basic Registration Requirements

The applicant must possess:

- (i). Status as a Japanese joint-stock company (Kabushiki Kaisha, which is similar to a C-corporation in other jurisdictions) unless the applicant is categorized as a "Foreign Virtual Currency Exchange Service Provider" mentioned in the section III-3 below
- (ii). At least JPY 10 million capital and positive net assets; and
- (iii). An internal system to ensure it complies with the relevant operation rules as stated in the PSA

Of these, item (iii) is the most time-consuming requirement for foreign service providers and item that is most scrutinized by the FSA during the registration screening process.

Non-compliance with the foregoing requirements can result in a punishment of up to three (3) years imprisonment with work or a fine of up to JPY 3 million.

3. Foreign Virtual Currency Exchange Service Provider

"Foreign Virtual Currency Exchange Service Provider" (Foreign VCE Service Provider) is defined as a service provider which engages in VCE Services in its home jurisdiction with an appropriate registration status equivalent to the registration status contained in the PSA.

Notwithstanding their foreign registration status, foreign service providers are still required to register under the PSA in order to provide VCE Services in Japan.

However, Foreign VCE Service Providers need not establish a company in Japan for the purpose of registering. It would suffice to have a branch, office or liaison office in Japan.

This means Foreign VCE Service Providers actually have broader options for corporate formation when entering the VC trading market in Japan. That is, they can choose to establish (i) a branch, office or liaison office or (ii) a joint-stock or limited liability company (respectively *Kabushiki Kaisha* or *Goudou Kaisha*).

An unregistered Foreign VCE Services Provider is prohibited from soliciting Japanese customers for VCE Services under the PSA. The FSA makes clear in its guidelines that online advertising is generally considered a "solicitation". However, this is not the case if reasonable measures are taken to prevent Japanese customers from transacting with unregistered foreign providers. According to the guidelines, an example of such reasonable measures would be the creation of a plain statement in the advertisement in the Japanese language stating that VCE services cannot be provided to Japanese customers. Such statement must be readily accessible by all Japanese customers. In light of the foregoing, unregistered Foreign VCE Service Providers should use considerable caution when creating advertisements for Japanese customers.

4. Screening Process

The general process for registration mainly involves two steps: (i) prior consultation with the FSA and (ii) submission of an application for registration to the FSA.

For (i), please note that this process is not statutorily required, however the FSA in practice will conduct a prior consultation with the applicant in person or over the phone. At this stage, the applicant must submit documentation outlining the following items for the FSA's confirmation:

- Overview of applicant
- Background and purpose of application
- Contents and method of business; and
- Business operation systems (personnel structure or internal rules etc.)

The consultation process generally requires three to four months to complete depending on the type of VC business and any relevant circumstances.

For (ii), the FSA examines the information provided based on its administrative guidelines after receiving the application together with the necessary ancillary documents stipulated by the PSA¹. The examination process generally requires one to two months depending on the type of VC business and any relevant circumstances.

Restrictions on Registered VC Operators

1. Obligations under the PSA

Once a provider begins carrying out VCE Services following registration, it must adhere to the PSA's operation rules, the relevant cabinet ordinances and the FSA's administrative guidelines. The guidelines set forth certain required actions such as the disclosure of information to customers, segregation of funds and the provision of periodical reports to the FSA.

- The VCE Service provider must segregate customers' cash from its own by placing customers' cash into (i) a separate bank account or (ii) a trust
- The VCE Service provider must segregate customers' VC from its own such that customers' VC is immediately identifiable (the VCE Service provider must confirm the account balance daily and correct any deficiency within five business days)
- The above segregation of cash and VC must be audited by a certified accountant or auditing firm at least once per year
- The VCE Service provider must notify the customer (i) that their VC is not considered Japanese currency or foreign currency and (ii) that a risk of loss that may result from fluctuations in VC value
- Before a customer conducts a transaction or enters into an agreement for VCE Services, the VCE Service Provider must disclose sufficient information to the customer. Examples of information required to be disclosed by the VCE Service Provider to its customers are as follows:
 - (i) Its trading name and address
 - (ii) Its registration number
 - (iii) The content of the transactions
 - (iv) An introduction of each virtual currency handled by the VCE Service provider
 - (v) The means of segregating customers' cash and VC from its own; and

- o (vi) Attendant fees and costs
- The VCE Service provider must also provide the FSA with periodic reports regarding its VCE Services in the form described by the Ordinance and set forth below:

Main Contents	Deadline
A business summary and status of income and expenditures	Within 3 months after the fiscal year end
The total amount of customer cash and VC currently under management	Within 1 month after each end of quarter

2. KYC procedures

The VCE Service provider must also follow standard "know your customer" procedures to prevent money-laundering activities and terrorist financing in accordance with the Act on Prevention of Transfer of Criminal Proceeds. These procedures include (i) verification and recordation of customer identity information upon prior to or upon contracting and (ii) preparation and maintenance of verification records and transaction records for the purposes of consumer protection.

II. Taxation on VCs

Consumption Tax

Under the Consumption Tax Act ("CTA"), a transfer (including a lease) of assets or the provision of services undertaken in Japan (domestic transactions) for business purposes is subject to consumption tax of 8% (which will likely increase to 10% in October, 2019). However, the transfer of "prepaid payments" listed in the CTA is not subject to consumption tax.

Since July 2017, those VCs defined in the PSA are included in the foregoing list, and therefore VC trading is not subject to consumption tax.

Tax on Income

In September and December 2017, the national tax agency revealed its position on the taxation status of VCs. In its view, profits derived from VC trading are subject to income tax, categorized in principal as "miscellaneous income". This is in contrast to the many specific categories of income such as dividend income, real property income, business income, and employment income.

Under the categorization of "miscellaneous income", profits from VC trading are calculated using "aggregate taxation", meaning that profits derived from VCs is aggregated together with other income such as salary or business income and then taxed at a rate of approximately 5% to 45% under the graduated tax system. In contrast, profits from securities are calculated using "separate taxation", meaning they are taxed separately from other income at a rate of approximately 20%.

The agency's official position does not mention corporate taxation measures, but it is highly likely these are included, i.e., the corporate profits generated by VC trading are also subject to corporate tax.

III. Initial Coin Offering (ICO)

ICOs are a new type of a crowdfunding method using digital coins or tokens including VCs (ICOs are also sometimes referred to as "initial token sale").

The FSA has clarified its regulatory stance on ICOs through issuance of an official statement in October of 2017(the Statement).² The Statement provides that dependent on type of token offered, ICOs will likely be regulated under certain Japanese laws such as the PSA or the Financial Instrument Exchange Act (FIEA).

ICOs under the PSA

As mentioned in Section II above, where digital coins or tokens offered through ICOs fall under the definition of Type 1 VCs or Type 2 VCs, registration is required to conduct VCE Services under the PSA. In this context, an offering of Bitcoin

or other major VCs through an ICO may require registration both because the VC would meet the statutory definition of VCs and because the issuer would sell the VC to investors, which is an activity regulated by the PSA.

ICOs under the FIEA

The Statement cautioned that ICOs may also be regulated under the FIEA.

The FIEA defines an interest in "collective investment schemes" as securities. An offering of interests in funds categorized as such requires registration as a financial service business operator unless certain exemptions apply. In general, an interest in a "collective investment scheme" would be an interest in any of the following legal vehicles and which is a right to receive dividends of profits or distribution of assets arising from businesses that use cash, securities, or other specified assets, in each case having been contributed by its investors:

- A fund in the form of a partnership under the Civil Code of Japan
- An anonymous partnership under the Commercial Code of Japan
- A limited partnership for investment under the Limited Partnership Act for Investment
- A limited liability partnership under the Limited Liability Partnership Act of Japan; or
- Any other form of a legal entity

Because the scope of "collective investment schemes" is very broad there are many cases where ICO-issued tokens could be considered interests in such schemes.

¹ The summary is available in English

² The document is available here

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