

P.R.I.M.E. Finance

Panel of Recognized International Market Experts in Finance

Law and Regulation of Crypto Assets in Japan



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Recent Events relating to Crypto Assets

2014/2 Collapse of Mt. Gox

2016/5 Amendment of Payment Services Act

- New Regulation of Virtual Currency Exchanges as a response to FATF's Guidance and Mt. Gox
- AML, Segregation of customers' assets, explanation to customers

2017/4 The amended Payment Services Act Entry into Force

- Virtual currency exchanges shall register with FSA

2017/7 FSA's Alert on ICOs

- Depending on the structure of ICOs, they may be subject to existing regulations, such as virtual currency exchange regulation and securities regulation

2018/1 Coincheck

- An exchange was stolen NEM deposited by customers (Yen 58 billion)
- No stolen NEM has been recovered, but Coincheck indemnified 48 billion cash to customers
- Monex purchased Coincheck

2018/3 FSA set up study group on virtual currency exchanges

- Discuss necessary regulatory framework to address Coincheck, poor management of exchanges, excessive speculation by individuals, ICOs.



Recent Events relating to Crypto Assets (cont.)

2018/8 FSA published the interim report on the inspection and monitoring of virtual currency exchanges

- It was found that corporate governance of many exchanges didn't work, and AML, risk management and customer protection were poor.
- 7 registered exchanges and 10 pre-registered exchanges received FSA's suspension or improvement orders. 1 pre-registered exchanges was rejected its application for registration

2018/9 Zaif was stolen virtual currencies (Bitcoin, Monacoin) of Yen 7 billion

- Zaif purchased Bitcoin from market and returned to customers, and indemnified in cash for loss of Monacoin
- The business was transferred to another exchange

2018/10 FSA published its policy of registration procedure of exchanges

- More than 100 pending application for registration

2018/10 Japan Virtual Currency Exchange Association was licensed as the Self Regulatory Organization under the Payment Services Act

2018/12 FSA's study group on virtual currency exchanges published its report containing proposals of new regulatory framework

- New regulatory framework will be enacted this year



Some Issues in Mt. Gox Insolvency

1. What is the right of customers who deposit virtual currencies to exchanges?
 - ◆ Tokyo District Court Judgment on August 5, 2015
 - A customer of Mt. Gox claimed for the return of “his” bit coin based on the “ownership”.
 - Judgment: Ownership may exist only on tangible assets that may be subject to exclusive control. Bitcoin is neither tangible nor subject to exclusive control.
 - ⇒Japanese law should analogically apply property laws to virtual assets, when their content, amount and owners are clearly identified, and they are subject to the exclusive control of owners.
 - ◆ Another customer has commenced litigation claiming the recovery of deposited bitcoin based on “trust” relationship between the exchange and customer.



Some Issues in Mt. Gox Insolvency (Cont.)

2. Insolvency Proceedings: Cash dividends or return of virtual currencies?

- ✓ When the bankruptcy proceeding commenced in 2014, it was expected that the bankruptcy estate would be far less than the amount of creditors' claims.
- ✓ However, due to the drastic increase of the price of bitcoin, the value of the bankruptcy estate evaluated in Yen exceeds the amount of creditors' claims.
- ✓ The amount of non monetary claims shall be evaluated at the commencement of the bankruptcy proceeding (Bankruptcy Act, Art. 103).
- ✓ If claims of customers who have deposited bitcoin are considered as non monetary claims, their claims would be evaluated in Yen based on the very low price (about Yen 50,000) at the commencement of the bankruptcy proceeding. If so, there would be huge remaining asset after the distribution to creditors, and such remaining asset would go to shareholders.
- ✓ If customers could get recovery of even a portion of bitcoin they deposited, they would be able to get far more value.
- ✓ In June 2018, the civil rehabilitation proceeding has commenced (bankruptcy proceeding has been stayed) and more flexible treatment of customers' claim is expected.



New Regulatory Framework

Basic Policy

Same Rules should be applied to businesses and activities having the same functions and risks.

Custody Service Providers
(Custody of private keys)

New

Crypto Asset Exchanges
(sales and exchanges)

New

Regulation of Derivatives

Issuers
(public offering)

New

Broker/Dealer of
Investment-Type ICOs

New

New

Customers
/Investors

Regulation of Unfair Acts



New Regulatory Framework

1. Enhanced Regulation of Virtual Currency Exchanges

(1) Enhancement of the Protection of Customers' Assets

- (1) Exchanges shall publish their policy of indemnification when customers' assets are lost.
- (2) Where exchanges keep customers' private keys online (hot wallet), exchanges shall maintain the same virtual currencies which is equal or greater amount than those kept in hot wallet.
- (3) Exchanges shall publish their financial statements.
- (4) Develop legal framework to entitle customers to statutory lien that secures their claim to deposited virtual currencies.

(2) Ensuring Proper business operation

- (1) Exchanges shall disclose information about the trading price, such as the spread, to increase transparency of the price.
- (2) Prohibition of advertisements/ promotions that encourage speculative trading.
- (3) Cooperation with Self Regulatory Organization.

(3) Prohibition of handling of problematic virtual currencies

- (1) Exchanges shall not handle virtual currencies that are problematic in customers protection and proper business operation.
- (2) Exchanges shall notify virtual currencies that they handle to FSA in advance.



New Regulatory Framework (Cont.)

2. Prohibition of Unfair Acts in Spot Trading

- (1) Prohibit all persons/entities from improper conduct, spreading rumors and price manipulation.
- (2) Exchanges shall manage nonpublic appropriately and are prohibited to make transactions aimed at profiting based on nonpublic information.

3. Regulation of Custody Service Provider

- (1) Custody service providers (keeping customers' private keys) shall be subject to similar regulation as exchanges.

4. Regulation of derivatives of virtual currencies

- (1) Derivatives of virtual currencies are subject to the same kind of regulations that are applied to derivatives of financial instruments.
- (2) Limit the leverage ratio (2 or 4?).
- (3) Measures to avoid excessively speculative transactions by unsophisticated individuals.



New Regulatory Framework

5. Regulation of ICOs

(1) Investment-type ICOs

➤ In light of high transferability of ICO tokens and risks to investors, investment-type ICOs shall be subject to similar regulation as existing securities regulations.

- (1) When soliciting 50 or more investors, require the issuer to provide public disclosure initially and subsequently.
- (2) Regulate brokers/dealers of investment-type ICOs in the same level as securities firms and require that they examine the business and financial conditions of issuers.
- (3) Solicitation by issuers are also subject to the same regulation as applied to self-solicitation of securities.
- (4) Apply current unfair trading regulations (except insider trading regulation).
- (5) Restrict solicitation to retail investors in the same manner as the restriction on unlisted stocks.

(2) Other types of ICOs

- (1) Where there are issuers, exchanges shall provide customers with information about issuer, investors' right against issuers, basis of issue price, white paper, etc.
- (2) Exchanges shall examine ICOs and shall not handle problematic ICOs.



New Regulatory Framework

- Relations between various regulations
- Definitions
- Exemptions
- Supervision
- Self-Regulatory Organization
- Uncertainties in private laws
- Enforceability
- International Cooperation

