

# **Discussion Paper**

## **Examination of the Regulatory Systems Related to Cryptoassets (Summary)**

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Financial Services Agency, the Japanese Government

# Current Status of Cryptoasset Transactions

## Current Situation

### ① The Progress of Inclusion of Cryptoasset as Investment Targets

- ◆ Compared to the situation at the time of the amendment of FIEA in 2019, the situation surrounding cryptoassets has changed. A significant number of both domestic and international investors have already **recognized cryptoassets as investment targets**.
- ◆ In Japan, **the number of accounts at cryptoasset exchange service providers exceeds 12 million, the balance of user deposits has reached over 5 trillion yen, and the rate of cryptoasset holders among investors with investment experience stands at about 7.3%**, surpassing FX trading and corporate bonds in terms of ownership rates. Furthermore, in the U.S., **more than 1,200 institutional investors** are investing in spot Bitcoin ETFs.

### ② The Development of Blockchain Technology/The Sound Investment in Cryptoasset

- ◆ **The sound development of Web3** is important to **address societal issues** and **improve productivity** in Japan. The expansion of cryptoasset transaction based on blockchain technology can lead to **the advancement of the digital economy**.
- ※ Broadly, cryptoassets can be categorized into two groups: (1) those widely circulated on foundational blockchain networks (such as Bitcoin and Ether), and (2) those issued for specific purposes (e.g., project operations) based on the circulation of the former group.
  - Vitalizing transactions in the (2) cryptoassets contributes to innovation through projects.
  - (1) cryptoassets serve as the foundation for issuing and circulating the (2) cryptoassets, playing a vital role in exchanges between cryptoassets and fiat currencies due to their high liquidity.
- ◆ Cryptoassets exhibit significantly high volatility. However, if appropriate **environmental improvement for cryptoasset investment** is implemented, cryptoassets could become valuable tools for portfolio diversification for asset formation of investors with the ability to assess risks and the capacity to bear them as viable alternative investment targets.

### ③ Fraudulent Solicitation

- ◆ While public recognition of cryptoassets as investment targets has grown, there have been rising **concerns about fraudulent investment solicitations**. The FSA continuously receives **complaints and inquiries related to cryptoassets**. (An average of over 300 cases per month)
- ◆ Investment seminars and online communities providing information on cryptoasset transactions are increasingly common. Some of them are suspected of engaging in illegal activities, such as defrauding users of money.

# Need for Environmental Improvement

- ❑ The further sound development of cryptoasset trading market requires enhanced **user protection** and the building of **broad public trust** in cryptoasset transactions. Without such trust, there is a risk that **momentum toward innovation** could be lost. Therefore, necessary improvements to the overall environment must be implemented to ensure continued progress.
  - ❑ It is necessary to consider trends in international regulations while taking into account that overly stringent regulations drive users and service providers to foreign markets and undermine **Japan's competitiveness**.
- ⇒ It is crucial to strike a **balanced approach between user protection and the promotion of innovation**.

## The pressing issues related to investment in cryptoasset(※1)

### ① Information Disclosure and Provision

- It is pointed out that white papers (explanatory material) accompanying new cryptoasset issuances often contain **unclear descriptions** or **discrepancies between the described codes and actual codes**.
- Under the current self-regulation imposed on exchange service providers, **cryptoasset issuers are not obligated to disclosure or provide accurate information**.

### ② User Protection / Unregistered Service Providers

- Recently, service providers **soliciting cryptoasset investments without exchange service providers registration** including overseas-based service providers emerge and the FSA receives **numerous possibly fraud-related inquiries**.

➤ Warnings have been posted on websites, such as Government's public relations office and the Tokyo Metropolitan Government Consumer Affairs Center, regarding fraud and malicious trouble.

### ③ Inappropriate Conduct in Investment Management or Advice

- **Investment seminars and online communities** providing information on cryptoasset transactions are increasingly common. Some of them are suspected of engaging in **illegal activities**, such as defrauding users of money.

### ④ Fairness in Price Formation and Trading

- International trends, including the listing of spot ETFs for Bitcoin and other cryptoassets in countries such as the U.S, highlight **the increasing inclusion of cryptoassets as investment targets**.
- **IOSCO(※2)** has issued recommendation to strengthen measures against **fraud and market abuse**, including insider trading, to a level comparable to traditional financial markets. Moreover, the regulations are enacted in Europe and other regions.

※1: In addition to the issues outlined in ① to ④, there are also concerns that cryptoassets are being misused for the transfer of criminal proceeds from organized fraud, or that hacking incidents involving service providers could facilitate the financing of terrorism. In this point, certain regulations are already introduced and it is expected that practical initiatives will continue to be undertaken to ensure the sound and proper operation of exchange service providers.

※2: International Organization of Securities Commissions(IOSCO) "Policy Recommendations for Crypto and Digital Asset Markets", Final Report (November, 2023) - 2

# Basic Principles for Regulatory Review

- ❑ The issues identified earlier include those related to information disclosure, investment fraud, and fairness in price formation and trading. Since **these issues align closely with problems traditionally addressed by the FIEA, leveraging the mechanisms and enforcement under the FIEA** may therefore be considered as one option.
- ❑ In reviewing regulations, it may be appropriate to divide cryptoassets into **two types (Type 1 and Type 2)**, focusing on **tailoring regulation to their characteristics and on the actual conditions** of cryptoasset trading.
- ❑ When considering regulatory reviews, it is necessary to develop an appropriate regulatory framework that takes into account the fact that **cryptoassets possess different characteristics from traditional securities, such as stocks**.

## Direction of Reviewing

	Classification based on <u>characteristics</u>	Need for regulatory review focusing on <u>actual conditions</u>
<b>Type 1</b> 【Fundraising/Business Activity Type】	<ul style="list-style-type: none"> <li>• Cryptoassets issued as <b><u>a means of fundraising</u></b>, with proceeds <b><u>used for projects, events, community activities</u></b>, etc.</li> </ul>	<ul style="list-style-type: none"> <li>• <b><u>Addressing the asymmetry of information</u></b> between issuers and holders (users) regarding how the funds will be used and the details of the project to which the funds will be allocated is deemed necessary.</li> </ul>
<b>Type 2</b> 【Cryptoassets not falling under Type 1】 (Non-fundraising/Non-business Activity Type)	<ul style="list-style-type: none"> <li>• Cryptoassets not falling under Type 1 (e.g., Bitcoin, Ether, and so-called meme coins)</li> </ul>	<ul style="list-style-type: none"> <li>• Cryptoassets such as Bitcoin have <b><u>high circulation volumes</u></b>. It may be crucial to develop environments to ensure safe transactions of such cryptoassets for users, such as by applying appropriate standards.</li> <li>• There have been rising concerns about <b><u>fraudulent solicitations</u></b> related to so-called meme coins or Bitcoin investments. Therefore, there may be a high need to protect users by regulating a wide range of cryptoassets, not limited solely to Bitcoin and Ether.</li> </ul>

### <Note>

- ✓ Increased decentralization can lead to a transition of characteristics of cryptoassets from Type 1 to Type 2 and this shift should be carefully addressed.
- ✓ Many NFTs (Non-Fungible Tokens) that do not qualify as cryptoassets under the PSA provide rights related to certain goods or services. Furthermore, because the characteristics of individual NFTs vary significantly, careful consideration is required to subject them uniformly to financial regulation. At present, it may be considered appropriate to review regulations based on the current scope of cryptoassets under the PSA.
- ✓ So-called stablecoins (similar to digital money) are what are issued at a price linked to the value of a fiat currency and are redeemable at the same issuance price (or something equivalent). While they have the potential to be widely used as a means of remittance and settlement, they are currently not considered likely to be traded as investment targets, and thus, the necessity to review regulations is deemed low at this time.

# Approach to Information Disclosure and Provision Regulation

- It may be necessary to **strengthen information disclosure and provisions** in order to eliminate information asymmetry between issuers and users, ensuring that users **base investment decisions on accurate information** about cryptoassets' functions and value.

## Direction of Reviewing

### Type 1

【Fundraising/Business Activity Type】

- The disclosure and provision of information that influences **trust** in and **the value** of cryptoassets are important when users consider investing. This information may include **summaries of the rules and algorithms associated with the cryptoassets, information on the parties involved with the cryptoassets, information regarding projects, and risks concerning cryptoassets.**
- The entities fundraising from cryptoasset issuance** are best suited to accurately disclose and provide such information. Therefore, it may be appropriate to impose regulatory obligations on the issuer of the cryptoassets to address **the asymmetry of information** between issuers and investors.
- On the other hand, it might be advisable to regulate only **issuances of the cryptoassets involving the solicitation of a broad base of retail investors** rather than imposing a uniform regulation on all cryptoasset issuances.

<Note>

- ✓ The methodology and content of information disclosure and provision must reflect the unique characteristics of cryptoassets, and careful consideration is important to avoid stifling the development of token business.
- ✓ In terms of the accuracy of disclosed information, it is pointed out that external audits (e.g., by audit firms or code auditors) may not be realistic. It might be one option to conduct a certain level of verification by exchange service providers or self-regulatory organizations.

### Type 2

【Cryptoassets not falling under Type 1】  
【Non-fundraising/Non-business Activity Type】

- For Type 2 cryptoassets, **many lack identifiable issuers**, making **direct obligations on issuers unsuitable.**
- Exchange service providers handling these cryptoassets** could be **obligated to explain relevant information** and **required to provide information that may significantly impact price fluctuations.**

<Note>

- ✓ It is necessary to carefully consider to what extent continuous information disclosure should be required from exchange service providers that are not directly involved in the issuance or design of cryptoassets.
- ✓ It is necessary to consider factors such as the fact that exchange service providers have no choice but to rely on publicly available information when providing information and numerous exchange service providers handle the same cryptoasset.

# Approach to Business Regulation

- ❑ Taking account of the increasing inclusion of cryptoassets as investment targets, from the perspective of **the user protection**, it may be necessary to **strengthen business regulations** while considering the impact on the burgeoning token business and its innovation.

## Direction of Reviewing

- Under current laws, service providers that conduct the purchase, sale, or exchange of cryptoassets are subject to both the statutory regulations applicable to exchange service providers and the self-regulation established by the Japan Virtual and Crypto assets Exchange Association (JVCEA). Taking these regulations as a whole, a regulatory framework for exchange service providers has been established that is broadly similar to the framework applied to financial instruments business operators under the FIEA. On the other hand, **certain self-regulatory rules cover matters that are stipulated at the statutory level under the FIEA**. From the perspective of user protection, it may be necessary to consider the difference between self-regulation and statutory regulation.
- **To deter illegal solicitations by unregistered service providers, more effective and stringent regulations** might be necessary.

### <Reference>

- Under the PSA, a person who provides cryptoasset exchange services without registration is subject to imprisonment for not more than three years, a fine of not more than three million yen, or both (Article 107, Item 12).
- Under the FIEA, a person that has conducted financial instruments business without registration is subject to punishment by imprisonment for not more than five years, a fine of not more than five million yen, or both (Article 197-2, Item 10-4). A person who posts an indication that a financial instruments business is being conducted or solicited without registration is subject to imprisonment for not more than one year (Article 200, Item 12-3).
- Financial instruments business operators are subject to inspections by the Securities and Exchange Surveillance Commission, and it is also possible to file (a petition for) an emergency injunction with the court against unregistered business operators (FIEA, Article 192).
- Taking account that investment seminars and online communities providing information on cryptoasset transactions are increasingly common, it might be considered to **regulate investment management and advisory services related to spot cryptoassets** that do not fall under cryptoasset exchange services.
- There are also concerns that cryptoassets are being misused for the transfer of criminal proceeds from organized fraud, or that hacking incidents involving service providers could facilitate the financing of terrorism. In this point, certain regulations are introduced and it is expected that practical initiatives will continue to be undertaken to ensure the sound and proper operation of exchange service providers.

### <Note>

- ✓ The FIEA provides for relaxed measures, such as easing entry restrictions based on the nature of business operations and relaxing conduct regulations according to customer attributes. In reviewing the regulations, it might be appropriate to pursue this kind of flexible structuring of the regulatory framework.
- ✓ The approach of business regulation, as stated above, is based on the current situation in which exchange service providers play the role of gatekeepers. Given the possibility that transactions on DEXs (decentralized exchanges) based on non-custodial wallets may expand in the future, it is necessary to remain attentive to future developments in practice.

# Approach to Market Operating Regulations

- ❑ When providing a platform that facilitates collective transactions with a large number of counterparties, it is important to ensure **fair price formation and neutral, proper business operations**. For this reason, under the FIEA, trading platforms are subject to market operating regulations.
- ❑ With respect to cryptoassets, in the case of **margin trading**, some service providers are conducting order matching between customers. However, under the interpretation that such platforms are not regarded as a “market” defined under the FIEA, these providers are not required to obtain a license as a financial instruments exchange.
- ❑ In **spot trading of cryptoassets** as well, there are exchange service providers conducting order matching between users.

## Direction of Reviewing

- Order matching between customers can serve a price formation function to some degree. On the other hand, given that **the same cryptoasset is often traded across numerous exchanges (exchange service providers), including overseas exchanges, the price formation function of any individual exchange is considered limited**.
- For cryptoassets that are also traded on another exchange service provider, even if one exchange service provider goes bankrupt, **customers still have alternative venues available for trading**. Additionally, even if a cryptoasset is not traded on any exchange service providers other than the bankrupt one, **it can still be traded off-exchange without involving an exchange service provider**.
- Given these features, although these platforms should at least **ensure proper trade management and system infrastructure** since they provide a venue for collective trading among multiple counterparties, **it does not appear necessary to impose strict market operating regulations**, such as requiring a license as a financial instruments exchange or regulations for proprietary trading systems (PTS), on cryptoasset exchanges.

# Approach to Insider Trading

- ❑ With regard to unfair trading practices involving cryptoassets, the FIEA provides some rules similar to those for listed securities. Though these include a general regulation prohibiting wrongful acts and etc., the FIEA does not directly regulate insider trading of cryptoassets.(※)

※: Under the FIEA, insiders, who have become aware of unpublished material facts related to listed securities, are prohibited from conducting transactions prior to the publication of such facts. Effective market surveillance is carried out through the coordinated approach of securities firms, financial instruments exchanges, and the Securities and Exchange Surveillance Commission in order to ensure regulatory effectiveness.

- ❑ Considering recommendations issued by IOSCO and the enactment in Europe and South Korea, to enhance the deterrence against insider trading involving cryptoassets, there may be an increasing need to strengthen measures.
- ❑ Given the various challenges, it is necessary to further explore the appropriate approaches to regulation and market-surveillance frameworks.
- ❑ In any case, from the perspective of ensuring effectiveness of unfair trading regulations, including insider trading regulation, it may be also important to strengthen the market surveillance by industry and authorities.

## Consideration

## Note

	Consideration	Note
Proposal A	<ul style="list-style-type: none"> <li>• To introduce formal crime provisions that specify terms such as material facts as specifically as possible, similar to those that apply to insider trading regulations for listed securities</li> </ul>	<ul style="list-style-type: none"> <li>• It is necessary to establish clear requirements, taking into account mechanisms of cryptoassets and diversity of stakeholders.</li> </ul>
	<ul style="list-style-type: none"> <li>• To specify material facts by category and supplement them with basket clause</li> </ul>	<ul style="list-style-type: none"> <li>• It is necessary to consider how clearly material facts can be enumerated for the types of cryptoassets (Type 1 / 2).</li> <li>• It is important to note that the factors influencing prices can change over a short period.</li> </ul>
	<ul style="list-style-type: none"> <li>• To define those who are considered to be in a position of having access to insider information (e.g., developers of cryptoassets)</li> </ul>	<ul style="list-style-type: none"> <li>• It is necessary to define “insiders” without excess or deficiency while taking into account the mechanisms of cryptoassets and the diversity of stakeholders</li> </ul>
	<ul style="list-style-type: none"> <li>• To define the entity responsible for publication and the method of publication based on the types of cryptoassets  <u>Type 1</u>: It is assumed that the issuer makes publication on the website of the exchange service providers or similar channel.  <u>Type 2</u>: It could be defined as “when an unspecified and large number of people have become available to the material facts.”</li> </ul>	<ul style="list-style-type: none"> <li>• It is necessary to take into account the reality that information related to cryptoassets is frequently disseminated via social media.</li> <li>• As for Type 2, it is necessary to consider whether there is any problem in terms of clarity of punishable conducts.</li> </ul>
Proposal B	<ul style="list-style-type: none"> <li>• To define “material facts” abstractly rather than explicitly, as seen in EU and South Korean regulations                      (To regulate transactions which material facts are “used” for and define material facts as, for example, “facts that could significantly influence investors' decisions”)</li> </ul>	<ul style="list-style-type: none"> <li>• A reasonable explanation is required for differences in regulation approaches from the crime provisions applied to insider trading in listed securities.</li> <li>• It is necessary to consider whether there is any problem in terms of clarity of punishable conducts.</li> </ul>
Proposal C	<ul style="list-style-type: none"> <li>• To utilize the general prohibiting wrongful acts regulation similar to U.S.                      (To specify egregious acts in guidelines)</li> </ul>	<ul style="list-style-type: none"> <li>• It is necessary to consider how clearly the scope of the punishable conducts can be specified.</li> <li>• It is necessary to consider how adequately egregious acts can be enumerated.</li> </ul>