Regulatory Framework for Crypto-assets and Stablecoins

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Three Major Policy Perspectives concerning Crypto-assets and Stablecoins

Financial stability

Particular attention should be paid to stablecoins since they are susceptible to runs. To address the risk of a run, policy measures need to be taken to ensure redemption at par and price stabilization.

User protection

User protection consists of various aspects, including the protection of user assets and the provision of sufficient information to users. From this perspective, intermediaries, including custodial service providers, should be subject to proper regulation and supervision and should maintain proper internal control systems.

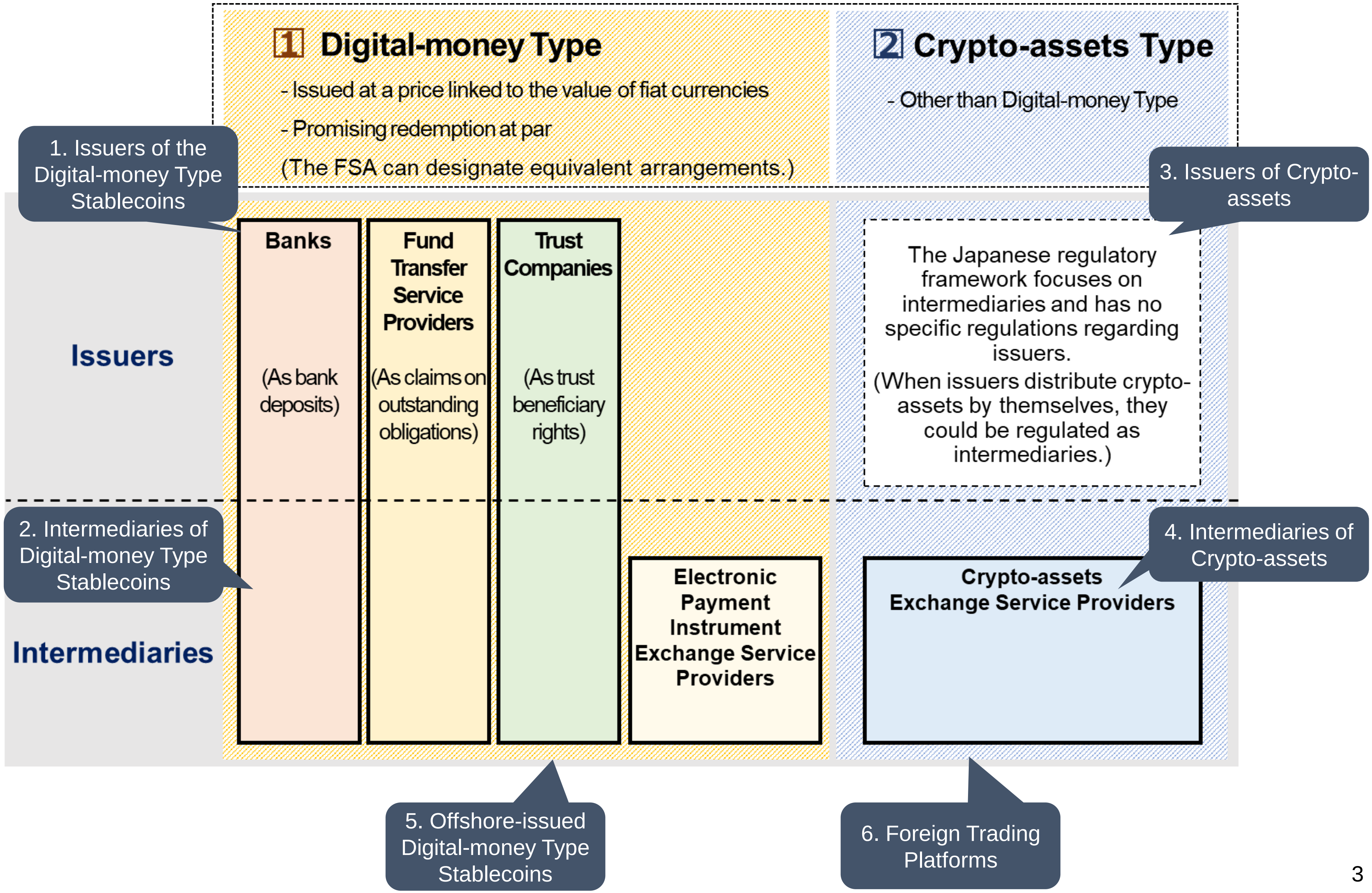
AML/CFT

The Crypto-asset-related AML/CFT framework was first developed by FATF (Financial Action Task Force) in 2015; FATF further clarified in June 2019 how the FATF standards should apply concerning crypto-assets. It is critical to coordinate the implementation of international standards.

Core Concept of Stablecoin Regulations

- From the perspective of financial stability, particular attention should be paid to digital-money type stablecoins, which are, or are claimed to be, linked to one or more fiat currencies, since they are susceptible to runs. To address the risk of a run, policy measures need to be taken to ensure redemption at par and price stabilization.
- To this end, in Japan, only banks, fund transfer service providers, and trust companies are entitled to issue digital-money type stablecoins, and each is subject to the requirement to ensure redemption, as follows.
  - ➢ Banks issue stablecoins as deposits. They are already subject to prudential regulations and stablecoin holders are protected by deposit insurance in the same manner as conventional bank deposits.
  - ➢ Fund transfer service providers issue stablecoins as claims on outstanding obligations. They are required to secure the obligation through either money deposits with official depositaries, bank guarantees, or entrusted safe assets, such as bank deposits and government bonds.
  - ➢ Trust companies issue stablecoins as trust beneficiary rights. They are required to hold all the trusted assets in the form of bank deposits.

Overview of Regulatory Framework for Stablecoins and Specific Issues



1. Issuers of the Digital-money Type Stablecoins

- Only banks, fund transfer service providers, and trust companies are able to issue digital-money type stablecoins, which are issued at a price linked to the value of one or more fiat currencies and promise redemption at par.

- These issuers of digital-money type stablecoins need to meet sufficient levels of user protection and AML/CFT requirements.

Note: Under the Japanese regulatory framework, tokens that do not meet the requirements to ensure redemption are categorized as “crypto-assets,” the same category as Bitcoins. Intermediaries of crypto-assets can only handle crypto-assets reviewed by the FSA and SRO. (See page 6) They are subject to advertising and solicitation regulations, and they have to explain that the prices are not necessarily stable. (See page7)

2. Intermediaries of Digital-money Type Stablecoins

- The activities of intermediaries of digital-money type stablecoins include: (i) buying, selling, exchanging, and intermediating stablecoins; (ii) providing custody of stablecoins; and (iii) transferring stablecoins on behalf of the issuer.
- Registration is required and the requirements for these intermediaries follow those for existing intermediaries of crypto-assets. (See page7)
- Notable requirements for these intermediaries are as follows:

  - Not to deal in digital-money type stablecoins other than those that (i) have clear rules on the transfer of rights; (ii) comply with AML/CFT requirements; and (iii) adequately protect the users' rights, such as subsequent revocation of transactions and compensation for losses, in the event of bankruptcy of the issuers or intermediaries, or technical failures.*

  - To enter into contractual agreements with issuers that stipulate the sharing of liability for losses in order to ensure proper coordination between the issuers and intermediaries in case of accidents.

The issues marked with an asterisk (*) are still under consideration.

3. Issuers of Crypto-assets

- The Japanese regulatory framework for tokens classified as "crypto-assets“ (e.g., Bitcoin, Ether) focuses on intermediaries and has no regulations regarding issuers.
- However, intermediaries of crypto-assets, “crypto-asset exchange service providers,” are required not to handle crypto-assets that may hinder user protection or the proper conduct of business.
- They can handle only crypto-assets that have been reviewed by a self-regulatory organization (SRO) and that FSA has been notified of.
- When issuers themselves distribute crypto-assets, they could be regulated as intermediaries.

Risk Category	Main items to be reviewed
(1) Technology	Sufficiency of technical support system, safety of blockchain network, security strength, stability and scalability
(2) AML/CFT	Intended use, geographic area of use, anonymity design of crypto-assets and its transactions, effectiveness of audits
(3) Project (in the case of ICOs)	Feasibility of the project, availability of human resources, legality, existence of material violations of laws and regulations, existence of licenses, financial condition, use of funds, third-party audits
(4) Management of said service provider	Security management system (e.g., private key management methods), cybersecurity measures, balance inquiry system, system capacity for increased transactions

4. Intermediaries of Crypto-assets

- The activities of intermediaries of crypto-assets are: (i) purchase and sale of crypto-assets or exchange with another; (ii) intermediary, brokerage, or agency services for the acts set forth in the preceding item; (iii) management of customer assets, in connection with the operations set forth in the preceding two items; and (iv) management of crypto-assets on behalf of another.
- Registration with FSA as a “crypto-asset exchange service provider” is required to conduct the abovementioned activities.
- In response to the experience of major hacking incidents, service providers are required to manage crypto-assets deposited by customers in an off-line environment (so-called “cold wallet”), in principle. The same type and amount of crypto-assets need to be held separately when managed in hot wallets.
- In order to avoid highly leveraged speculative transactions, a minimum margin of 50% is required for CFD transactions by retail users.
- While so-called algorithmic stablecoins could be classified as "crypto-assets,"(note) these intermediaries are subject to advertising and solicitation regulations and are required to explain the risk of price fluctuations to users (e.g., it is illegal to provide explanations as if redemption of crypto-assets is certain).

Note: the FSA may designate this type of stablecoins as digital-money type stablecoins, taking into consideration the circumstances in which these stablecoins are widely used as a means of payment and other factors.

(Cont.) 4. Intermediaries of Crypto-assets

- The requirements for intermediaries of crypto-assets are as follows:
  - ➢ Capital requirements
  - ➢ To preserve users' assets (users' money should be managed in a trust, and users' crypto-assets should be managed in an offline environment).
  - ➢ To have proper segregation of assets and financial statements audited.
  - ➢ Maintain system security and user information management systems.
  - ➢ Provide information to users.
  - ➢ Subject to advertising and solicitation regulations.
  - ➢ Not to handle crypto-assets that may hinder user protection or the proper conduct of business.
  - ➢ A minimum 50% margin requirement for CFD transactions by retail users.
  - ➢ All AML/CFT/CPF measures (e.g., KYC, CDD/EDD, suspicious transaction reporting)

5. Offshore-issued Digital-money Type Stablecoins

- In principle, digital money-type stablecoins that can be circulated in Japan can be issued by banks, fund transfer service providers, or trust companies under Japanese law.
- Issuers of offshore-issued digital money-type stablecoins must take the same user protection and other measures as issuers of digital money-type stablecoins in Japan.(note)

Note: The details of requirements for offshore-issued digital money-type stablecoins are under consideration.

6. Foreign Trading Platforms

- Service providers engaged in business targeted at residents in Japan must register with FSA as “crypto-asset exchange service providers.” A domestic establishment is required.
- In practice, companies that promote business through Japanese-language websites are considered to be targeting residents in Japan, and the FSA issues warnings.