

Regulating the crypto assets landscape in Japan

Tomoko Amaya



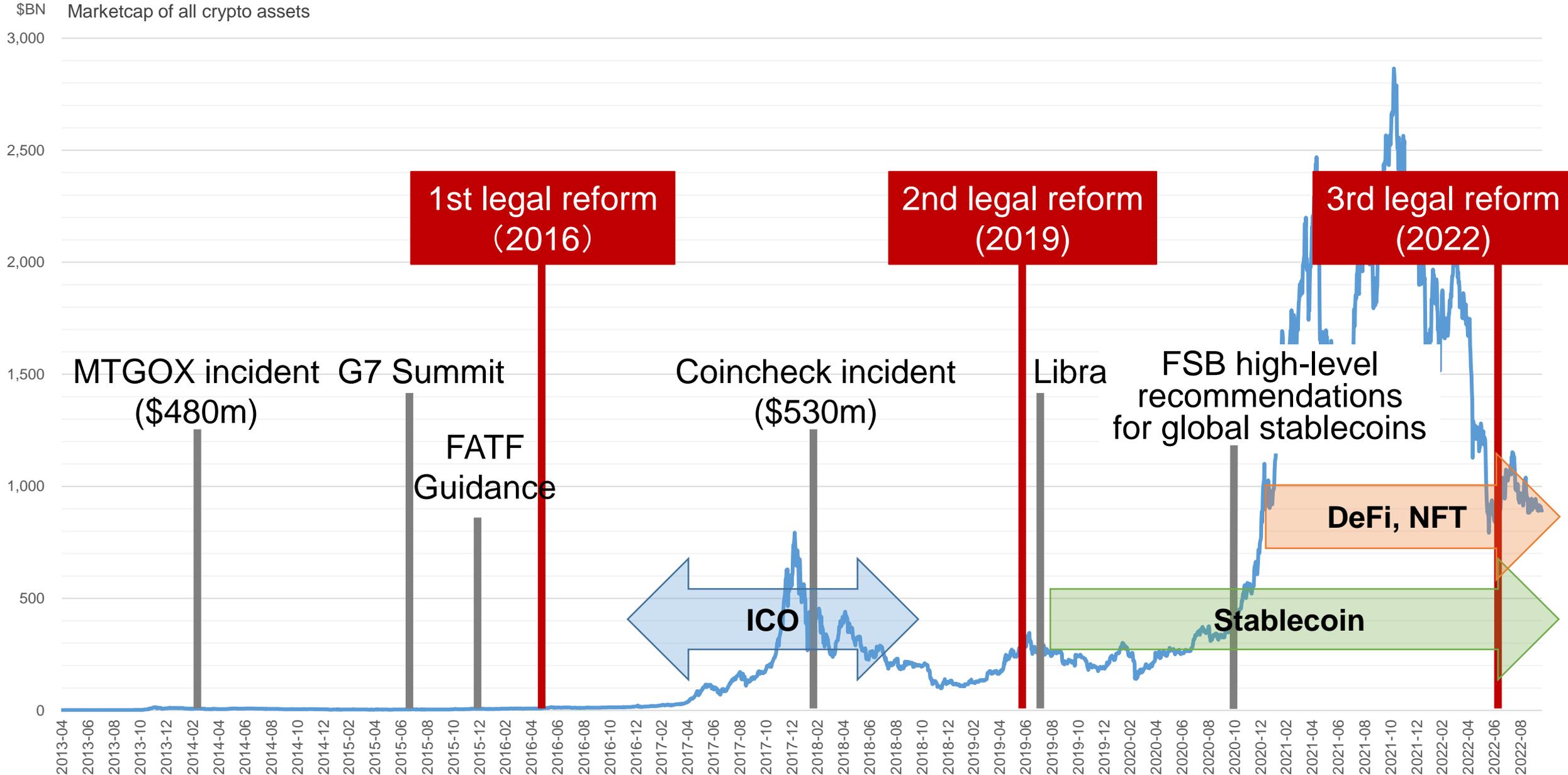
Vice Minister for International Affairs,
Financial Services Agency Japan

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1. Development of Japan's Regulatory Framework

Development of a Crypto Asset Regulatory Framework in Japan

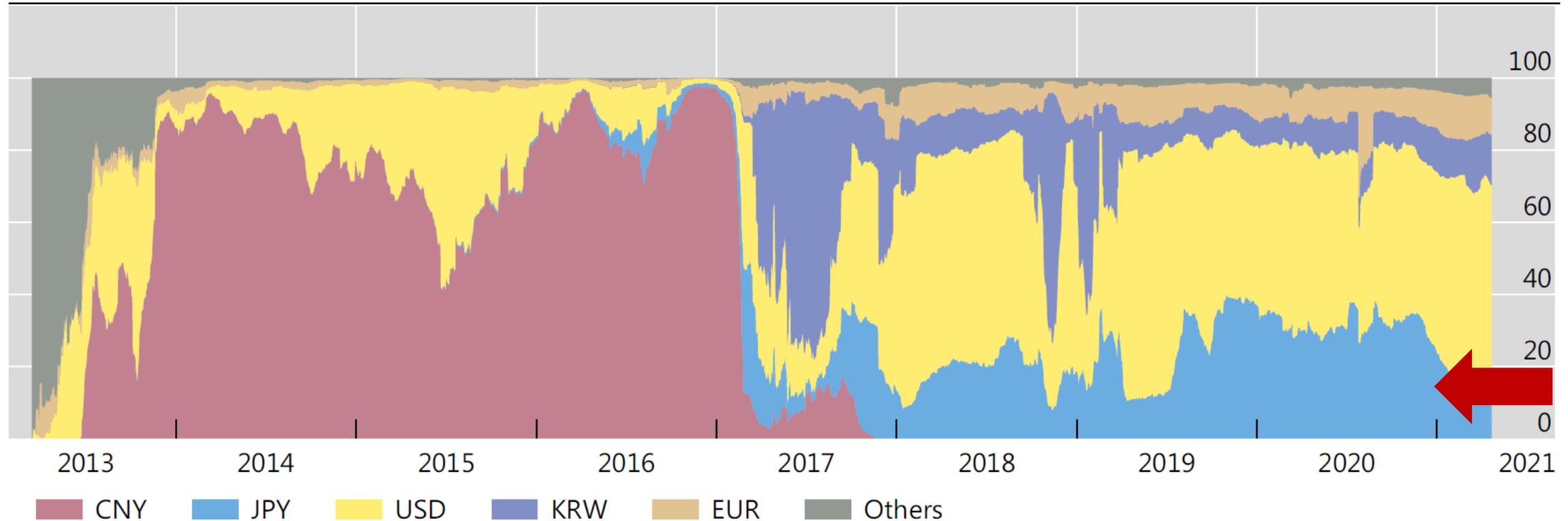


* Coindance, <https://coindance/stats/marketcap/historical>

[Reference] Bitcoin Trading Volume for Fiat Currencies

In per cent

Graph 10



The graph shows 10-day moving average percentage shares of Bitcoin trading volume for each of the largest trading currencies, ranked by their trading volume. The trading volume for each currency is the sum of the Bitcoin-to-currency volume and the currency-to-Bitcoin volume. Others includes AUD, CHF, CAD, GBP, HKD, ILS, INR, PHP, SGD.

Source: CryptoCompare.com; authors' calculations.

1st Legal Reform of the Crypto Asset Regulatory Framework in 2016

New Environment for Crypto Assets

External leakage of customers' crypto assets (MT GOX Incident)

G7 Elmau Summit Leaders' Declaration (in June 2015)

"We will take further actions to ensure greater transparency of all financial flows, including through an appropriate regulation of virtual currencies and other new payment methods."

Financial Action Task Force (FATF) Guidance (in June 2015)

Each country should impose registration/licensing requirements and AML/CFT regulations, such as the obligation to verify customer identity on exchanges that exchange virtual currencies and legal currencies.

Amendment of the Payment Services Act and the Act for Prevention of Transfer of Criminal Proceeds, etc. (enforced in April 2017)

- Introduce a registration system for Crypto Asset Exchange Service Providers.
 - ✓ Identity verification was required upon opening accounts.
 - ✓ A regulatory framework was developed from the perspective of user protection (requirements for minimum capital, provision of information to customers, segregation of customers' assets, and secure management of systems).

2nd Legal Reform of the Crypto Asset Regulatory Framework in 2019

Changes in the Environment for Crypto Assets

External leakage of customers' crypto assets (Coincheck Incident, etc.)

Increase in speculative transactions

Insufficient internal management capabilities for expanded business

The emergence of new types of transactions (i.e., CFDs and ICOs)

The Study Group on Virtual Currency Exchange Services was held 11 times (from April to December 2018) to discuss regulatory responses to various issues concerning crypto asset exchange services.

Amendment of the Payment Services Act and the Financial Instruments and Exchange Act, etc. (enforced in May 2020)

- Include crypto asset derivatives transactions in the scope of regulation.
- Strengthen user protection requirements, including advertising and solicitation regulations, and address the risk of external leakage of crypto assets.

3rd Legal Reform of the Crypto Asset Regulatory Framework in 2022

New Environment for Stablecoins

Expanded use of stablecoins abroad

Increased risk to financial stability and user protection posed by stablecoins

International agreements such as the FSB high-level recommendations

Increased discussion of stablecoin regulations in various jurisdictions

The Working Group on Funds Settlement under the Financial System Council was held to discuss regulatory responses to various issues concerning stablecoins.

Amendment of the Banking Act, the Payment Services Act, and the Trust Business Act, etc. (enforced by June 2023)

- Introduce a regulatory framework with banks, fund transfer service providers, and trust companies as issuers of stablecoins.
- Introduce a registration system for stablecoin intermediaries, requiring, e.g., identity verification.

2. Overview of Japan's Regulatory Framework

Three Policy Priorities for Crypto Assets and Stablecoins

Financial stability

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

User protection

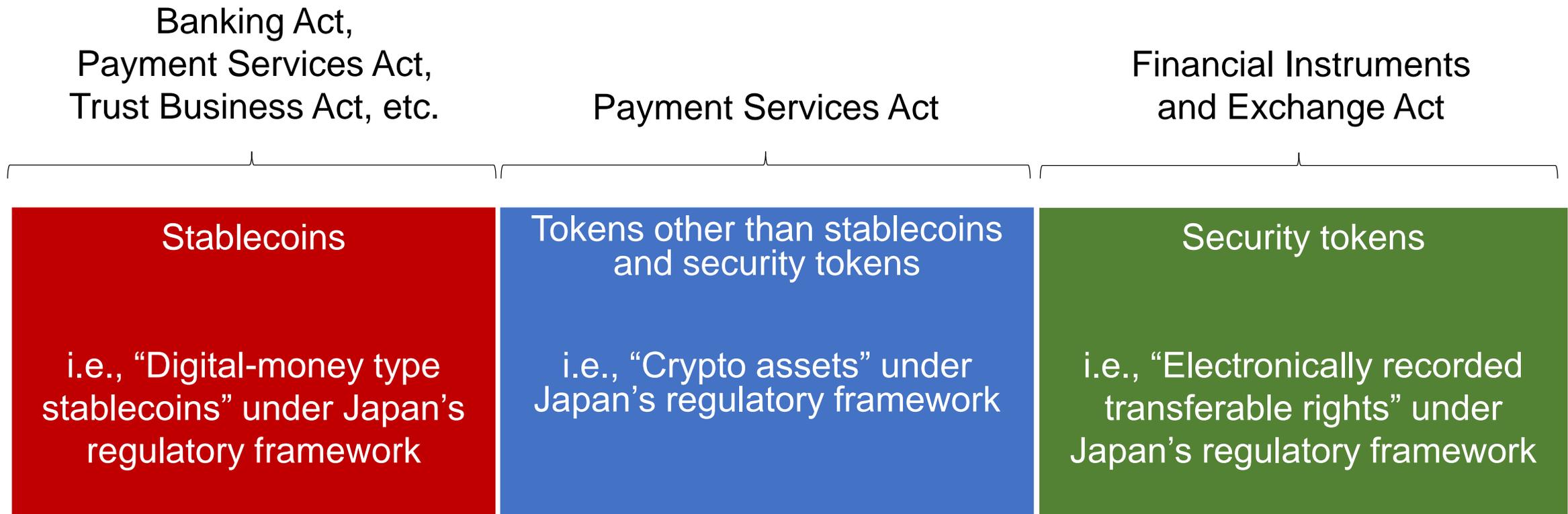
User protection requires a number of considerations, including the protection of user assets and the provision of sufficient information to users. From this perspective, intermediaries, including custodial service providers, should be subject to proper regulation and supervision and should maintain proper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

AML/CFT

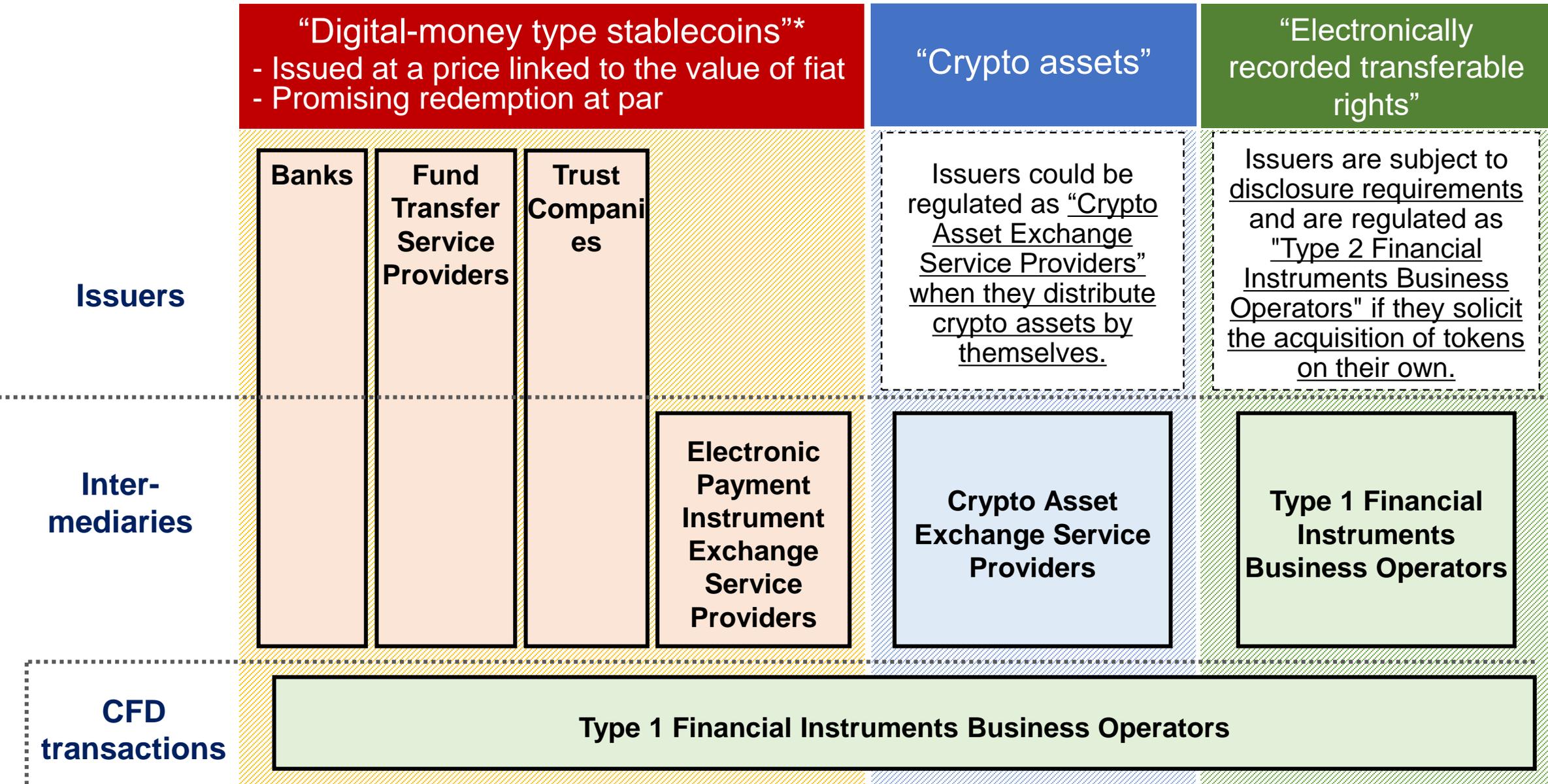
The crypto-asset-related AML/CFT framework was first developed by FATF (Financial Action Task Force) in 2015; FATF further clarified in June 2019 how the FATF standards should apply concerning crypto-assets. It is critical to coordinate the implementation of international standards.

Tokens subject to Japan's Regulatory Framework

Broad regulatory coverage is one of the unique aspects of Japan's crypto asset regulatory framework, which covers a variety of tokens. For example, Japan's regulatory supervision and oversight are applied to trading platforms that conduct spot trading of tokens that are neither stablecoins nor security tokens.



An Overview of Japan's Regulatory Framework for Crypto Assets and Stablecoins

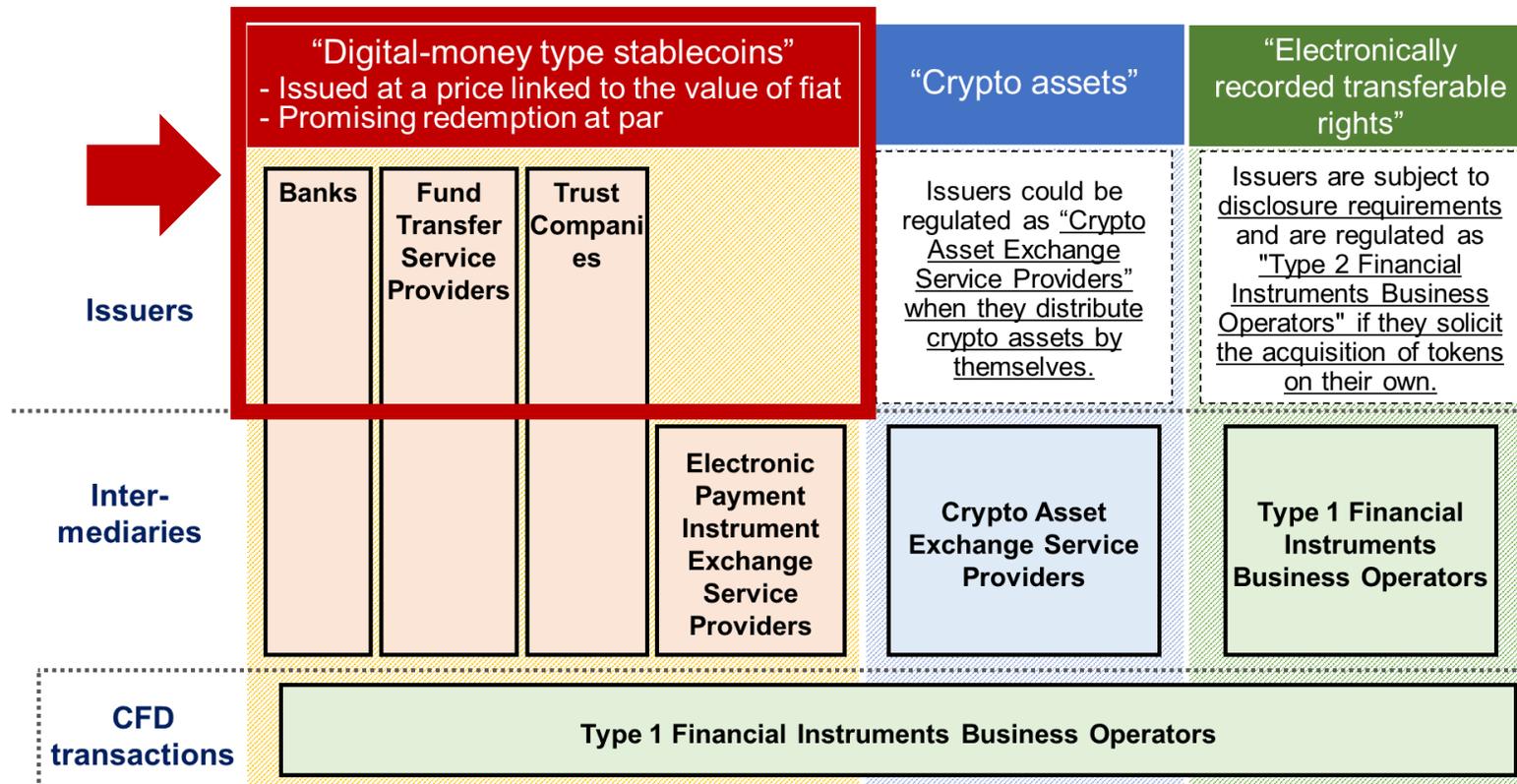


* The FSA can designate an equivalent arrangement for digital money-type stablecoins.

2-1. Financial Stability

Stablecoin Issuers (1)

To address the risk of runs, policy measures need to be taken to ensure redemption at par and price stabilization. To this end, stablecoin issuers are required to be licensed as a bank, fund transfer service provider, or trust company and to provide users with clear redemption rights.



* Stablecoin issuers also need to meet sufficient levels of user protection and AML/CFT compliance.

Stablecoin Issuers (2)

Each is subject to the requirement to ensure redemption, as follows.

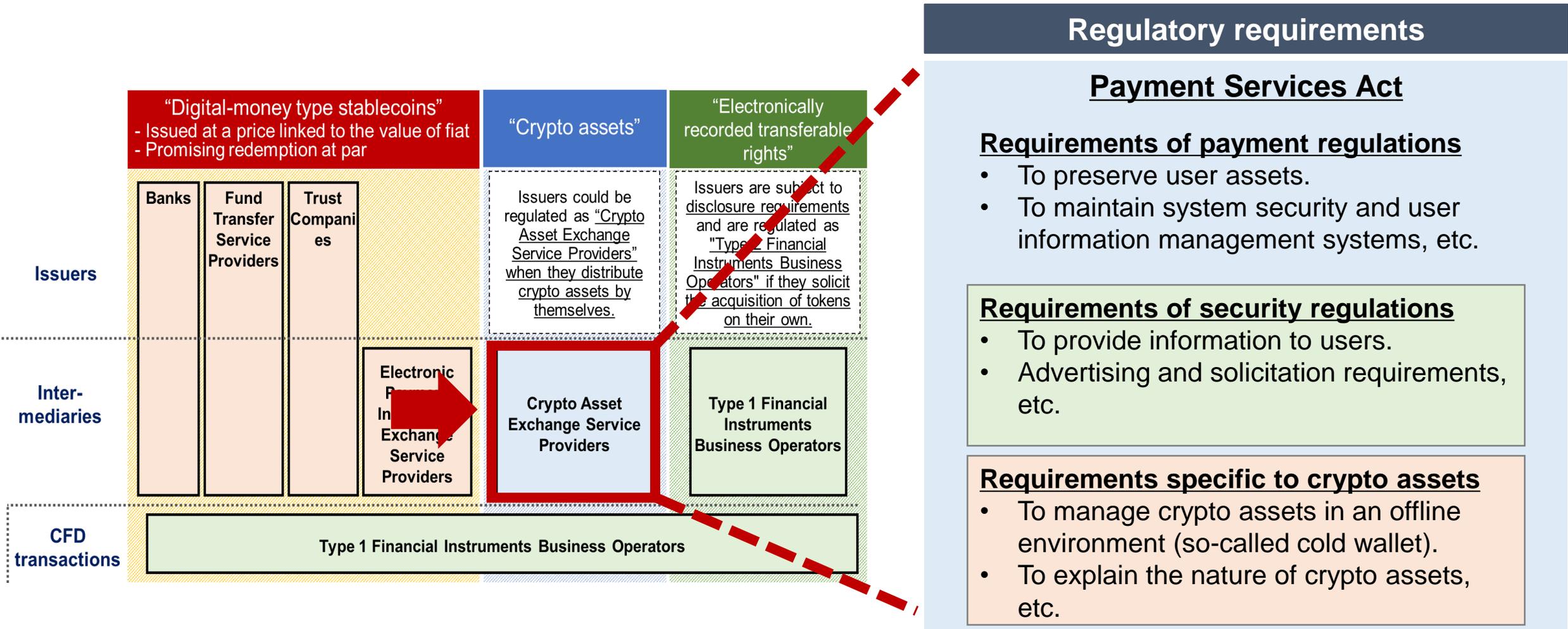
- Banks may issue stablecoins as deposits. They are already subject to prudential regulations, and stablecoin holders are protected by deposit insurance in the same manner as conventional bank deposits.
- Fund transfer service providers may issue stablecoins as claims on outstanding obligations. They are required to secure the obligation through either money deposits with official depositories, bank guarantees, or entrusted safe assets, such as bank deposits and government bonds.
- Trust companies may issue stablecoins as trust beneficiary rights. They are required to hold all the trusted assets in the form of bank deposits.

* Other self-claimed stablecoins, such as algorithmic stablecoins (e.g., Terra) and non-redemption stablecoins (e.g., DAI), are categorized in the same regulatory category (“Crypto Assets”) as Bitcoin in Japan.

2-2. User Protection

Crypto Asset Exchange Service Providers (1)

User protection requires considerations for protection of user assets, provision of sufficient information to users, and market integrity.



Crypto Asset Exchange Service Providers (2)

“Crypto Asset Exchange Service Providers” (e.g., trading platforms) are required to register with the FSA and must meet the following requirements.

Protection of user assets

- To preserve user assets
 - ✓ At least 95% of users' crypto assets should be managed in an offline environment
 - ✓ Users' money should be managed in a trust.
- To maintain system security and user information management systems
- To have the segregation of assets and financial statements audited
- To publish a policy on how to respond in the event of a leakage of users' crypto assets
- To handle only crypto assets that have been reviewed by a SRO and notified to the FSA.

Provision of sufficient information

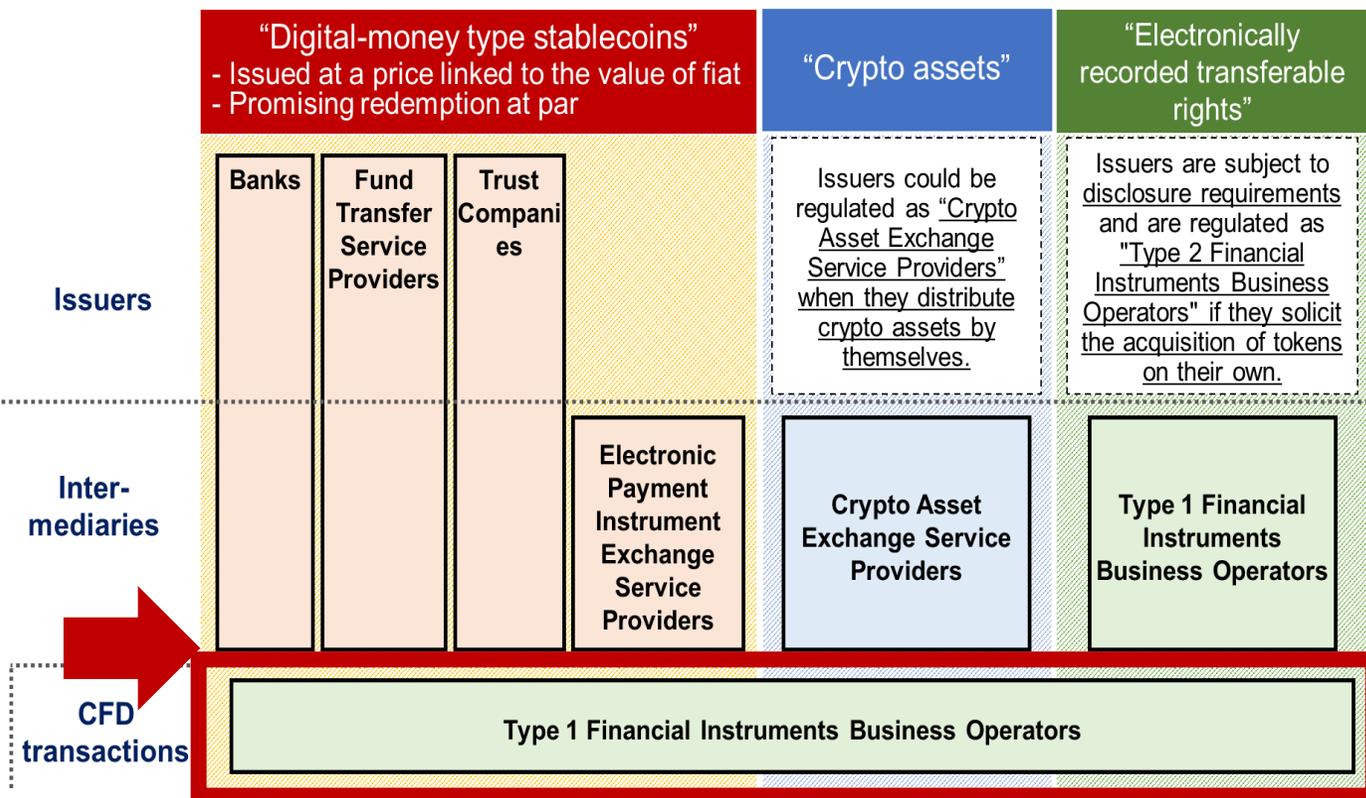
- To provide information on contract details and fees
- Advertising and solicitation regulations
- To publish a balance sheet and an income statement
- To explain the nature of crypto assets to users (e.g., the fact that crypto assets are not fiat currencies, the outline and characteristics of the crypto assets, and the risk of loss due to price fluctuations)

Market integrity

- The prohibition of unfair acts (e.g., market manipulation, disguised trading, and front-running)
- Publication and implementation of conflict of interest prevention and best execution policies

Financial Instruments Business Operators (1)

Derivative transactions in crypto assets are regulated by the Financial Instruments and Exchange Act because they are considered to have similar economic functions and risks as other derivative transactions.



<Additional requirements>

Provision of sufficient information

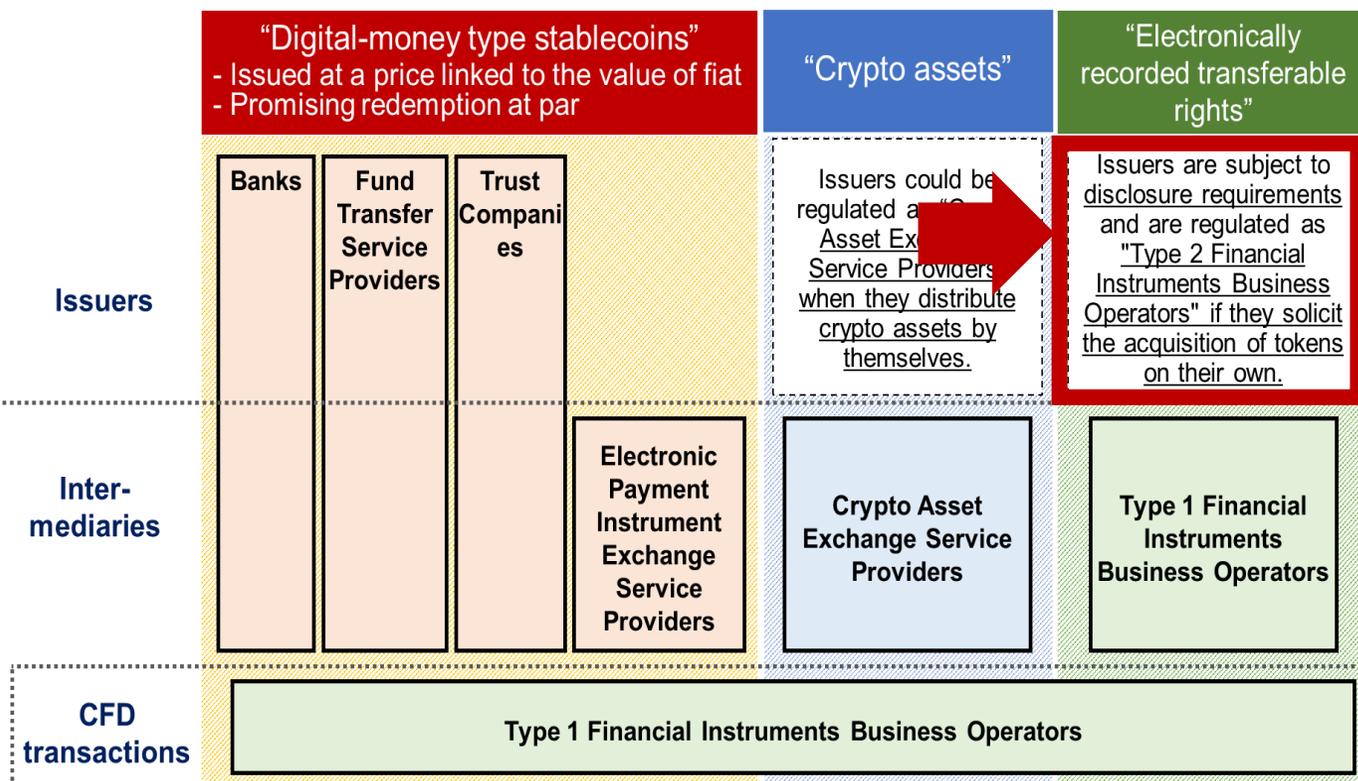
- To explain the nature of crypto assets to users (e.g., the fact that crypto assets are not fiat currencies, the outline and characteristics of the crypto assets, and the risk of loss due to price fluctuations)

Market integrity

- To set a minimum margin for CFD transactions (e.g., 50% for retail users)

Financial Instruments Business Operators (2)

For ICOs/STOs, tokens that grant investors the right to receive profit-sharing are categorized as “Electronically recorded transferable rights,” while other tokens are categorized as “Crypto assets.”



Provision of sufficient information

- Disclosure requirement ^{*1, *2}
- Registered as a Type II Financial Instruments Business Operator and subject to advertising and solicitation regulations (when the issuer solicits the acquisition of tokens on its own)

*1 Exemptions for solicitations to 49 or fewer general investors or for issues of less than 100 million yen.

*2 The conditions for exemption from disclosure requirements are less stringent for tokens that are limited to certain investors, such as qualified institutional investors, and technical measures are taken that require the issuer's consent for their transfer.

Financial Instruments Business Operators (3)

Since security tokens may be distributed to a virtually unlimited number of people, business operators that handle them are subject to the same regulations as those that handle stocks, bonds, and mutual funds interests.

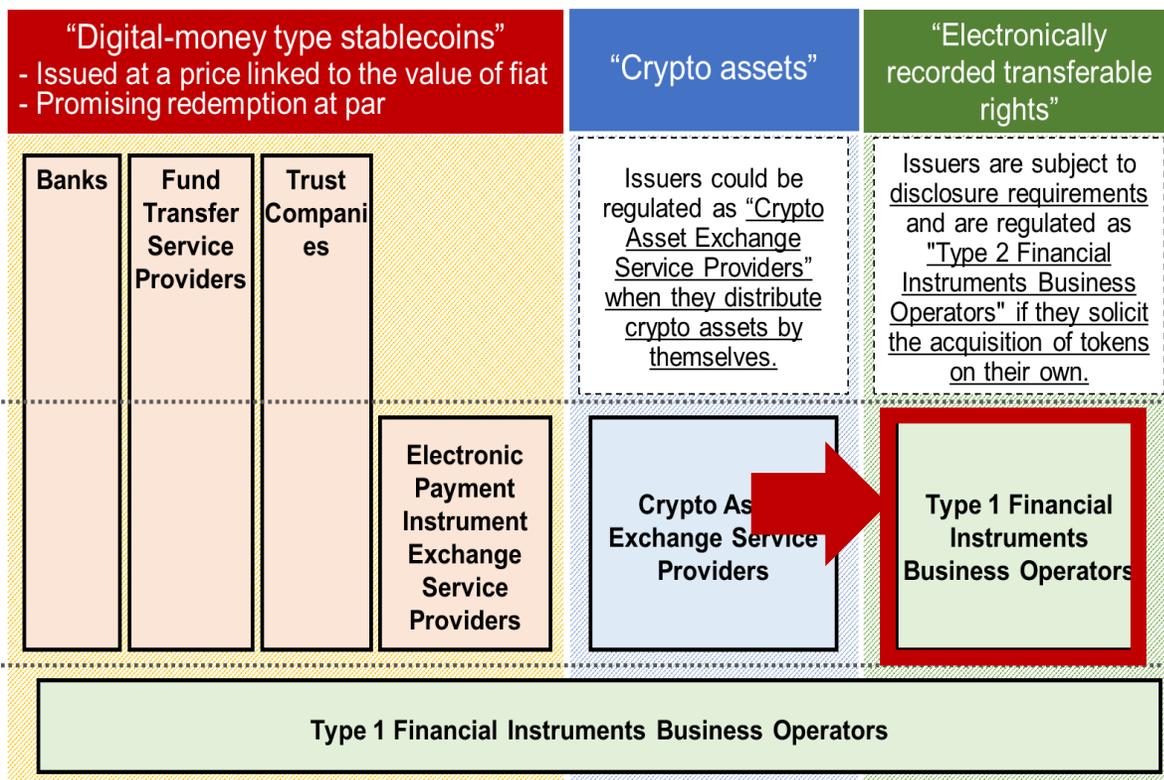
<Additional requirements>

Protection of user assets

- Users' crypto assets should be managed in an offline environment

Provision of sufficient information

- To explain the nature of crypto assets to users (e.g., the fact that crypto assets are not fiat currencies, the outline and characteristics of the crypto assets, and the risk of loss due to price fluctuations)



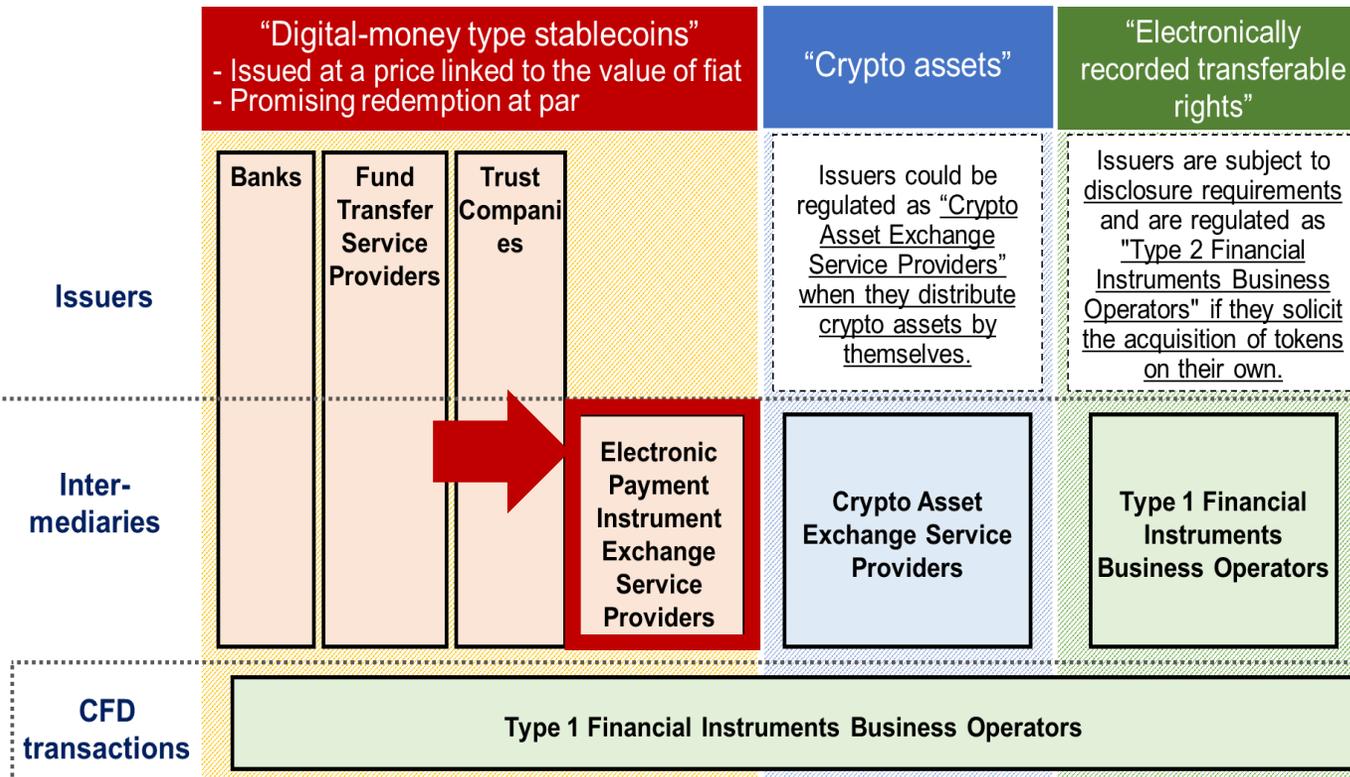
Electronic Payment Instrument Exchange Service Providers

Registration is required and the requirements follow those for existing “Crypto Asset Exchange Service Providers.”

<Additional requirements>

Protection of user assets

- To enter into contractual agreements with issuers that stipulate the sharing of liability for losses to ensure proper coordination between the issuers and intermediaries in case of accidents.
- Not to deal in 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.*



2-3. AML/CFT

AML/CFT measures

It is essential to facilitate global implementation of the FATF Standards, including the “Travel Rule,” given the cross-border nature of crypto asset activities and the provision of services.

- The recent Communiqué and the Chair’s Summary of G7 and G20 in 2022 also recognized the importance of the implementation of the requirements.

In Japan, any crypto-related service providers, including “Crypto Asset Exchange Service Providers,” “Financial Instruments Business Operators,” and “Electronic Payment Instrument Exchange Service Providers,” are required to take all applicable AML/CFT/CPF measures for competent authorities to detect illicit usage (e.g., KYC, CDD, the Travel Rule, and suspicious transaction reporting), in line with the FATF Standards finalized in June 2019.

Japan submitted a revised bill regarding the Travel Rule for crypto assets to the National Diet in October 2022 to further strengthen its AML/CFT/CPF regime.

3. Traditional Financial Institutions

Involvement of Traditional Financial Institutions in Crypto Assets

Considering the risks posed by crypto assets (e.g., volatility risk, operational risk, ML/TF risk, and reputational risk), the need to minimize the acquisition of crypto assets by traditional financial institutions to the minimum necessary is communicated in dialogue with financial institutions and in supervision.

- The assessment of the acquisition, holding, and disposal of crypto assets by traditional financial institutions focuses mainly on the appropriateness of: (i) identifying and mitigating risks based on the characteristics of crypto assets; (ii) AML/CFT measures; (iii) measures to ensure financial soundness; and (iv) cybersecurity control.

Trust banks are allowed to provide custody services for crypto assets from October 2022.

- Trust banks will be able to provide custody services for all tokens, including “Digital-money type stablecoins,” “Crypto assets,” and “Electronically recorded transferable rights,” which is expected to lead to the creation of financial innovation that enhances user convenience while protecting users.

4. Way forward

Way forward

- FSB recommendations for crypto-assets and markets (October 2022)
 - ✓ The proposed recommendations apply to all crypto-asset activities, issuers, and service providers that could pose a risk to financial stability.
 - ✓ The recommendations are based on the “same activity, same risk, same regulatory outcome” principle.
- FSB recommendations on global stablecoin arrangements (October 2022)
 - ✓ A proposed review of the FSB's October 2020 high-level recommendations.
 - ✓ The proposed recommendation can apply to arrangements for stablecoins that can become global stablecoins.
 - ✓ The proposed review states that “global stablecoins must not use algorithms in stabilizing their value” and strengthens the ensuring of redemption rights.



The FSA will continue to work in a comprehensive and forward-looking manner on crypto asset markets. In addition, the FSA will actively contribute to international policy discussions and will also cooperate with national authorities.

Thank you for your attention.