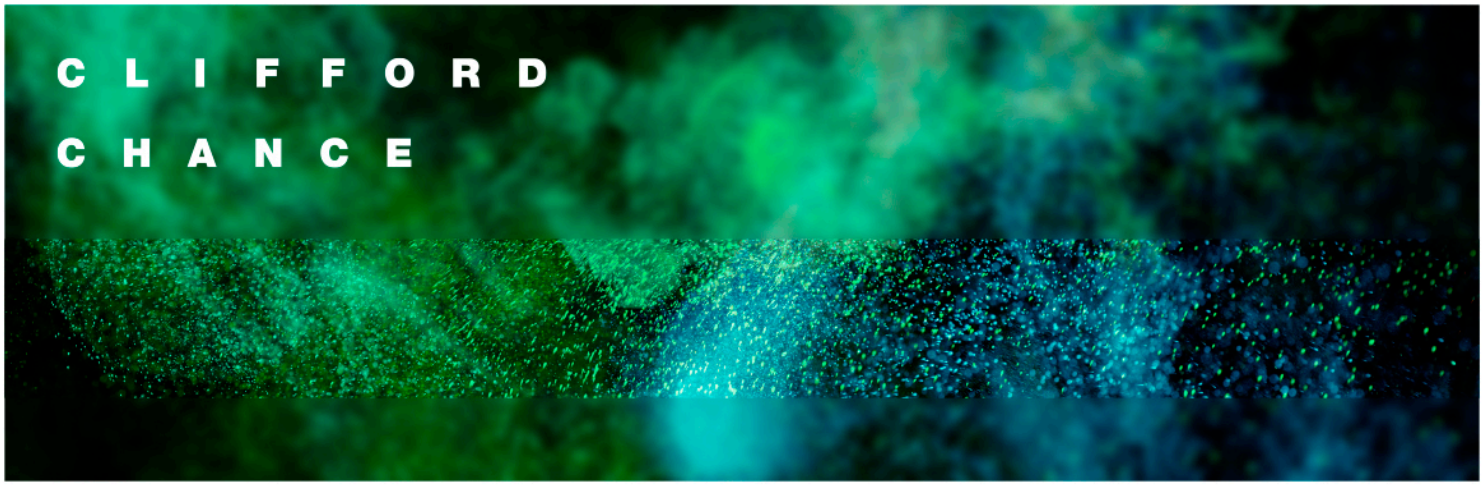

NEW REGULATIONS FOR CRYPTO-ASSETS (VIRTUAL CURRENCIES) AND INITIAL COIN OFFERINGS AND SECURITY TOKEN OFFERINGS IN JAPAN

Japan is one of the world's first countries to establish regulations and licences for crypto-assets, initial coin offerings (ICOs) and security token offerings (STOs). On 14 January, 2020, the Japan Financial Services Agency (FSA) released drafts of ordinances implementing amendments enacted in May 2019 to key legislation. This provides some clarity on the regulation of fundraising using this emerging asset class.

WHICH ICOs OR STOs ARE REGULATED AS OFFERINGS OF "SECURITIES"?

As discussed in our client briefing (New regulation of ICOs) in June 2019, in the context of collective investment schemes, the amendment to the FIEA recognised cryptocurrencies as "money". Accordingly, when cryptocurrencies are contributed to collective investment schemes (e.g. subscribers paying cryptocurrencies as consideration in return for tokens issued under an ICO or STO), the interests (represented in the form of tokens) in the collective investment scheme are deemed to be "securities" and treated as Type I Securities when the conditions mentioned below are not satisfied (such tokens are defined as "FIEA Security Tokens" (*denshi kiroku iten kenri*)). If those conditions are satisfied, the tokens generally qualify as Type II Securities. The category of Type I Securities generally includes traditional securities such as shares and bonds and is strictly regulated under the FIEA. The category of Type II Securities generally covers fund securities.

MAJOR EXEMPTION

The conditions for a token to be an FIEA Security Token have been made clear in the new drafts of the ordinances. This helps clarify a significant exemption. If there is a technological restriction that makes (i) the tokens capable of transfer only to qualified institutional investors (QIIs*) or certain experienced investors (Eligible Investors**) and (ii) each transfer of tokens require an offer by the transferor and consent from the issuer, then the tokens do not qualify as "FIEA Security Tokens", and they can be offered and sold more easily*** as Type II Securities.

Terminology

- An **ICO** is a fundraising in which an issuer offers tokens to participants or investors in return for consideration (e.g. another crypto-asset, fiat currency, or as a reward for marketing / referral activities).
- **Tokens** are electronic records generated by a smart contract system that is based on crypto-assets with a separate blockchain.
- An **STO** is similar to an ICO, however, the tokens represent an investment contract relating to an underlying investment asset and are subject to more regulation than an ICO.

* QIIs include, among others, licensed securities companies, banks, investment managers and insurance companies in Japan.

** Eligible Investors include, among others:

- an entity with stated capital of JPY 50 million or more;
- an individual, in his/her own capacity, (1) investing in financial instruments of JPY10 billion or more, and (2) maintaining an account for securities, derivatives or crypto-asset transactions at a bank(s) for one year or more;
- an individual acting as a general partner of a fund with assets of JPY 100 million or more; and
- certain pension funds

*** An offering of tokens as Type II Securities must be handled by a Type II Financial Instruments Business Operator (FIBO) licensed entity or, if the number of Eligible Investors to whom the tokens are marketed is fewer than 50, an issuer who has relied upon the Article 63 exemption. The issuer must be registered as an Investment Manager to manage the funds raised by way of an offering of tokens. To be exempted from this licensing requirement, the issuer may seek to rely upon the Article 63 exemption for investment management.

OFFERING OF FIEA SECURITY TOKENS

If the prospective investors in FIEA Security Tokens include persons who are neither QIIs nor Eligible Investors, the issuer of the FIEA Security Tokens must file a Securities Registration Statement prior to the commencement of the offering of the FIEA Security Tokens unless the offering satisfies the conditions for relying on a private placement exemption. The conditions for relying on a private placement exemption for Type I Securities are stricter than those for Type II Securities. In general, the number of offerees of FIEA Security Tokens must be fewer than 50 in order to be exempted from the disclosure obligation. "Offerees" may include any person who visits the website on which the ICOs or STOs are announced or reported, and therefore, in practice, it will be important to limit the number of persons with access to the site to fewer than 50 to conduct a private placement of the FIEA Security Tokens in a safe manner.

In addition, as discussed in our client briefing (New regulation of ICOs) in June 2019, the offering of FIEA Security Tokens must also be handled by a Type I FIBO licensed entity.

Issuers of FIEA Security Tokens are subject to the same licensing requirements as those applicable to the issuers of tokens that do not qualify as FIEA Security Tokens.

WHAT CHANGES IN TRADITIONAL TYPE I SECURITIES?

The draft ordinances propose the introduction of a new private placement framework for the situation where traditional Type I Securities such as shares and bonds are constituted and transferrable electronically. The rights represented by such electronically constituted and transferrable securities may be sold without registration if there is a technological restriction that makes, for example, (i) only QIIs capable of acquiring the rights or (ii) the rights only capable of transfer *en bloc*. This means that, in contrast to a traditional transfer restriction, the investors themselves do not need to be contractually

"The Japanese approach differs from that of Singapore, where although non-binding guidance on the subject of token offerings has been issued, the Monetary Authority of Singapore has taken the stance that the relevant legislation is technology-neutral. As such, where a person conducts regulated activity in respect of tokens that satisfy the existing definitions of the various regulated products (generally termed “capital markets products”), which includes securities, they would be subject to the traditional regimes for disclosure and/or licensing, amongst other things, unless they are otherwise exempt. Separately, the facilitation of buying and selling of cryptocurrencies that are not such regulated products (such as bitcoin) is now regulated under the Payment Services Act, which came into force on 28 January 2020."
Lena Ng, Partner Singapore

restricted from transferring, provided they are physically unable to make a transfer due to the technological restriction, unless they satisfy the conditions of the exception.

The issue here is the scope of "electronically transferrable rights". This is subject to broad interpretation and too vague to apply in practice unless a clearer view on the scope or on the method of technological restriction is provided by the Japanese FSA.

Further, if Type I Securities are directly represented by a token, such token could fall within the category of "electronically transferrable rights". One issue arising here is whether or not a Japanese company can validly issue shares or bonds represented by tokens under the Companies Act of Japan.

OTHER NEW REGULATIONS APPLICABLE TO CRYPTO-ASSET TRADES UNDER THE FIEA

As the prices or values of crypto-assets depend on the status of the issuer and the market, crypto-asset trades or crypto-asset derivatives transactions are regulated in the same way as traditional financial instruments such as securities.

Crypto-asset derivatives transactions

The amendment to the FIEA regulates crypto-asset derivatives and, in general, brokers of crypto-asset derivatives are required to be licensed as Type I FIBOs. As a result, the loss-cut rule and margin regulations are applicable to future trades leveraging crypto-assets.

Market manipulation

Dissemination of rumours and price manipulation are illegal where conducted in relation to crypto-asset trades or derivatives.

NEW REGULATIONS UNDER THE PAYMENT SERVICES ACT

If the tokens offered in an ICO do not represent investment contracts but some referral activities or benefit as utility tokens, the offering of the tokens is subject to the Payment Services Act. Pursuant to the amendment to the Payment Services Act, the safeguards in the relevant regulations have been widened and strengthened.

New licensing requirements to manage crypto-assets owned by clients

Under the amendment to the Payment Services Act, any person seeking to manage crypto-assets owned by third parties must be licensed as a crypto-assets exchange business operator. This will include custodians of crypto-assets. In the context of ICOs and STOs, crypto-assets to be used for investing in FIEA Security Tokens or crypto-assets to be distributed in return for investment will need to be managed and recorded by a licensed crypto-assets exchange business operator.

New code of conduct applicable to crypto-assets exchange business operators

Restrictions on sale

Certain types of conduct by crypto-assets exchange business operators, such as false representations, misrepresentations and exaggerated advertising, are prohibited in relation to crypto-asset trades. In addition, they are prohibited from encouraging the trading or exchange of crypto-assets for excessively

"The Hong Kong Securities and Futures Commission published in late 2019 detailed terms and conditions for licensed corporations which manage portfolios that invest in virtual assets and the new regulatory framework to grant licences to virtual asset trading platform operators. It is great to see that APAC jurisdictions are developing more regulatory clarity towards virtual assets, in particular on security tokens."
Rocky Mui, Partner, Hong Kong

speculative purposes. Further, the draft ordinances propose to add restrictions on sales activities in respect of crypto-asset trades, for example, operators are required to confirm each client's intention in entering into the trade and to provide a more detailed and accurate explanation of the crypto-asset trade to the client.

Regulation of credit transactions relating to crypto-assets

Credit transactions on crypto-assets are also newly regulated. Providing accurate and sufficient information to clients is required.

Segregation

Clients' monetary assets need to be managed separately from those of business operators by way of a trust. Furthermore, clients' crypto-assets need to be managed separately from those of business operators. Clients' crypto-assets will generally need to be recorded and stored in a data area which cannot be accessed via the Internet (a "cold wallet"). Some crypto-assets can be recorded and stored in a data area that can be connected to the Internet (a "hot wallet"). However, when client assets are managed separately using this method, the business operator must secure funds to repay the clients' crypto-assets.

Lien (right to be repaid in preference)

Irrespective of how the segregation works, a client has the right to be repaid in preference to other creditors with regard to the right to have the crypto-assets transferred to it.

TIMELINE

The draft ordinances are currently undergoing a public consultation procedure. The deadline for submitting comments on the drafts is 13 February 2020. The final version of the ordinances is expected to be published in the second quarter of 2020, and the amendments will come into force no later than 7 June 2020.

"It is interesting that Japan has built a legal framework that is similar to the US framework for conducting an STO under Regulation D, Section 506(c). It will be key to follow whether issuers embrace the use of this type of exemption in the US and Japan and how secondary markets for security tokens offered under these exemptions develop under this framework."
Steven Gatti, Partner, Washington D.C.

CONTACTS

Eiichi Kanda
Partner
Tokyo

T +81 3 6632 6643
E eiichi.kanda
@cliffordchance.com

Satoshi Nomura
Special Advisor
Tokyo

T +81 3 6632 6312
E satoshi.nomura
@cliffordchance.com

Chihiro Ashizawa
Counsel
Tokyo

T +81 3 6632 6414
E chihiro.ashizawa
@cliffordchance.com

Yasuaki Dote
Senior Associate
Tokyo

T +81 3 6632 6319
E Yasuaki.dote
@cliffordchance.com

Keisuke Otsuka
Associate
Tokyo

T +81 3 6632 6641
E keisuke.otsuka
@cliffordchance.com

Steven Gatti
Partner
Washington DC

T +1 202 912 5095
E steven.gatti
@cliffordchance.com

Rocky Mui
Partner
Hong Kong

T +852 2826 3481
E rocky.mui
@cliffordchance.com

Lena Ng
Partner
Singapore

T +65 6410 2215
E lena.ng
@cliffordchance.com

Allison Tan
Associate
Singapore

T +65 6661 2090
E allison.tan
@cliffordchance.com

www.cliffordchance.com

Clifford Chance (Gaikokuho Kyodo Jigyo)

Palace Building, 3rd floor

1-1, Marunouchi 1-chome, Chiyoda-ku, Tokyo 100-0005, Japan