COMMENTARY

DECEMBER 2017

IN SHORT

The Situation: The Financial Services Agency of Japan ("FSA") has released a statement on initial coin offerings ("ICOs"). It clarifies the regulatory position of ICOs under Japanese law and also highlights potential risks to consumers of participating in ICOs.

The Results: The FSA has made clear that, depending on the structure used, ICOs may be regulated under Japanese law, including by the Payment Services Act and the Financial Instruments and Exchange Act. It has also emphasized that a person engaging in ICO activities without required registrations may be subject to criminal penalties.

Looking Ahead: Parties engaging in ICO activities should seek appropriate legal and other professional advice to ensure compliance with the applicable legal and regulatory requirements in Japan.

In light of the increased use of ICOs to raise funds in Japan and elsewhere, the FSA issued a statement on October 27, 2017 ("FSA Statement") to clarify the regulatory position of ICOs under Japanese law.

How are ICOs Regulated under Japanese Law?

Payment Services Act
First, the FSA has indicated in the FSA Statement that "certain digital tokens issued by ICOs may fall into the definition of virtual currency under the Payment Services Act and thus an operator involving the exchange of such digital tokens as its business must be registered with the FSA."

By way of background, Japan has been a leading nation in its approach to regulation of certain virtual currencies under the amended Payment Services Act, which came into force in April 2017 and which introduces the registration requirement for operators of "Virtual Currency Exchange Businesses" (defined as businesses engaging in the exchange of virtual currency for legal currency or another virtual currency or brokerage of such exchange).

Following the six-month grace period that ended on September 30, 2017, the Payment Services Act has been fully enforced, and the FSA recently announced the first 11 companies that completed the registrations as operators of the Virtual Currency Exchange Business.

> If digital tokens issued by an ICO meet the relevant criteria and are therefore categorized as virtual currencies, an issuer and promoter of the ICO is required to register as an operator of a Virtual Currency Exchange Business.

Under the amended Payment Services Act, "virtual currency" is defined as a proprietary value that satisfies all of the following criteria:

- Between unspecified persons: (i) it can be used to settle payments for goods and/or services and exchanged with legal currency; or (ii) it can be exchanged with another virtual currency.
- It can be transferred using an electronic data processing system.
- It is not denominated in Japanese Yen or any foreign legal currency.

Therefore, if digital tokens issued by an ICO meet the criteria above and are therefore categorized as virtual currencies, an issuer and promoter of the ICO is required to register as an operator of a Virtual Currency Exchange Business.

In this connection, all digital tokens issued by ICOs are not necessarily categorized as virtual currencies under the Payment Services Act. For example, if the transfer of digital tokens is restricted by the issuer, depending on facts and circumstances, the regulators may conclude that the digital tokens are not virtual currencies because, *between unspecified persons*, they can neither: (i) be used to settle payments for goods and/or services and exchanged with legal currency nor (ii) be exchanged with another virtual currency (that does not meet the criteria of the first bullet point above).

Although the FSA did not specifically refer to it, the FSA Statement clarifies this issue because it states

that "certain" (but not all) digital tokens may fall into the definition of "virtual currency."

Financial Instruments and Exchange Act
Second, the FSA Statement noted that ICOs may also be subject to the Japanese securities law, the Financial Instruments and Exchange Act ("FIEA").

The FIEA regulates so-called "collective investment schemes" and securities, and the marketing and management of funds or other assets collected through any collective investment scheme require registration with the FSA, unless any specific exemptions apply.

The definition of a "collective investment scheme" under the FIEA is broad, and it generally covers any arrangement (regardless of its legal form) under which cash and cash equivalent are collected from investors to invest in a certain business and investors are entitled to receive dividends or distribution of assets.

In this connection, prior to the FSA Statement, there was a market view that ICOs should not be categorized as collective investment schemes because ICO participants usually pay virtual currencies (such as Bitcoin or Ethereum's Ether) in consideration for digital tokens, and such virtual currencies are not "cash and cash equivalent" in the context of the FIEA.

However, the FSA Statement has clearly rejected such view by stating that, "if an ICO has characteristics of an investment and the purchase of a digital token by a virtual currency is in fact deemed equivalent to that by a legal currency, an ICO will be subject to the regulations under the FIEA." This approach by the FSA is also fully consistent with the official recognition of use of certain virtual currencies, such as Bitcoin, in Japan under the Payments Services Act.

If an ICO is deemed as a collective investments scheme, the issuer and promoter of the ICO is required to be registered as an operator of a Type II Financial Instruments Exchange Business and/or Investment Management Business, and it will also be subject to various regulations under the FIEA.

Potential Risk on ICOs to Participants

The FSA Statement has emphasized that an ICO has other "high" risks and that ICO participants should participate in the ICO at their own risk after duly analyzing such risks, as well as the details, of an ICO project.

- **Price volatility**: The value of digital tokens may suddenly decline or even become worthless.
- **Potential for fraud**: Projects in a white paper may not be implemented, or goods and services planned may not be offered in fact.

This confirms that the FSA's commitment to protecting investors from fraud remains the same, regardless of the technologies involved and the means of raising capital.

TWO KEY TAKEAWAYS

1. Parties engaging in ICO activities should seek appropriate legal and other professional advice to ensure compliance with the applicable legal and regulatory requirements in Japan.
2. The FSA is planning to reorganize legislation in order to introduce a cross-sectoral regulatory regime for fintech industries, which may have impacts on ICOs. Future developments should be closely monitored.

CONTACTS


Hirokazu Ina
Tokyo


Yuki Yoshida
Tokyo

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