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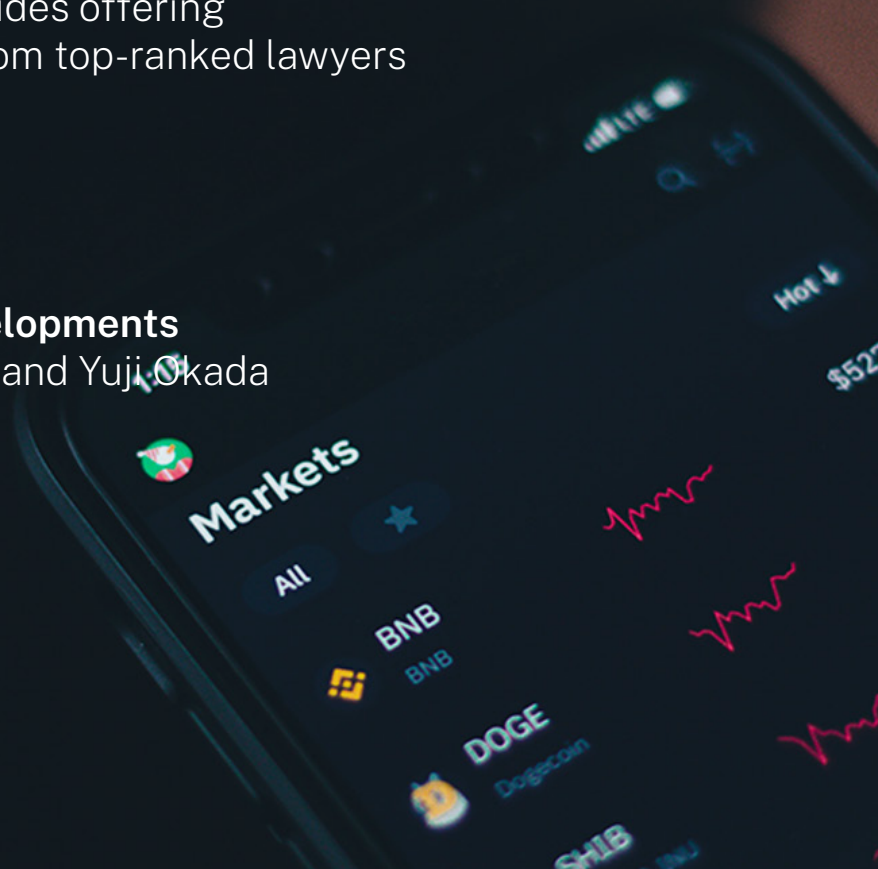
Japan: Trends and Developments
Akihiro Shiba, Dai Mizui and Yuji Okada
Nishimura & Asahi



Trends and Developments

Contributed by:
Akihiro Shiba, Dai Mizui and Yuji Okada
Nishimura & Asahi

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Authors

Akihiro Shiba is a partner at Nishimura & Asahi. He represents numerous financial institutions and fintech firms, both in and outside Japan, in connection with financial regulations and domestic and cross-border financial transactions (including those related to structured finance and asset management), by utilising the experience he gained through his secondment to the Financial Services Agency and the Singapore branch of a Japanese bank. Since 2014, he has advised on digital tokens and other various fintech matters. He was admitted to the Bar in Japan (2007) and New York (2018), and received his LLB from the University of Tokyo (2005) and LLM from Cornell Law School (2016).

Dai Mizui is an associate at Nishimura & Asahi. Since 2017, he has advised on a variety of fintech matters, particularly crypto-asset regulations, regulatory requirements for registration, NFTs, and other blockchain-based services. From 2020 to 2022, he was seconded to a fintech company, and has also focused on various financial regulations and an array of related matters, including AI, API and data protection. He received a JD from the University of Kyoto School of Law in 2014 and an LLB from the University of Osaka in 2012. He was admitted to the Japan Bar in 2016.

Yuji Okada is an associate at Nishimura & Asahi. His key practice areas are REITs/real estate finance, fintech, finance regulation/compliance, structured finance/securitisation, and project finance. He has advised on transactions involving security tokens and other various fintech matters since 2020. He received a JD from the University of Tokyo School of Law in 2018 and an LLB from the University of Tokyo in 2016. He was admitted to the Japan Bar in 2019.

Nishimura & Asahi

Otemon Tower
1-1-2 Otemachi
Chiyoda-ku
Tokyo
100-8124
Japan

Tel: +81 3 6250 6200
Fax: +81 3 6250 7200
Email: info@nishimura.com
Web: jurists.smktg.jp

NISHIMURA & ASAHI

Background to Recent Developments

On 7 June 2022, in its "Basic Policies on Economic and Fiscal Management and Reform 2022", the government of Japan declared that it would implement legislative and other measures to create the environment needed to realise a distributed digital society, including various measures to promote a Trusted Web, Web3.0 (including non-fungible tokens (NFTs) and decentralised autonomous organisations (DAOs)), the metaverse, security tokens (digital securities) and crypto-assets. On 27 December 2022, the Web3.0 Study Group of the Digital Agency published a report which identified various issues with digital assets (such as crypto-assets and NFTs), DAOs, distributed identities (DIDs), connections to the metaverse, user protection and law enforcement.

Japan's ruling Liberal Democratic Party has also demonstrated a positive attitude towards the development of blockchain business. The web3 Project Team under the party's Headquarters for the Promotion of a Digital Society, Policy Research Council proposed legislative and other measures to promote Web3 businesses in its "interim proposals" in December 2022 and its "web3 White Paper" in April 2023, in regard to crypto-assets, stablecoins, security tokens, NFTs and DAOs.

The "Mutual Evaluation Report of Japan" issued by the Financial Action Task Force on 30 August 2021 identified various issues with regulations and requirements under Japanese law in relation to anti-money laundering (AML), countering the financing of terrorism (CFT) and countering proliferation financing (CPF).

In this context, legislative and other measures have been taken regarding blockchain-related business, as explained below.

Clarification on the Differences Between Crypto-Assets and NFTs

Currently, there are no specific regulations on NFTs under Japanese law. However, the applicability of each financial regulation should be carefully considered, particularly the crypto-asset regulations under the Payment Services Act (Act No 59 of 2009) (PSA). Under the PSA, Bitcoin, Ether and other cryptocurrencies are generally categorised as "crypto-assets". Accordingly, exchanges and custodians for crypto-assets are generally required to be registered and regulated as a "crypto-asset exchange service provider" (CAESP) under the PSA, and are subject to the AML/CFT requirements under the Act on Prevention of Transfer of Criminal Proceeds (Act No 22 of 2007) (APTCP) and the sanction-related requirements under the Foreign Exchange and Foreign Trade Act (Act No 228 of 1949) (FEFTA).

Concerns exist in relation to whether certain NFTs may constitute crypto-assets under the PSA, especially in cases where many NFTs with similar characteristics are issued, which is regarded as a bottleneck to the development of NFT business in Japan.

Given this, on 24 March 2023, the Financial Services Agency (FSA) amended its administrative guidelines for CAESPs in order to clarify the PSA's definition of crypto-assets. According to the amended guidelines, digital tokens (such as NFTs) are not regarded as crypto-assets (unless they are actually used for payments of consideration to unspecified persons) if they satisfy both of the following conditions or are otherwise regarded as no more than digital assets that can be bought or sold using fiat currency or crypto-assets in light of socially accepted ideas.

- Where the issuer or related party makes it clear that the digital tokens are not intended

to be used for the payment of consideration for goods or other assets to unspecified persons (for example, by including a statement to that effect in the terms and conditions or in the technical specifications of the relevant system).
- Where the factors that may cause the digital tokens to be used for the payment of consideration for goods or other assets to unspecified persons are limited, in light of the price, amount, technical features, specifications or other circumstances, such as where either of the following two conditions is satisfied:
  (a) the price of the minimum tradable unit is too expensive for an ordinary payment instrument (the FSA's view is that this condition is satisfied if the price is JPY1,000 or higher); or
  (b) the issued quantity divided by the minimum tradable unit is limited (the FSA's view is that this condition is satisfied if such amount is one million or less).

Relaxation of Listing Examinations for Crypto-Assets

Under the self-regulatory rules of the Japan Virtual and Crypto-assets Exchange Association (JVCEA), a self-regulatory organisation for crypto-asset exchange services and crypto-asset-related derivatives, when a CAESP member of the JVCEA begins handling a new crypto-asset (as defined in the PSA), the crypto-asset must be examined by the JVCEA before the CAESP commences handling such crypto-asset.

In order to reduce the time required for undergoing a JVCEA examination, in December 2022 the JVCEA amended the relevant self-regulatory rules to introduce the following two systems: the "Green List System" and the "CASC System".

Under the Green List System, an eligible CAESP member of the JVCEA is exempted from JVCEA examination if the member begins engaging in the handling of a crypto-asset on the Green List, which is a list of crypto-assets that the JVCEA regards as satisfying the following four conditions:

- the crypto-asset is handled by three or more JVCEA members;
- at least six months have passed since a JVCEA member began handling the crypto-asset;
- the handling of the crypto-asset is not subject to any conditions specified by the JVCEA; and
- no events have occurred that have caused the JVCEA to determine that the inclusion of the crypto-asset on the Green List is inappropriate.

Under the CASC (crypto-asset self-check) system, the scope of JVCEA examination is limited where an eligible CAESP member of the JVCEA intends to handle a new crypto-asset.

Introduction of Regulatory Framework for Stablecoins

In order to introduce a regulatory framework for the issuance and circulation of stablecoins, amendments to the PSA, APTCP and other statutes were enacted in June 2022, and came into force on 1 June 2023, along with relevant regulations and guidelines.

Under the amended PSA, fiat currency-denominated stablecoins are categorised as "electronic payment instruments" (EPIs), and the aforementioned amendments introduced a regulatory framework for EPIs under the PSA, APTCP and other statutes. Other stablecoins (such as algorithm stablecoins and crypto-asset-backed sta-

blecoins) are still categorised as crypto-assets under the PSA or, depending on the structure, securities under the Financial Instruments and Exchange Act (Act No. 25 of 1948) (FIEA). According to the FSA's administrative guidelines, CAESPs are prohibited from referring to algorithm stablecoins and crypto-asset-backed stablecoins as "stablecoins" because such reference is misleading.

As a basic rule, the business of issuing EPIs to Japanese residents can be conducted by:

- a bank or any other deposit institution;
- a Type II or Type III funds transfer service provider registered under the PSA; or
- a trust company or foreign trust company licensed or registered under the Trust Business Act that has submitted a notification to the regulator under the amended PSA to issue an EPI in the form of trust beneficial interests, where the trust assets are deposits with a bank or any other deposit institution in the same currency.

Generally, exchanges and custodians for EPIs must be registered and regulated as "electronic payment instrument exchange service providers" (EPIESPs) under the amended PSA, and are subject to AML/CFT requirements (including the "Travel Rule" requirement as well as the requirement to collect and keep a record of information on wallets that are not subject to the Travel Rule (please see below under **Developments in AML/CFT and Sanction-Related Requirements**)) under the APTCP. EPIs are also subject to sanction-related requirements under the amended FEFTA (please see below under **Developments in AML/CFT and Sanction-Related Requirements**). According to the regulations, an EPIESP may handle an EPI issued outside Japan if all certain conditions are satisfied, including the following.

- Where the foreign issuer is a regulated financial institution equivalent to those listed above that is registered or licensed by, or has made a notification to, the regulator under the provisions of foreign laws and regulations that are equivalent to the PSA or to the Banking Act (Act No 59 of 1981).
- Where the foreign issuer administers the assets necessary to redeem the EPI pursuant to the relevant foreign financial regulations, and the status of such administration has been audited.
- Where the foreign issuer is supposed to take measures, such as suspension of transactions, if it is suspected that a related crime has been committed.
- Where the EPIESP:
  (a) promises, in the case where it becomes difficult for the foreign issuer to redeem the EPI or the value of the EPI significantly decreases, to purchase the EPI that the EPIESP holds in custody for users (or users in Japan if they are distinguished) at the redemption price; and
  (b) preserves assets for performing such promise or takes other equivalent user protection measures.

Trading Venue for Tokenised Securities

Under the current FIEA the operator of an online trading venue for securities (including tokenised securities) must be a financial instruments business operator registered with the regulator to operate Type I financial instruments business and be authorised by the regulator to operate a proprietary trading system (PTS). However, there is no PTS that handles tokenised securities.

On 28 April 2023, in order to create a PTS that handles unlisted securities for professional investors, which is currently not permitted under the FIEA, the FSA published proposed amendments to the relevant Cabinet Order. On the same date, two self-regulatory organisations, the Japan Securities Dealers Association and Japan STO Association, also published proposed self-regulatory rules concerning trading on a PTS. These actions are expected to promote the creation of a PTS which provides a secondary tokenised securities market for professional investors.

Regulation of Tokenised Real Estate-Backed Fund Interests as Securities

Interests in a partnership-type fund that directly invests in real estate (rather than indirectly through a trust or otherwise) are regulated under the Act on Specified Joint Real Estate Ventures (Act No 77 of 1994) (ASJREV), and such interests are excluded from the definition of "securities" under the FIEA unless they are issued by a special purpose company (SPC). However, while the FIEA has already introduced rules for tokenised securities, the ASJREV does not set forth any rules on such tokenised real estate fund interests. Furthermore, the ASJREV does not contain any rules that regulate the secondary trading of fund interests.

On 14 March 2023, the Japanese government submitted a bill to define such tokenised real estate fund interests as "securities" under the FIEA and to make the necessary amendments to the ASJREV.

If the bill passes and comes into force, the rules on tokenised securities under the FIEA will apply to any and all tokenised real estate fund interests regulated under the ASJREV.

Investment in Digital Tokens by Limited Partnership Funds Under Japanese Law

The types of investments made by an "investment limited partnership" organised under the Limited Partnership Act for Investment (Act No 90 of 1998) are limited to certain types of assets, which include certain securities but not crypto-assets as defined in the PSA.

In this regard, on 19 April 2023 the Ministry of Economy, Trade and Industry (METI) published a statement clarifying that any assets eligible for investment by an investment limited partnership will remain eligible for such investment even if they are tokenised (such as tokenised securities). The METI warned that crypto-assets are not eligible for such investments, but stated that it will engage in further consideration in this regard.

Developments in AML/CFT and Sanction-Related Requirements

In order to address the issues identified in the FATF's report, certain amendments to the AML/CFT and the most of which sanctions were made on 2 December 2022, and came into force on 1 June 2023. Due to these amendments:

- CAESPs are now subject to the statutory "Travel Rule" requirement under the APTCP;
- EPIESPs are subject to sanction-related requirements under the FEFTA, and CAESPs; and
- EPIESPs are required to collect and keep a record of information on wallets used by transaction counterparties if such wallets are not regulated under the Travel Rule in any jurisdiction (such as un-hosted wallets and non-regulated hosted wallets).

Developments in Accounting Treatment of Digital Tokens

The accounting treatment of crypto-assets held by a third party other than the issuer was clarified in a report issued by the Accounting Standards Board of Japan (ASBJ) on 14 March 2018, as well as in the examples published by the JVCEA in June 2020.

The ASBJ further clarified the accounting treatment of the issuance and holding of tokenised securities (as regulated under the FIEA) in a report issued on 26 August 2022.

The ASBJ is still deliberating on the accounting treatment of the issuance and holding of crypto-assets (as defined in the PSA) by the issuer, as well as on the issuance and holding of EPIs.

Tax Reform to Promote Fundraising With Crypto-Assets

Generally, under the Corporate Tax Act (Act No 34 of 1965), actively traded crypto-assets held by a corporation are subject to taxation on unrealised gains at the end of the fiscal year based on their fair market value at that time.

In this regard, the Corporate Tax Act and the relevant regulations were amended – such amendments came into force on 1 April 2023. Under the new tax rules, crypto-assets (as defined in the PSA) continuously held by the issuing corporation are exempted from fair market value taxation under certain conditions (such as being subject to transfer restrictions).

It should be noted that actively traded crypto-assets held by any third-party corporation are still subject to fair market value-based taxation. The “web3 White Paper” issued by the web3 Project Team of the Liberal Democratic Party proposes that crypto-assets held by a third party for purposes other than short-term trading purposes (which was outside the scope of the aforementioned tax reform) also be exempted from fair market value-based taxation.

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