

Japanese FSA outlines its future Crypto Regulations

On December 12, 2018, the Japanese Financial Services Agency (FSA) has published the report of its “Study Group on the Virtual Currency Exchange Services”. This report was released a few weeks after the Swiss Federal Council's report on the legal framework for blockchain and distributed ledger technology (DLT) in the financial sector (https://www.mme.ch/de/magazin/shaping_switzerlands_future_in_dlt/).

Based on an analysis of the specific risks deriving from trading crypto assets and distributed ledger technology (DLT), the Japanese FSA-Study Group recommends new regulatory measures for exchanges and ICO's in order to mitigate crypto specific risks, thereby focusing on matters in areas that are not currently addressed in existing laws such as hacking incidents, self-regulation, and margin trading. It is expected that FSA will in a next step draft respective regulations.

Source: <https://www.fsa.go.jp/en/refer/councils/virtual-currency/20181228.html>

I. General Risks identified by the Report

The FSA has identified four major risks which are to be mitigated by implementing adequate regulatory measures:

1. Risk of thefts of customers' crypto assets from exchanges;
2. Service providers have failed to develop appropriate internal control systems in response to rapid business expansion;
3. Crypto Assets are highly fluctuating in price and being traded based on speculations;
4. New types of transactions involving virtual currencies (margin trading and ICOs) have emerged.

According to the report, the respective risks shall be mitigated by introducing new regulations covering predominantly Exchange Service Providers and Investment Type ICO's.

II. Common Measures for Crypto Exchanges, Margin Trading and ICO's

The FSA-Study Group defines five measures to be implemented in future regulations applicable to Crypto Exchanges, Margin Trading and ICO's:

- a) Principle of Self-Responsibility: A close cooperation with self-regulatory organization's rules is envisaged. Non-SRO members which have not established internal rules compliant with the SRO's requirements shall be refused

registration (see <https://cointelegraph.com/news/japanese-financial-regulator-receives-190-cryptocurrency-exchange-license-applications>).

- b) Addressing unfair acts in virtual currency spot trading: The regulative measures shall prohibit any improper conducts, spreading rumors and price manipulations. Further, a monitoring system shall control the virtual currency exchange service providers in order to prevent prohibit transactions aimed based on non-public information.
- c) Addressing custodial services for virtual currencies: The regulative measure shall protect both customer's custodial services and currency exchange services at the same level.
- d) Transitional treatments associated with the introduction of new registration requirements: No virtual currency margin trading and custodial services shall be allowed before registration proceedings have been finalized.
- e) Terminology: With reference to internationally used terminology, the FSA-Group suggests to change the name of the defined legal term from "virtual currencies" to "crypto-assets".

III. Measures specifically for Exchange Service Providers

In 2018, the Japanese crypto market faced two major hacks of Japanese exchanges: Coincheck in January followed by Zaif in September 2018. The FSA-Study Group submits regulatory proposals with aim to protect consumers and to oblige Exchange Service Providers to implement adequate organisational structures for the management and maintenance of customer property:

- a) Custody of funds: Where private keys of customers deposited virtual currency are managed online, service providers shall be required to maintain net assets and funds equal to or more than the amount equivalent to the currency in order to protect the customers claim for reimbursement. Respective funds must consist of the same types as the deposited virtual currency.
- b) Securing funds: The FSA-Study Group further proposes to develop a framework to entitle customers to statutory liens that secure their claim to deposited virtual currencies.
- c) Transparency: Service providers shall further be required to disclose financial statements and information regarding trading prices. They shall be prohibited from advertising, promoting or otherwise encouraging speculative trading.

- d) Trading restrictions: Service providers shall be prohibited from dealing crypto assets that could impede user protection or proper and reliable business operations.

IV. Crypto Assets Margin Trading

Trading with funds borrowed from an exchange is called Margin Trading. It allows traders to increase their leverage and is mostly done on a day trading bases. Margin Trading with crypto currencies has become very popular in Japan. There are various exchanges offering respective services.

In order to reduce risks associated with margin trading, the FSA-Study Group proposes to

- a) impose a registration requirement on service providers dealing in virtual currency margin trading as foreign-exchange margin traders (Forex trading);
- b) prohibit unrequested solicitation;
- c) limit the leverage ratio based on actual virtual currency price fluctuations;
- d) oblige the service providers to explain specific risks related to virtual currencies.

V. Regulating ICOs (Initial Coin Offerings)

The FSA-Study Group proposes to establish a regulatory framework for ICOs addressing in particular the following matters:

- a) Addressing investment-type ICOs: Soliciting investments for funding investment type ICOs shall be subject to general financial regulations requirements.
- b) Establishing regulatory framework for ICOs: The following elements of this framework shall ensure high transferability of ICO tokens and mitigate the risks of investors:
 - The issuer shall be obliged to provide public disclosure initially and subsequently, when soliciting 50 or more investors;
 - Brokers/dealers of investment-type ICOs shall be obliged to inform on the same level as brokers/dealers in connection of the issuance of traditional securities;
 - Brokers/dealers of investment-type ICOs shall be obliged to examine the business and financial conditions of the issuer;

- The current unfair trading regulations and the future (pending) insider trading regulations shall be applicable to ICOs;
 - Solicitation to retail investors shall be the same as the restriction on unlisted stocks.
- c) *Addressing other types of ICOs:* Virtual currency exchange service providers dealing with ICO shall provide information on the ICO including a report on the feasibility of the project.

VI. Conclusion

According to various resources, there was no major objection to the proposed measures in the report and the FSA is expected to draft regulations based on its content.

The FSA-Study Group uses various terms such as “Virtual Exchanges”, “virtual currencies that could impede user protection or proper business operations” or “investment type ICO’s” which will need to be defined in the regulations. A diligent definition of these terms in the new regulations will have a major influence on their effectiveness and success.

The report does in our view not yet sufficiently reflect the various possible functionalities of crypto assets or tokens. Applying MME’s Token Classification Framework (BCP), the report seems predominantly to address BCP 2 tokens (tokens which are synchronized with relative rights against a counterparty). It seems not entirely clear if BCP 1 Tokens (Native Tokens which have a mere technical functionality in a decentralized, open-source and cybernetic network and which are not synchronized with any relative or absolute rights such as protocol tokens, e.g. BTC, ETH, or XTZ, but also - in our view - tokens of decentralized applications such as MLN or GNT) and BCP 3 Tokens (tokens with absolute rights) will fit in the regulatory framework proposed by the FSA-Study Group. It will be interesting to see which definitions the FSA will use in its drafts for the new or amended regulatory framework.