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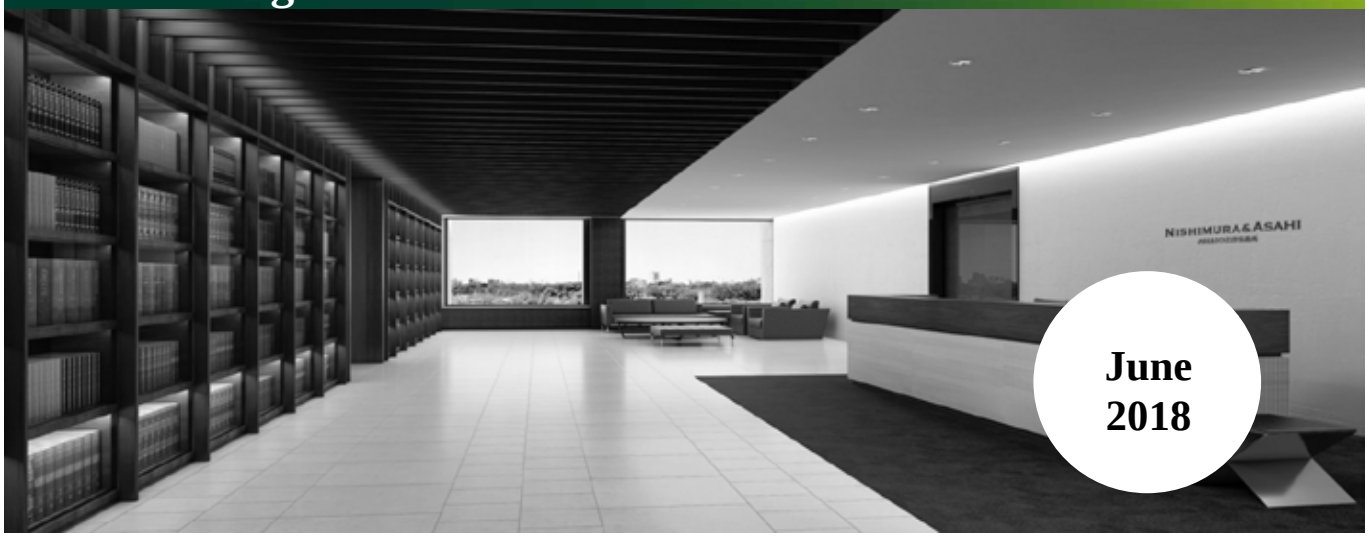

Japanese Legal Issues Concerning Cryptocurrency Funds

Kei Ito, Yusuke Motoyanagi

1. Introduction

Cryptocurrencies have been attracting attention as an investment opportunity. While enthusiasm for cryptocurrencies has somewhat calmed due to increased regulations in many countries, around the world new cryptocurrencies continue to be introduced and investors are seeking opportunities to invest in these.

Not all cryptocurrencies are suitable for investment, so investment in cryptocurrencies requires the ability to assess suitability. Therefore, more and more investors wish to invest in cryptocurrency funds and delegate their investment decisions to an expert. As investment fund managers expose investors' assets to risks, regulators in many countries try to regulate them to protect investors. How would a cryptocurrency fund be regulated in Japan?

Investment funds investing in stocks and bonds etc. are subject to strict investor-protection regulations, including under the Financial Instruments and Exchange Act (the **"FIEA"**). Although funds investing in cryptocurrencies also require regulation, their activities are not necessarily covered by current legislation. This newsletter outlines the regulations that would be applicable to cryptocurrency funds.

Applicable regulations differ depending on type of fund vehicle, of which three are possible: partnership-type funds, trust-type funds and corporate-type funds. Below we discuss each type.

2. Partnership-type Funds

(1) Choice of Entity

Partnership-type structures are generally preferred for funds due to their flexibility. When a partnership-type fund is formed in Japan, the usually-preferred entity is an "investment limited partnership" (*toshi jigyo yugen sekinin kumiai*; a **"J-LPS"**) under the Limited Partnership Act for Investment (the **"LPS Act"**). However, a J-LPS's scope of business is limited by the LPS Act and does not include investment in cryptocurrencies[1]. Thus, a J-LPS cannot invest directly in cryptocurrencies. Nonetheless, if it invests indirectly in cryptocurrencies through another entity, the fund's investment is seen as an investment in securities. Therefore, one may form a cryptocurrency fund as a J-LPS if, operating as a fund of funds (**"FoF"**), it invests in securities issued by other funds that in turn invest in cryptocurrencies.

In order for a partnership-type fund to invest directly in cryptocurrencies, it may be formed as a general partnership (*nin-i kumiai*; **"NK"**) or a silent partnership (*tokumei kumiai*; **"TK"**)[2], the scope of business of neither of which is limited. While each partner of an NK owes unlimited liability, a TK member can enjoy limited liability. Note also that Japanese law places no limitations on a non-Japanese limited partnership's scope of business.

(2) Securities

When shares of a fund constitute securities, activities relating to the fund are generally subject to regulation under the FIEA. Interests in a partnership-type fund, whether or not the fund is formed under Japanese law, generally constitute securities (within the meaning of the FIEA) if the fund conducts its business utilizing cash contributed by the right holders (i.e., partners) and distribution of profit or property by the fund is contemplated. The subject of investment does not matter. Therefore, interests in cryptocurrency funds formed as a partnership generally constitute securities.

In this regard, if a fund's business is to accept contributions in cryptocurrencies from its partners and utilize them, that would not seem to meet the requirement of "utilizing cash contributed by the right holders", as mentioned above. Such a fund feature would require careful examination to ensure the structure will not be seen as a circumvention of the law.

(3) Marketing of Shares

Where shares of a fund constitute securities, the marketing of such shares constitutes "Type II Financial Instruments Business" under the FIEA. Marketing of such shares by the fund operator itself (e.g., a general partner of a J-LPS or foreign limited partnership or a TK operator) is called "self-offering" (*jiko boshu*). Marketing by another person is called "handling a public offering" (*boshu no toriatsukai*) or "handling a private placement" (*shibo no toriatsukai*), depending on whether the offering is conducted as a public offering or private placement. All three activities fall within Type II Financial Instruments Business. Generally speaking, to conduct Type II Financial Instruments Business an entity must be registered under the FIEA as a

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1 In this letter, the word "cryptocurrency" does not include any digital currencies that may be characterized as securities, prepaid payment instruments or other type of financial instruments in discussions concerning the Japanese laws and regulations.

2 A TK is a kind of profit sharing arrangement between a TK operator (*eigyosha*) and a TK member (*tokumei kumiai in*), whereby the TK operator conducts business as prescribed in the TK agreement and shares the profit with the TK member, who stays silent and has no relationship with third parties the TK operator deals with in carrying on the business. Although a TK agreement is an agreement only between two parties (i.e., a TK operator and a TK member), a TK operator quite often enters separate TK agreements with several TK members, each on essentially identical terms and conditions (except for shares of investment), thereby forming a TK fund for multiple investors.

"Financial Instruments Business Operator" (a **"FIBO"**) and be registered specifically to conduct Type II Financial Instruments Business (a FIBO so registered, a **"Type II FIBO"**).

In the case of a self-offering, an exemption may be available (see (5) below). Otherwise, the handling of a public offering or private placement must be conducted by a Type II FIBO.

(4) Management of Fund Assets

When management of fund assets is performed as an investment primarily in securities or derivative transactions based on investment decisions relying on analyses of the value of financial products[3], that constitutes "Investment Management Business" (*toshi unyo gyo*) under the FIEA. However, a fund that invests directly in cryptocurrencies does not invest "primarily in securities or derivative transactions" and, therefore, managing the fund assets in cryptocurrencies does not generally constitute Investment Management Business. Nonetheless, investing in a cryptocurrency could be seen as investing in securities, depending on the cryptocurrency's features.

In addition, management of a fund that invests in cryptocurrencies only indirectly through investment in securities, such as an FoF, does constitute Investment Management Business. Where fund assets are managed by the fund operator, that is called "self-management" (*jiko unyo*). Where fund assets are managed by another person, that is categorized as discretionary investment management, which is to be conducted under a discretionary investment management agreement (*toshi ichinin keiyaku*) between the fund (or its operator) and that other person. Both activities fall within Investment Management Business.

Generally speaking, registration as a FIBO is required to conduct Investment Management Business. However, as discussed in (5) below, an exemption may be available for self-management (but not discretionary investment management).

(5) Specially Permitted Businesses for Qualified Institutional Investors, etc.

In the case of partnership-type funds, there is an important exemption (called "Specially Permitted Businesses for Qualified Institutional Investors, etc.") from the requirement to register as a FIBO. When (i) a fund has one or more qualified institutional investors (within the meaning of the FIEA; each, a **"QII"**), (ii) the number of investors that are not QIIs is 49 or less and they all meet the required qualification, and (iii) the fund meets certain other requirements, then the fund operator may conduct both the marketing of the fund (self-offering) and the managing of the investor assets of the fund (self-management) without registration as a FIBO. While the FIEA still imposes certain conduct requirements and other regulations on an operator so exempted, these are relaxed in comparison with those applicable to FIBOs.

(6) Disclosure Obligations

When shares of a fund constitute securities, public disclosure obligations may be an issue, including the obligation to file a securities registration statement (**"SRS"**). However, where a fund does not invest mainly in securities, the fund's issuer is exempted from these obligations.[4]

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[3] In this context, "financial products" means securities or other types of instruments, such as currencies, that may constitute the underlying assets of derivative transactions.

[4] Even if a partnership-type fund invests mainly in securities, the offering of interests does not constitute a public offering unless the number of investors who acquire the interests is 500 or more. If the marketing of a partnership-type fund investing mainly in securities is conducted as a private placement, rather than public disclosure, notice of certain matters only (including that no SRS has been filed) is to be given to each investor, often in the form of a legend contained in the offering document.

It is possible that a FIBO or exempted operator may be required to deliver certain disclosure documents to each investor under the FIEA. However, this delivery obligation can be dispensed with where the investor is a "specified investor" (*tokutei toshika*).

(7) Recap

Certain types of partnership vehicles (such as a TK or foreign limited partnership) may make direct investments in cryptocurrencies, while a J-LPS may only make indirect investments. An appropriately registered FIBO or an exempted operator would need to be involved.

3. Trust-type Fund

(1) Investment Trust

In the case of a trust-type fund, the first question is whether a cryptocurrency fund can be set up as, or otherwise utilize the legal form of, an "investment trust", a kind of domestic vehicle (normally used for mutual funds) formed under the Act on Investment Trusts and Investment Corporations (the **"AITIC"**). Given that one requirement for an investment trust is to invest mainly in "specified assets" (such as securities, rights under derivative transactions, real property and monetary claims), a fund that directly invests in cryptocurrencies does not constitute an investment trust. However, a fund may constitute an investment trust if it invests in cryptocurrencies indirectly, in the manner described above in relation to partnership-type funds. Nonetheless, such a fund would still not qualify as an investment trust if cryptocurrencies are contributed by investors as trust assets, given that trust assets must be contributed in cash in order for a fund to so qualify.

When a fund constitutes an investment trust, activities relating to the fund are subject to both the AITIC and the FIEA. Marketing by the trust settlor itself (which the manager of the investment trust becomes) requires registration as a Type II FIBO. Marketing by another person requires registration as a FIBO that conducts Type I Financial Instruments Business (a **"Type I FIBO"**). Management of an investment trust's assets requires registration as a FIBO that conducts Investment Management Business.

In addition, marketing to 50 or more investors constitutes a public offering and public disclosure obligations are imposed by the FIEA, including the obligation to file an SRS and annual securities reports.

(2) Foreign Investment Trust

If a foreign vehicle is used for a trust-type fund, the first question is whether a cryptocurrency fund using a foreign trust vehicle can fall within "foreign investment trust" under the AITIC. This is defined as "a trust established under the laws of a foreign country and is similar to a domestic investment trust". Therefore, it is important to determine whether the foreign fund is similar to a domestic investment trust. Although comprehensive consideration regarding similarity is required, a fund that invests directly in cryptocurrencies would not likely be regarded as similar to a domestic investment trust. This is because it does not invest in "specified assets". Thus, an indirect investment arrangement is necessary if one desires to set up the fund as a foreign investment trust.

Where a fund constitutes a foreign investment trust, a notification must be filed under the AITIC before any marketing commences in Japan. In addition, the trust settlor (or anyone considered to be in the same position), if it itself intends to market units of the fund, must be registered as a Type II FIBO. Marketing by a person other than the trust settlor requires registration as a Type I FIBO. In addition, marketing to 50 or more investors constitutes a public offering and public disclosure obligations apply.

(3) Trust/Foreign Trust

Where a trust-type fund is not an investment trust, it is not subject to the AITIC, but is still subject to other laws and regulations, such as the Trust Act, the Trust Business Act, and the FIEA. One issue is whether a cryptocurrency constitutes "property" under the Trust Act (which requires that the object of the trust be "property"). Various other issues may well arise, depending on the specific circumstances.

Even where a foreign trust-type fund investing in cryptocurrencies does not constitute a foreign investment trust, interests in such fund would still be deemed "securities" under the FIEA and can, theoretically, be marketed by a Type II FIBO.

(4) Recap

One option for marketing a cryptocurrency fund as an FoF may be to use a domestic investment trust with the involvement of a properly registered investment trust manager (i.e., a FIBO registered to conduct Investment Management Business). Cryptocurrency funds using a foreign trust vehicle may or may not constitute a "foreign investment trust" under the AITIC and can theoretically be marketed in Japan through an appropriately registered FIBO[5].

4. Corporate-type Fund

(1) Investment Corporation

As with an investment trust, an "investment corporation", a domestic corporate vehicle defined under the AITIC, is an entity that invests mainly in "specified assets", and so a fund that directly invests in cryptocurrencies cannot constitute an investment corporation. In any event, in practical terms there is little need to establish an investment corporation that invests in cryptocurrencies given the strict regulations applicable to investment corporations.

(2) Foreign Corporate-type Fund

If a foreign vehicle is used for a corporate-type fund, the first question is, as with a trust-type fund, whether a cryptocurrency fund using a foreign corporate vehicle can fall within "foreign investment corporation" under the AITIC. The regulations applicable to foreign investment corporations are generally similar to those for foreign investment trusts. However, the marketing of interests in a foreign investment corporation by the corporation itself does not constitute Financial Instruments Business and thus does not require FIBO registration. In contrast, marketing by a person other than the foreign investment corporation does require registration as a Type I FIBO. Also, public disclosure obligations are imposed if marketing is conducted to 50 or more investors and no exemption applies.

In this regard, a foreign corporate-type fund that directly invests in cryptocurrencies would not likely constitute a foreign investment corporation. In that case, such fund would be treated as an ordinary foreign corporation and would not be obligated either to file a notification under the AITIC or to register as a FIBO under the FIEA. However, marketing by a person other than the foreign corporation itself still requires registration as a Type I FIBO. Public disclosure obligations are also still imposed.

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[5] The scope of each FIBO's business is limited to that prescribed in its business rules (*gyomu houhou sho*) submitted to the relevant authority and other internal rules. Therefore, a FIBO, even if appropriately registered, may need to amend its rules in order to market the fund.

(3) Recap

In the case of a cryptocurrency fund using a non-Japanese corporate vehicle, depending on the kind of instruments such vehicle invests in, the vehicle may or may not constitute a foreign investment corporation under the AITIC. Considering the difference in FIBO registration requirements applicable to each type of vehicle, a non-Japanese corporate vehicle may be subject to less strict restrictions than a partnership or trust. In any event, if marketing is conducted by a person other than the fund itself, that person must be a Type I FIBO.

5. Regulations Applicable to Counterparties

When a fund invests in cryptocurrencies, the fund operator must be careful about laws and regulations applicable to transaction counterparties. For stable transactions, it is important that a counterparty's activities be legal.

First, it must be ensured that the counterparty is properly registered as a "Virtual Currency Exchange Operator" under the Payment Services Act. When a person, as a business, exchanges a legal currency for a virtual currency, or conducts exchanges between virtual currencies, registration as a Virtual Currency Exchange Operator is generally required.

If the exchange takes place entirely outside Japan, it is considered that Japanese law does not apply to the exchange. However, if the fund operator is located in Japan, the exchange does not take place entirely outside Japan and Japanese law does apply. Moreover, even if the operator is located outside Japan, if it engages an "advisor" located in Japan, then, depending on the advisor's role, the exchange may be regarded as taking place in Japan. Careful examination is required.

Furthermore, the business of acting as an intermediary, broker or agent relating to exchanges of cryptocurrencies also constitutes Virtual Currency Exchange Business. Accordingly, registration as a Virtual Currency Exchange Operator is necessary for a person performing any such business in Japan. Because acting as an intermediary means making efforts to effect a contract between parties, a wide range of activities could fall under the ambit of Virtual Currency Exchange Business.

When a counterparty is a fund that invests in cryptocurrencies indirectly through securities, such as an FoF, registration as a FIBO may be required for the counterparty, as the marketing of securities and managing of fund assets generally require registration as a FIBO. If activities are completed outside Japan, Japanese law does not apply. However, any activities occurring in Japan or directed towards Japanese investors are generally subject to Japanese law.

6. Other Considerations

The laws and regulations applicable to a cryptocurrency fund are not limited to those mentioned above. For example, the Act on Sales, etc. of Financial Instruments will apply. Further, know-your-customer procedures under the Act on Prevention of Transfer of Criminal Proceeds would be required. Also, depending on the structure of a cryptocurrency or a fund, the Money Lending Business Act may apply.

As there is no typical structure of a cryptocurrency fund, careful consideration of the specific product is indispensable.

Kei Ito
Partner
E-mail: k_ito@jurists.co.jp

Kei Ito is a partner at Nishimura & Asahi, specializing in asset management, investment funds, banking, derivatives, securities and other financial and international transactions.

Yusuke Motoyanagi
Partner
E-mail: y_motoyanagi@jurists.co.jp

Yusuke Motoyanagi is a partner at Nishimura & Asahi, specializing in capital markets, asset management, financial regulations and other financial and international transactions.