

JAPAN TO HAVE WORLD'S FIRST CLEAR REGULATORY FRAMEWORK FOR STABLECOINS

Japan will soon have the world's first clear regulatory framework for stablecoins. This new framework has been developed following international discussions triggered by the announcement of the Diem (Libra) concept back in 2019. In May 2022, TerraUSD, an algorithmic stablecoin which was supposed to be pegged to the U.S. dollar, lost its dollar peg, collapsed and sent shockwaves through the crypto market. Regulators all over the world claim a focused regulatory framework is now urgently needed.

Key issues

- Scope of stablecoins whose issuance and distribution will be regulated under the framework
- Distribution of stablecoins will be regulated separately from issuance of stablecoins
- Stablecoins issued overseas may be excluded from the Japanese market

AMENDMENT TO THE PAYMENT SERVICES ACT

In June 2022, an amendment to the Payment Services Act, which aims to regulate digital money to be used for fund transfers and payments, including stablecoins, was enacted in Japan. The amendment reflects the international discussion surrounding stablecoins, especially the [Financial Suitability Board's final report and recommendations on the Regulation, Supervision and Oversight of "Global Stablecoin" Arrangements published in October 2020 \(the 2020 FSB Recommendations\)](#), and is therefore in line with regulations being considered in other jurisdictions such as the US and EU, which regulate similar digital assets. Japan has opted out of a central bank digital currency (CBDC) approach, instead allowing private firms to issue stablecoins. The amendment enables the use of legislatively permitted stablecoins in Japan. Permission to issue stablecoins in Japan is only granted to licenced banks, fund transfer agents and trust companies. A registration requirement will also be introduced for the distribution of stablecoins, to strengthen investor protection and measures against money laundering, although assessment of the exact details will require analysis of the implementing ordinances, which are yet to be published.

SCOPE OF REGULATED STABLECOINS

As set out in the 2020 FSB Recommendations, stablecoins can be categorised according to the various types of stabilisation mechanisms used. Stablecoin designs currently reflect two broad types of mechanisms:

- asset-linked; and
- algorithmic.

The asset-linked type can be further divided into currency-based, financial instrument-based, commodity-based and crypto asset-based stablecoins.

The new framework under the amendment covers asset-linked currency-based stablecoins as "electronic payment instruments". The amendment defines these as "currency-denominated assets that can be used for remittance and settlement to unspecified persons and can be transferred using an electronic information processing organisation".

Stablecoins that stabilise their value by using algorithms (cryptographic asset-like type) are not within the scope of the new framework. They will continue to be regulated under a different regulatory framework that applies to cryptoassets and security tokens, treating them as cryptoassets exchange business and securities dealing business, respectively.

This definition of regulated stablecoins under the amendment is in line with the principle of "**same business, same risk, same rules**" in the 2020 FSB Recommendations. As a result, it is also in step with the direction of regulation in other jurisdictions. For example:

- In its November 2021 Report on Stablecoins, the US President's Working Group on Financial Markets defined "payment stablecoins" as stablecoins designed to maintain a stable value against statutory currencies and recommended that Congress act promptly to enact legislation to ensure that payment stablecoins and payment stablecoin arrangements are subject to a federal prudential framework on a consistent and comprehensive basis. US legislative proposals to date have generally been consistent with this recommendation.
- The European Commission's Markets in Crypto-assets (MiCA) regulation, the relevant amendment to which adopted by the European Parliament on 14 March 2022 includes two categories of stablecoins: (1) "e-money tokens", a type of cryptoasset whose main purpose is to be used as a means of payment, and which purports to maintain a stable value by maintaining a portfolio which ensures that the token references the value of a fiat currency that is legal tender, it being specified that an e-money token referencing an EU currency (euro, or any non-eurozone Member State currency) shall be deemed e-money subject to the E-Money Directive and (2) "asset-referenced tokens", a type of cryptoasset that is not an e-money token and that purports to maintain a stable value by referring to any other value or right or a combination thereof, including one or more official currencies.

The amendment does not necessarily require the digital money to be created and settled through digital ledger technology in order for it to qualify as a regulated "electronic payment instrument". As long as it is used for remittance and settlement to unspecified persons and can be transferred using an electronic information processing organisation, it will be subject to the new regulations under the amendment.

SEPARATION OF ISSUER AND INTERMEDIARY

With stablecoins, the functions can be separated conceptually as follows:

- Issuance function (provision of structure for issuance, redemption and value stabilisation)
- Transfer function (including transaction verification mechanism)

- Customer facing points for management and trading function (including custody services for customers and the provision of apps that enable trading)

It is not commercially necessary to provide all of these functions comprehensively in order to conduct stablecoin related business, and there are firms providing only some of the functions.

The issuance of stablecoins in Japan has already been restricted to licenced banks, fund transfer agents and trust companies, but the transfer and management of stablecoins were not previously regulated. This means that, from the viewpoint of investor protection, the amendment has introduced a new licensing requirement for performing intermediary functions such as the transfer and management of stablecoins. A firm obtaining the new licence will be subject to codes of conduct, such as anti-money laundering and countering the financing of terrorism.

This is in line with the 2020 FSB Recommendations and overseas regulatory policy and legislative proposals. For example:

- In the US, the President's Working Group on Financial Markets Report on Stablecoins stated that to address risks to stablecoin users and guard against stablecoin runs, legislation should require stablecoin issuers to be US FDIC-insured depository institutions and intermediaries are to be subject to supervision at federal-level as opposed to the current patchwork of differing US state-based money transmission and virtual currency laws and regulations.
- In the EU, the European Commission has proposed by amending the MiCA regulation to limit issuers of (a) "e-money tokens" to credit institutions, e-money institutions or issuers on the list of national entities that are exempted under the Capital Requirement Directive (including, notably, the *Caisse des dépôts* in France and KfW in Germany) and (b) "asset-referenced tokens" to entities authorised as credit institutions or as asset-referenced token issuers under the MiCA regulation.

MAKING IT DIFFICULT FOR FOREIGN BUSINESSES TO ENTER THE MARKET?

As noted above, only Japanese licenced banks, fund transfer agents and trust companies are entitled to act as stablecoin issuers in Japan. However, intermediaries are not expressly prohibited from dealing in stablecoins issued overseas.

That said, the Japan Financial Services Agency's Working Group (**WG**) suggests in its report published in January 2022 that when an intermediary distributes electronic payment instruments issued overseas, it would be necessary for the relevant stablecoin issuer to maintain assets in Japan corresponding to the stablecoins distributed in Japan. If actually required by the implementing ordinances of the amendment, this would make it difficult for stablecoins issued overseas to be used in Japan. At the same time, the WG has indicated that other investor protection measures could be implemented instead of the requirement to maintain assets in Japan, and this should be discussed further among stakeholders, including regulatory authorities and their working groups, taking into account the future development of regulatory and supervisory systems in other countries, and the practical implications.

CONCLUSION

Stablecoins are a fast-growing area globally and pose a potential risk to financial stability, as demonstrated by the recent high-profile collapse of TerraUSD. A focused regulatory framework therefore seems justified and, in some eyes, urgently required. Japan will be the first country in the world to have a clear regulatory framework paving the way for the issuance and distribution of permitted stablecoins; a framework that is founded on specific legislation and not simply the interpretation of existing laws or regulatory guidelines. Similarly to security tokens, this is a manifestation of the Japanese government's intention to regulate the distribution of digital assets and create an effective environment for their use.

The amendment does not go so far as to allow stablecoins issued overseas to be distributed in Japan at this stage, but we expect further discussion and development in this area.

The amendment will come into force no later than on 2 June 2023. An assessment of its impact will require analysis of the implementing ordinances, which are yet to be published. Drafts of the ordinances are expected to be released at the beginning of 2023 and to be finalised during the second quarter of 2023.

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