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# Virtual currencies: issues remain after Payment Services Act amended

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## Executive Summary



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*Innovation is afoot in the virtual currency space. While the government will encourage such innovation, it is also facing pressure to protect consumers and prevent money laundering. Even after the recent amendment of the Payment Services Act, regulatory issues remain to be addressed with respect to payment services.*

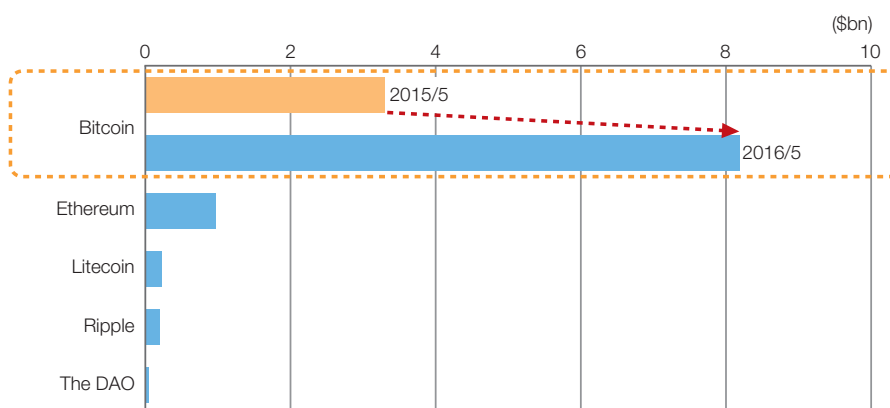
**NOTE**

1) Citigroup and BNY Mellon are developing virtual currency platforms called Citicoin and BK coins, respectively, while Goldman Sachs is developing SETLcoin as a platform for securities settlement.

### Virtual currency use on the rise globally

Use of virtual currencies, most notably bitcoins, is growing globally. In the US, virtual currencies are increasingly being used as a means of payment on websites, including IT companies' B2C sites and travel reservation sites, and at bars and restaurants. Even major US financial institutions are developing their own virtual currencies<sup>1)</sup>. As of May 31, 2016, bitcoins' total market capitalization was over US\$8 billion (Exhibit 1) and their daily transaction volume had grown to over 200,000 transactions. Meanwhile, new virtual currencies have been springing up, including the Ethereum platform, the strength of which is digitalization of financial claims and securities, and Ripple (part owned by Google), which offers nearly instantaneous settlement of transactions.

**Exhibit 1: Market capitalizations of major virtual currencies (as of May 31, 2016)**



Source: NRI, based on CoinMarketCap data

Virtual currencies are in a growth trend in Japan also. In fiscal 2015, domestic bitcoin transactions executed via major bitcoin exchanges grew to over ¥180 billion. Currently, however, bitcoin use in Japan is mostly for speculative purposes. Japanese merchants that accept bitcoins as a means of payment number only

about 90. While virtual currency markets are thus still in an embryonic stage in Japan, Bank of Tokyo-Mitsubishi UFJ has announced plans to launch a low-fee virtual currency service called MUFG Coin from autumn 2017. Japanese megabanks' full-scale entry into the virtual currency market is expected to drive growth in virtual currency use in Japan. To facilitate virtual currency usage, Japan's Financial Services Agency (FSA) has taken steps to expand the permissible scope of financial holding companies' operations and promote more equity investment by banks in development-stage IT companies pursuant to a May 25, 2016, amendment of the Banking Act (Articles 16-2 and 52-23)<sup>2)</sup>.

2) Equity ownership of development-stage companies was previously capped at 5% for banks and 15% for financial holding companies, but these caps have been lifted subject to case-by-case regulatory approval (based on financial soundness, absence of abuse of superior bargaining position, expansion of financial service offerings, etc.).

3) The Financial Action Task Force (FATF) was established in July 1989 by a Group of Seven (G-7) Summit in Paris, initially to examine and develop measures to combat money laundering.

4) The Financial Crimes Enforcement Network (FinCEN) enforces the US Bank Secrecy Act, an anti-money-laundering law. It has adopted a hardline approach to regulating virtual currency platforms. For example, it fined Ripple Lab subsidiary XRP II \$700,000 in May 2015 for violating the Bank Secrecy Act.

## Amendment of Payment Services Act to accommodate virtual currencies

Meanwhile, the FSA has been at the center of discussion on the need for regulatory oversight of virtual currencies from the standpoint of consumer protection and prevention of money laundering in the wake of 2014 bankruptcy of Mt. Gox, formerly the world's largest bitcoin exchange, the June 2015 Elmau G7 Summit's agreement on regulation of virtual currencies, the Financial Action Task Force<sup>3)</sup> on Money Laundering's 2015 guidance on promoting registration and licensure of virtual currency exchanges, and the US Financial Crimes Enforcement Network's issuance of guidance on strengthening regulatory supervision of virtual currencies<sup>4)</sup>.

On May 25, 2016, Japan's Payment Services Act (PSA) was amended to regulate virtual currencies. The main changes to the PSA were as follows.

### (1) Definition of virtual currency (Article 2-5)

The amended PSA defines a virtual currency as a store of value that can be used in the settlement, trade or exchange of goods and/or service transactions among large numbers of unspecified parties and is transferable via information processing systems. In other words, a virtual currency is construed as a means of payment that is not a legal currency.

### (2) Registration of virtual currency exchanges (Article 63-2)

The amended PSA defines virtual currency exchanges (Article 2-7) and requires virtual currency exchange operators to meet capital/financial requirements and register with the national government.

### (3) Regulation of virtual currency exchanges' operations (Article 63)

Virtual currency exchanges are required to disclose information to their users on matters such as transaction practices and fees, safeguard their IT systems,

segregate users' assets from their own assets and undergo periodic compliance audits by a certified public accountant or audit corporation (Article 63-11).

**(4) Supervision of virtual currency exchanges (Article 63)**

Virtual currency exchanges are required to maintain books and records, file reports with audit reports appended thereto, submit to on-site examinations, comply with business improvement orders and otherwise submit to regulatory supervision.

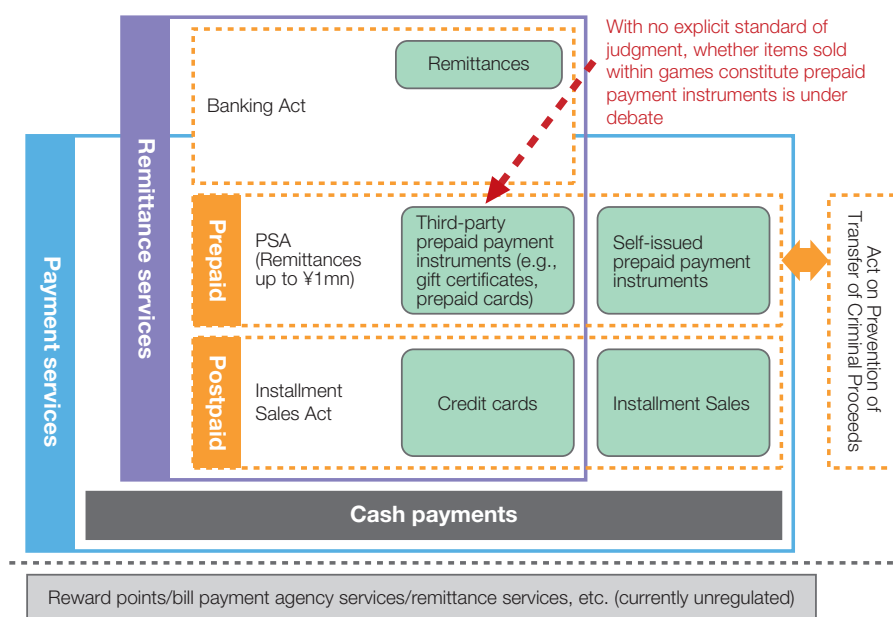
In addition to the above provisions, virtual currency exchanges were added to the list of "designated businesses" required to comply with the Act on Prevention of Transfer of Criminal Proceeds' anti-money-laundering provisions (Article 2). Virtual currency exchanges must also comply with the Act on Prevention of Transfer of Criminal Proceeds' provisions on verification of the identity of individuals opening new accounts (Article 4) and reporting of suspicious transactions to the relevant authorities (Article 8).

Such strict regulations are liable to serve as a barrier to entry to the virtual currency exchange business. From customers' standpoint, however, government oversight of exchanges should be conducive to peace of mind, potentially leading to growth in virtual currency usage.

**Factors behind PSA's amendment and issues yet to be resolved**

As shown in Exhibit 2, the PSA (enacted in 2010) pertains to prepaid payment

**Exhibit 2: PSA's position in the remittance services ecosystem**



Source: NRI, based largely on "Shousetsu Shikin Keizai ni Kan Suru Housai" by Yasufumi Takahashi

instruments (e.g., gift certificates, prepaid cards), funds transfers and funds settlement (interbank funds settlement and registration). It was drafted to legally complement the Act on Prevention of Transfer of Criminal Proceeds with respect to anti-money-laundering. If virtual currencies such as bitcoin are designated as a means of payment/remittance, revision of the PSA instead of industry laws such as the Banking Act or Financial Instruments and Exchange Act would be appropriate from the standpoint of anti-money-laundering, consumer protection and development of IT for payment services.

A number of PSA-related issues have been identified by industry. For example, in May 2016 a controversy arose over whether prepaid tokens used to purchase items within the Line messaging app's online games are within the PSA's purview (Exhibit 2). If so, Line would be subject to burdensome identity verification requirements<sup>5)</sup> and on-site examinations by regulators. Life Card is already offering a service for exchanging rewards points for bitcoins. The government may revisit the issue of regulating rewards points, bill payment agency services and remittance agency services. Additionally, with European authorities moving toward exempting virtual currencies from taxes<sup>6)</sup>, discussion of tax reform and reinterpretation of the Consumption Tax Act may heat up going forward<sup>7)</sup>. Moreover, the PSA's ¥1 million limit on transactions under its purview is seen as undermining payment services' utility for cross-border transactions. How to deal with such issues is under discussion by the Financial System Council's Working Group on Upgrading Payment Services. We will likely see more active discussion of comprehensive, cross-sectoral regulation of payment services like the EU's Payment Services Directive<sup>8)</sup>, which addresses unbundling of services and a risk-based approach in lieu of one-size-fits-all regulation.

5) Funds transfers involving nonresidents require verification of identity under the Foreign Exchange and Foreign Trade Act (Article 18-5).

6) In October 2015, the European Court of Justice (ECJ) ruled that bitcoin transactions should be exempt from VAT. European countries will presumably codify the ECJ's decision into legislation.

7) In Japan, whether virtual currency should be taxed is under debate in two respects. First, from a globalization standpoint, a growing number of other countries have already exempted virtual currencies from their VATs. Second, taxation of virtual currencies could constitute double taxation (i.e., taxation at the time of the virtual currency's purchase and taxation at the time the virtual currency is used to purchase goods/services).

8) The European Commission issued its Payment Services Directive (PSD) in November 2007 in the aim of unifying EU-member countries' payment services markets, improving the efficiency of payment services and creating a single EU payment services market. However, the European Commission is now formulating a new directive (PSD2) that adds a mandatory open API standard to the existing PSD.

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