



REGULATORY CHALLENGES THROUGH NEW FORMS OF
FINANCE FOR BUSINESS:
MISALIGNED INCENTIVES IN CHINA'S REGULATORY
APPROACH TO ICOS

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PRC SECURITIES LAW

- ICO is not in the purview of China's Securities Law
 - “[The Securities] Law shall apply to the offering of, and trading in, **stocks, corporate bonds, depository receipts, and any other securities as recognized by the State Council** as such in accordance with the Securities Law...
 - “[The Securities] Law shall apply to the listing of, and trading in, **government bonds** and **securities investment fund units**, except as otherwise provided by any other law or administrative regulation.
 - “The measures for the administration of the offering and trading in **asset-backed securities** and **asset management products** shall be stipulated by the State Council by reference to the principles of this [Securities] Law.”
- Closed-end, not open-end, definition of securities in Chinese law context
- Non-exhaustive list of securities, yet entailing no flexibility in accommodating and adapting to new forms of securities in the future
- Fragmented regulation of financial products that may be characterized as securities in other jurisdictions

CHINA'S GENERAL APPROACH TO ICOS

- A fast changing landscape: promulgation of a number of “notices,” “circulars,” and “decisions”
- Taking the hostile approach towards ICOs: ban on ICOs has been in place since 2017; intensifying the ban over the years
- Relying heavily on *ex post* law enforcement, as opposed to *ex ante* regulation
- As a result, China does not follow a typical route of securities regulation: (i) first recognizing a financial product as security → (ii) regulation of the security by mandating information disclosure → (iii) granting exemptions, e.g., allowing an issuer to raise a certain amount of capital without having to issue a statutory prospectus
- Mandatory disclosure, anti-fraud provisions, insider trading rules, etc. built in the PRC Securities Law do not apply to ICOs

2013 BITCOIN NOTICE

- *Notice on the Prevention of Risks Associated with Bitcoins* (promulgated by PBOC etc. in Dec. 2013)
 - [Virtual commodity, not virtual currency](#): Chinese regulators refuse to recognize Bitcoin as currency, and characterize it as a type of “virtual commodity”
 - Individual investors remained able to trade Bitcoins on the Internet
 - [Intermediaries](#):
 - Regulated financial institutions and payment institutions, however, were banned from conducting any business related to Bitcoin
 - Therefore, brokers and banks not allowed to assist their clients to consider what kind of assets they can digitalize, etc.
 - [Trading platform](#):
 - Online trading platforms allowed to operate in China to provide services related to registration and trading of bitcoins (note: repealed by subsequent “notices”)
 - No mechanism for issue of “virtual asset trading platform license” erected

2017 ICO NOTICE

- *Notice on Clearing up and Rectifying ICOs* (promulgated by PBOC & six other agencies in Sep. 2017)
 - [Definition of ICO:](#)
 - “ICO refers to an issuer’s raising of Bitcoin, Ethereum and other so-called ‘virtual currencies’ from investors through an *illegal* sale and distribution of coins” (emphasis added)
 - No distinction between different types of tokens, i.e., payment tokens, utility tokens and security tokens
 - Impossible for a digital payment token services provider to obtain any digital payment token services license allowing purchase and sale of any digital token in exchange for money or other digital payment tokens
 - [Virtual commodity?](#): reiterating the regulators’ refusal to recognize cryptocurrency as a “currency;” no longer mentioning Bitcoin as a kind of “virtual commodity”
 - declaring ICOs as illegal
 - “ICOs...in essence, should be characterized as a public financing activity *without due approval*. It fringes on such criminal activities as *illegal* sale of tokens, *illegal* issue of securities, *illegal* fundraising, financial fraud, pyramid scheme financing.” (emphasis added)
 - No channel offered to legalize ICOs

2017 ICO NOTICE (CONT'D)

- Intermediaries:
 - Tightening ban on, not regulation of, digital asset intermediaries, market infrastructure providers etc.
 - “No online platform should
 - (i) engage in any business to exchange any legal tender with virtual currency or other tokens; (*note: addressing custodians & digital payment services providers*)
 - (ii) purchase or sell, or purchase or sell as a market maker, any virtual currency or other tokens; or (*note: addressing market makers*)
 - (iii) provide such services as pricing or informational intermediation for virtual currency or other tokens. (*note: addressing market infrastructure providers*)”
- Impact:
 - Local cryptocurrency exchanges shut down
 - China’s cryptocurrency exchanges moved offshore
 - Loopholes remained, allowing mainland Chinese traders to buy and sell digital currencies on offshore exchanges

2021 VIRTUAL CURRENCY NOTICE

- *Notice on Further Preventing and Mitigating the Risks of Virtual Currency Trading and Speculation* (promulgated by PBOC & seven other agencies in Sep. 2021)
 - Extending ban to cover the full cycle of ICOs
 - “All virtual currency-related financing activities that are forbidden include:
 - (i) exchange between any legal tender and virtual currency; *(note: addressing custodians & digital payment services providers)*
 - (ii) exchange between different types of virtual currency; *(note: addressing custodians & digital payment services providers)*
 - (iii) purchase and sale of virtual currency as a market maker; *(note: addressing market makers)*
 - (iv) provision of such services as information intermediation and pricing to virtual currency traders; *(note: addressing market infrastructure providers)*
 - (v) [ICOs](#), &
 - (vi) [derivative trading related to virtual currency](#).”

2021 VIRTUAL CURRENCY NOTICE (CONT'D)

- Incriminating all financing activities associated with virtual currency:
 - (i) illegal sale of tokens,
 - (ii) public offering of securities without due registration,
 - (iii) illegal conduct of futures business, &
 - (iv) illegal fundraising, etc.
- [Extra-territorial reach](#): addresses extraterritorial ICO activities
 - Banning any offshore-located servers from providing any service to onshore Chinese investors;
 - Reaching out to any employee working in the territory of China for offshore exchanges: chasing after the onshore employees, as well as any other onshore undertakings or individuals, as long as they
 - (i) know or should have known that these onshore employees engage in virtual currency related business, and
 - (ii) provide such aids to the employees as solicitation, marketing, payment and clearing, and technical support

IMPACTS OF THE 2021 VIRTUAL CURRENCY NOTICE

- Huobi, one of the exchanges, ended account registrations for new mainland Chinese users; gradually retiring existing accounts of mainland Chinese users by end of 2021
- Binance, one of the world's largest cryptocurrency exchanges, blocked account registrations using Chinese mobile phone numbers; Binance app no longer available for download in China



POSSIBLE INCENTIVES UNDERLYING OUTRIGHT BAN ON ICOS

- Stabilizing economic and financial orders?
- Responding to social riots?
- Protecting national security?
- Protecting investors?
- Responding to small businesses' need for financing?
- Maintaining the status quo of the financial system
- Maintaining the monopoly of approved centralized exchanges

PROBING INTO THE “INVESTOR PROTECTION” CLAIM

- No information disclosure mechanism is put in place with respect of ICOs
- *Caveat emptor* approach:
 - investors are asked to “fend for themselves” (2017 ICO Notice; 2021 Virtual Currency Notice);
 - Investors have to bear any losses associated with virtual currency related investments (2017 ICO Notice; 2021 Virtual Currency Notice)
- Targeting and condemning mainland Chinese investors regarded as engaging in illegal financial activities (2021 Virtual Currency Notice)
- Impossibility of enforcement of contracts in respect of virtual currency (2021 Virtual Currency Notice)
- Nullification of contracts if deemed “against public order and good morals” (2021 Virtual Currency Notice)

2020 REGULATION ON ILLEGAL FUNDRAISING

*Regulation on the Prevention and Disposition of
Illegal Fundraising* (promulgated by State
Council in Dec. 2020)

- The Sword of Damocles hanging over China-based entrepreneurs has been the potential criminal charges for engaging in “illegal fundraising”
 - “Illegal fundraising refers to solicitation of funds from public investors, in return of a promise to repay the principle plus the accrued interest, to pay other investment returns, *without due approval* from the [competent] financial regulatory agency of the State Council, or in violation of national financial regulatory rules.” (emphasis added)
- Banned fundraising activities include,
 - “(i) setting up Internet companies, ...establishing all forms of *exchanges or platforms*...for purpose of soliciting funds,
 - (ii) soliciting funds in the form of offering, or transferring, equity interests, debts; raising funds; ...or soliciting funds in the name of engaging in asset management, *virtual currency* or debt-financing business;...”
- It is foreseeable the ban on ICOs is here to stay
- Chinese entrepreneurs who become susceptible to criminal charges whenever they innovate in respect of financing are greatly deterred from any risk-taking behavior

2011 EXCHANGES NOTICE

Decision on Cleaning up and Rectifying Various
Exchanges to Prevent Financial Risks
(promulgated by State Council in 2011)

- “Except duly approved exchanges, no trading venue shall be permitted
 - (i) to divide any interests into equal shares for purpose of public offering,
 - (ii) to enable centralized bidding, use a market maker, or utilize other centralized trading mechanisms, or
 - (iii) to list and trade any interests divided into standard units on a continuous basis.
- “When any investor sells the same product which it has purposed, or purchases the same product which it has sold, the interval between the purchase and the sale shall be a minimum of five trading days.
- “Unless otherwise provided by laws or administrative regulations, the aggregate number of equity holders [in a financial product] shall not exceed 200.”

CONCLUSION

- Chinese regulators' decision to eliminate ICOs altogether is driven by their need to guard the vested interests in the regulated financial industry and the centralized exchanges
- While the concern about social instability is legitimate, it reverses the causal relationship between regulation and frauds
- Investor protection is not among the top priority
- The legitimate needs for small businesses to find viable channels of finance are ignored
- The decision is at risk of ignoring secondary consequences of regulation
- A similar line of analysis is applicable to other new forms of finance, such as crowdfunding and NFTs

THANK YOU AND LOOK
FORWARD TO OUR DISCUSSIONS!