China moves to limit activities relating to ICOs and Cryptocurrencies: game over or level up?

September 2017
China moves to limit activities relating to ICOs and Cryptocurrencies: game over or level up?

Overview

On 4 September 2017, the People's Bank of China ("PBOC") and six other government agencies1 issued the Statement on Preventing the Risks of Fund Raising through Initial Coin Offerings (the "ICO Statement"), declaring that fundraising through so-called initial coin offerings ("ICOs") is prohibited. The ban took effect immediately. In the days that followed, further actions were rumored that may suggest a broader shift within China to the burgeoning use of cryptocurrencies and fundraising through ICOs. In particular, various published reports suggested a plan was being developed to shut down all domestic bitcoin exchanges in China, which would severely limit the ability of individuals and businesses in China to buy or sell bitcoin and ether in exchange for renminbi.

ICO Ban

The ICO Statement defines the term "ICOs" as a process involving an offer or issue of digital tokens by fund raisers in exchange for widely-accepted virtual currencies, like Bitcoin or Ethereum, from investors. The ICO Statement determined ICOs to be an unauthorized illegal public fundraising method, potentially involving criminal activities such as illegal sales of digital tokens, illegal securities issuances and illegal fundraising, financial fraud, pyramid schemes, and other prohibited activities. Where there are suspected crimes, criminal liabilities may be imposed.

The ICO Statement mandates that any individuals and organizations that have already completed ICOs must make arrangements for returning funds raised through ICOs. Platforms (websites and apps) that, until now have been facilitating financing and trading in digital tokens must stop doing so, including by ceasing to effect exchanges of one digital token or virtual currency into another or into a fiat currency. These platforms must not buy or sell or act as intermediaries to buy or sell digital tokens and virtual currencies, or provide related intermediary services, such as pricing and information vendor services. Violation of these requirements may lead to shutdown of the platforms and revocation of their business license.

All financial institutions and non-banking payment institutions doing business in China must not directly or indirectly provide related services (such as account opening, registration, trading, clearing and settlement and other products or services) to those organizing, facilitating or participating ICOs or dealing in virtual currencies. These institutions are also forbidden from underwriting insurance for ICOs or virtual currencies or including them into the coverage of the insurance liabilities.

The Statement reiterated that digital tokens offered in ICOs and virtual currencies are not currencies issued by the official monetary authorities. They do not possess legal status as a currency and cannot therefore be circulated or used in the market as a currency. This position is generally in line with the 2013 Notice on Guarding against the Risks of Bitcoin (the "2013 Notice")2, where it stipulated that bitcoin has no legal status as a currency and cannot therefore be circulated or used in the market as a currency.

No financial institution or payment institution shall conduct any bitcoin-related business or accept or use bitcoin as a payment settlement tool. It is understood that the Notice also applies to other virtual currencies by reference.

---

1 The other six government agencies are: Cyberspace Administration of China ("CAC"), Ministry of Industry and Information Technology of the People's Republic of China ("MIIT"), State Administration for Industry & Commerce of the People's Republic of China ("SAIC"), China Banking Regulatory Commission ("CBRC"), China Securities Regulatory Commission ("CSRC") and China Insurance Regulatory Commission ("CIRC").

2 Issued by PBOC, MIIC, CSRC and CIRC on 3 December 2013.
Background

ICOs have experienced rapid ascent globally and in China this year. According to an official report issued by a Chinese government agency, there had been 65 ICOs raising a combined 2.62 billion Yuan ($394.6 million) from 105,000 individuals in China during the year.

ICOs are generally conducted using distributed ledger or blockchain technologies. The issuing companies, normally blockchain startups, will publish white papers or other fund raising documents setting forth a business plan and the date on which anyone can purchase unique digital tokens linked to that project. The white papers usually also specify the price of the token based on another currency, a maximum number of tokens to be sold, and/or a cap on the amount or a minimum amount to be raised. Purchasers of tokens in an ICO profit when their digital tokens gain in value at a faster rate than the virtual currencies they used to pay for them. These digital tokens are usually intended to have a particular function, but holders may also realize value when the tokens become exchangeable on cryptocurrency exchanges and can then be resold, potentially at premium prices.

Unlike the traditional form of share offering, the digital tokens offered through ICOs generally do not provide the holders with an equity or ownership interest in the companies that issued the tokens, or any right to profits or dividends, or any voting rights in the companies. Instead, the tokens are generally intended to provide a service or the right to use a service, such as decentralized data storage.

By creating and issuing digital tokens, start-up companies have been able to raise significant funding in a short period of time with much lower transaction costs (such as broker fees) and little or no regulatory oversight.

Unfortunately, in many cases in China, token purchasers have not been presented with sufficient information to accurately determine whether the tokens are good investments and whether the prices have accurately reflected the token's potential values. ICOs have also been used as tools for illegal or fraudulent financing activities. All of these facts have driven fears of a bubble that could burst and raised investor protection concerns among worldwide regulators.

Regulatory positions of other jurisdictions regarding ICOs

Regulators from other jurisdictions have also taken a closer look at ICOs recently. However, unlike China's outright ban on ICOs, in most other jurisdictions, regulators have for the time being taken a more moderate approach.

In July 2017, the U.S. Securities and Exchange Commission ("SEC") published an investigative report cautioning market participants that offers and sales of digital assets by virtual organizations may be subject to the requirements of the federal securities laws. Importantly, the SEC noted that whether a particular investment transaction involves the offer or sale of a security will depend on the facts and circumstances, including the economic realities of the transaction. The report confirmed the current position in the U.S. that if the digital tokens being offered qualified as securities, issuers must register offers and sales of such securities unless a valid exemption applies. Those participating in unregistered offerings also may be liable for violations of the securities laws. Importantly, the SEC noted that whether a particular investment transaction involves the offer or sale of a security will depend on the facts and circumstances, including the economic realities of the transaction. The report confirmed the current position in the U.S. that if the digital tokens being offered qualified as securities, issuers must register offers and sales of such securities unless a valid exemption applies. Those participating in unregistered offerings also may be liable for violations of the securities laws. Additionally, securities exchanges providing for trading in these securities must register unless they are exempt. The SEC’s position on token sales was later followed by the regulators of Singapore and

---


5 Monetary Authority of Singapore Media Releases: MAS clarifies regulatory position on the offer of digital tokens in Singapore
Canada\textsuperscript{6} in August and in the United Kingdom\textsuperscript{7} in earlier in September.

Similarly, the Hong Kong Securities and Futures Commission ("SFC") issued a statement regarding ICOs on 5 September 2017\textsuperscript{8} explaining that depending on the facts and circumstances of the ICO, digital tokens that are offered or sold may be securities regulated under the Securities and Futures Ordinance ("SFO") and, if this is the case, those dealing in or advising on the digital tokens, or managing or marketing a fund investing in such digital tokens, are required to be licensed by or registered with the SFC, irrespective of whether the parties involved are located in Hong Kong, so long as such business activities target the Hong Kong public. Parties engaging in the secondary trading of such tokens may also be subject to the SFC’s licensing and conduct requirements. Certain requirements relating to automated trading services and recognised exchange companies may be applicable to the business activities of cryptocurrency exchanges. The SFC’s statement of 5 September 2017 also highlights the anti-money laundering and counter-terrorist finance risks associated with ICOs, reminding those licensed by the SFC to take appropriate measures to manage these risks.

Implication of the Ban Imposed by the ICO Statement

The ICO Statement is generally consistent with China’s long-term policy of tight currency control.\textsuperscript{9} As a result of the ICO Statement, organizations now cannot legally conduct ICOs in China. The existing business of all domestic platforms facilitating financing and trading in digital tokens will have to be shut down. This may include the offshore apps listed on Chinese app stores. No financial institutions or non-banking payment institutions can conduct any services related to ICOs and virtual currencies.

Major domestic ICO platforms have already temporarily shut down their services and posted announcements on their websites to notify investors. Several blockchain projects have begun the refunding process. Beijing has launched an overall clean-up and rectification of the financing and trading platforms of digital tokens, requiring all platforms immediately cease issuance and promotion of all ICO projects. According to the Notice Regarding Clean-up and Rectification of the Fundraising Platforms of ICOs issued by Beijing local authorities\textsuperscript{10} ("Beijing Notice"), all platforms in Beijing are required to file detailed information regarding its ICO projects, including the total number of ICO projects, projects completion time, financing scale, number of registered users etc. However, under the Beijing Notice, in light of the difference between the digital token’s offering price and their later reselling price in the secondary market, the refund price and arrangement may need to be determined on a case by case basis.

One thing to note is that the ICO Statement distinguishes virtual currencies from the now illegal digital tokens, and does not extend the ban to virtual currencies, though it does warn against their use. There is news reporting that PBOC and some other PRC government agencies are contemplating a plan to shut down China’s cryptocurrencies exchanges.\textsuperscript{11} However, Huobi.com and BTC China, the two

\textsuperscript{8}Financial Conduct Authority, “Initial Coin Offerings”: https://www.fca.org.uk/news/statements/initial-coin-offerings
\textsuperscript{10}As stated in the 2013 Notice, PBOC has always been cautious about digital money beyond its control, such as Bitcoin.

\textsuperscript{11}The complete text of the Beijing Notice cannot be found on the internet. Its main content is available at the website of Beijing Municipal Bureau of Financial Work: http://www.bjjrj.gov.cn/gzdt/c12-a1041.html
\textsuperscript{11}FT China posted the news on 12 September 2017 (http://www.ftchinese.com/story/001074244), which is in Chinese.
major cryptocurrencies exchanges in China, have responded that they have not yet received any official orders from regulatory authorities. Meanwhile, some other exchanges, such as Bikan.com, chose to wind down or suspend certain products and services (e.g., BTC and BCC) by themselves in response to the ban. Some sources further clarify that PBOC only intended to shut down the cryptocurrencies exchanges that allow investors to convert digital currencies into legal tender, but not all cryptocurrencies exchanges. Many experts said that the ban on ICOs may just be the beginning of additional and more stringent follow-up regulations of virtual currencies, including Bitcoin, and the exchanges that deal in them.

Following the issuance of the ICO Statement, the prices of Bitcoin and Ethereum, two of the largest cryptocurrencies, slumped sharply, although prices have rebounded somewhat in the days following the announcement.

Some analysts said the ban imposed by the ICO Statement may not be enough to entirely shut Chinese companies out of fundraising through ICOs, since some of them could sidestep the regulations by relocating their projects to jurisdictions like Switzerland, the UK and other countries that have friendly regulations toward blockchain start-ups. To be prudent, it is anticipated some blockchain start-ups based outside of China may choose to conduct ICO projects with strict guidelines disallowing investors from within China in participating in their token sales. Nevertheless, it is not clear for the time being if the ICO Statement will have any extraterritorial effect and, if so, how it will apply to the Chinese nationals who utilize an offshore website/app to participate in an ICO offered in other jurisdictions. Since all the domestic digital trading platforms and financial institutions within China are now forbidden from conducting any intermediary services related to ICOs, it has become tremendously difficult to conduct ICO campaigns among Chinese investors.

The bottom line is that the sale of cryptographic tokens to raise funds through an ICO presents a brand new set of challenges and interpretive questions to regulators the world over – not just in China. Matters are made all the more complex by the fact that cryptographic tokens can have almost unlimited functionalities, some identical or very similar to what most people would consider “securities”, while other tokens are clearly much more similar to software that can be used to access a computer platform or protocol and less like “securities”. Within China, it remains unclear whether the ICO Statement will result in a permanent ban on fundraising through ICOs in China or whether China will permit certain ICOs subject to regulatory requirements in the future after buying time to develop sensible regulations. Given the flexibility of this new form of fundraising, it will be of great interest to issuers, investors and regulators to watch this space carefully for the latest developments – we certainly will be doing so.

---

12 We do not believe China’s ban on ICOs is to target blockchain technology itself. However, the implications of the ban on the blockchain technology are to be observed.
Key Contacts

Jun Wei
Partner, Beijing
jun.wei@hoganlovells.com

Andrew McGinty
Partner, Shanghai
andrew.mcginty@hoganlovells.com

Mark Parsons
Partner, Hong Kong
mark.parsons@hoganlovells.com

Sherry Gong
Counsel, Beijing
sherry.gong@hoganlovells.com

Lewis Cohen
Partner, New York
lewis.cohen@hoganlovells.com

Gabriel Shapiro
Senior Associate, Silicon Valley
gabriel.shapiro@hoganlovells.com