Davis Polk

China further tightens controls over crypto transactions

October 4, 2021 | Client Update | 7-minute read

The Chinese authorities recently issued a notice regarding cryptocurrency activities, prohibiting (i) overseas cryptocurrency exchanges from servicing residents in mainland China and (ii) individuals in mainland China from working as employees of overseas exchanges. The Notice also bars marketing, payment, settlement services or technical support to overseas cryptocurrency exchanges and calls for a comprehensive monitoring system over cryptocurrency activities.

The PRC appears to be further tightening controls on cryptocurrency activities. On September 24, 2021, the People's Bank of China (PBoC), China's central bank, issued the *Notice Regarding Further Prevention and Management of Risks Associated with Cryptocurrency Trading Hype* (September 2021 Notice) jointly with nine other Chinese national government bodies[1].

The September 2021 Notice prohibits (i) overseas cryptocurrency exchanges from providing services to residents in mainland China and (ii) individuals in mainland China from working for overseas exchanges as their employees., and bars companies and individuals from providing marketing, payment, settlement services or technical support to overseas cryptocurrency exchanges. It also calls for a comprehensive monitoring system over cryptocurrency activities of individuals and companies in mainland China, as evidenced by the number of government agencies involved, giving local authorities wide authority to monitor their regions and raise early warning flags.

This client alert highlights some of the key provisions of the September 2021 Notice and puts it in the context of the history of prior controls imposed by the Chinese government over the crypto industry.

Highlights of the September 2021 Notice

The September 2021 Notice declares cryptocurrency-related business activities in mainland China as illegal and prescribes implementing measures to be taken by various governmental agencies to ward off the risk associated with cryptocurrency trading hype. Its key elements are summarized below.

The PBoC issued a Q&A in relation to the September 2021 Notice. The Q&A confirmed that the objective is to continue to exert high pressure against cryptocurrency activities which are believed by the Chinese government to pose high fraud and AML risks and threaten the nation's financial stability, and to draw on the government's experience in dealing with domestic cryptocurrency exchanges and ICO platforms.

Characterization of cryptocurrency businesses as illegal

The September 2021 Notice reiterates the Chinese government's long-standing position that cryptocurrencies are not equivalent to fiat money and cannot be circulated freely in the market as currencies. It goes further by explicitly characterizing cryptocurrency-related business activities as illegal:

Copyright 2021 Davis Polk & Wardwell LLP

- Cryptocurrencies such as bitcoin, ether and tether are not legal tender. Their circulation in the market as currencies is prohibited (section 1).
- Cryptocurrency-related business activities are declared as illegal financial activities. This includes the operation of exchange between fiat currencies and cryptocurrencies or between cryptocurrencies, cryptocurrency market making activities, providing quotes for cryptocurrency transactions, initial coin offerings (ICOs), and trading of cryptocurrency derivatives. The Notice indicates that these activities are suspected of involving illegal financial activities, including illegal issuance and sales of tokens and notes, unauthorized public issuance of securities, illegal operation of futures business, and illegal fundraising, which can be punished under criminal law (section 2).
- The provision of services by overseas cryptocurrency exchanges to Chinese residents through the internet is illegal financial activity. Employees of overseas cryptocurrency exchanges who are physically in mainland China, as well as organizations and natural persons who know or should have known that they are providing marketing, payment and settlement services or technical support to overseas cryptocurrency exchanges, shall be held accountable in accordance with the law (section 3).
- The investment into cryptocurrencies and relevant derivatives that contravene public interests has no legal force, and any losses incurred as a result shall not be remedied. Relevant departments shall investigate and penalize activities that are suspected of disrupting financial order and endangering financial security (section 4).

Measures to be taken to implement the September 2021 Notice

The September 2021 Notice calls for coordination between central government and regional/local authorities, and among the different ministerial agencies overseeing financial and banking matters, public security, cybersecurity, as well as the prosecuting authority and the judiciary (sections 5 and 6). The focus will be:

- strengthening online monitoring of the life-cycle of cryptocurrencies to identify illegal conduct (sections 7 and 8);
- blocking payment channels (section 9);
- punishing illegal crypto-related marketing and advertisement (sections 10 and 11);
- cracking down on criminal activities (sections 12 and 13); and
- requiring self-regulating associations to monitor and educate their members (section 14).

Further, regulators overseeing different sectors and local governments are mandated to engage fully in monitoring the industries and regions under their respective jurisdictions (section 15), and launch education campaigns to raise public awareness regarding the risks of cryptocurrency trading hype (section 16).

Chinese Government's historical position regarding cryptocurrency activities

The Chinese Government has issued several guidance letters and notices regarding cryptocurrency businesses in mainland China, adopting an increasingly tight approach in recent years as shown below.

- **Notice on Preventing Risks Associated with Bitcoin (issued on December 3, 2013)**

  The PBoC issued the *Notice on Preventing Risks Associated with Bitcoin* jointly with the regulatory authorities overseeing information the technology industry, securities and banking. This notice stressed that bitcoin should be deemed as a specific kind of virtual commodity and should not have equal status with fiat currencies. It also emphasized that relevant financial and payment institutions should not provide bitcoin-related services, and warned about the potential money-laundering risks associated with bitcoin.

- **Announcement on Preventing Risks Associated with Financing Activities through ICOs (issued on September 4, 2017)**

  The PBoC issued the *Announcement on Preventing Risks Associated with Financing Activities through ICOs* jointly with the regulators responsible for overseeing cybersecurity, information technology, market regulations, securities and banking. This announcement characterized ICOs as potentially criminal activity, involving suspected illegal issuance and sales of tokens and notes, unauthorized public issuance of securities, illegal fundraising, financial fraud,

Copyright 2021 Davis Polk & Wardwell LLP

and Ponzi schemes. It also stressed again that digital tokens issued through ICOs do not have legal status as fiat currencies and should not be circulated freely in the market.

– **Risk Alert about Illegal Fundraising Conducted in the Name of "Digital Token" and "Block Chain" (issued on August 4, 2018)**

  Further to the 2017 announcement, the Chinese financial regulators including the CBIRC and the PBoC again in 2018 jointly issued a risk alert to individual investors in China, warning them about the risk of Ponzi schemes with the characteristics of illegal fundraising and financial fraud under the disguise of financial innovations based on blockchain and digital token technologies.

– **PRC Court setting aside an arbitral award regarding damages awarded in fiat money in lieu of loss in cryptocurrency (ruled in April 2020)**

  In April 2020, Shenzhen Intermediate People's Court ordered the setting aside of an award made by the Shenzhen Arbitration Commission in 2018 on the ground that awarding damages in US dollars in lieu of cryptocurrency is against public interest. The Court held that the 2013 Notice and the 2017 Announcement mentioned above essentially prohibit the redemption, trading and circulation of bitcoin in mainland China. The contested arbitral award therefore contravened the spirit of the above documents and violated the public interest.

– **Self-regulating Associations' Announcement on Preventing Risks Associated with Cryptocurrency Trading Hype (issued on May 18, 2021)**

  Three quasi-regulatory authorities, the Internet Financial Association of China, the Banking Association of China and the Payment and Clearing Association of China jointly issued an announcement, calling for the rightful characterization of cryptocurrencies as a specific kind of virtual commodity as opposed to "real" currency. Similar to the September 2021 Notice, this also warned that cryptocurrency businesses are suspected of illegal fund raising, unauthorized public issuance of securities, illegal issuance and sales of tokens and notes, and other illegal financial activities. The 2021 Announcement essentially prohibited domestic financial institutions and payment companies from providing cryptocurrency transaction-related services.

– **Notice regarding Cryptocurrency Mining Activities (issued on September 3, 2021)**

  The National Development and Reform Commission, together with publicity, cybersecurity, information technology, financial, taxation, natural resources, public security and market regulators at the national level, published a notice banning any new cryptocurrency mining projects and mandating a nationwide survey of existing cryptocurrency mining operations to prepare for their gradual winding down.

Observations

The September 2021 Notice contains pointed language targeting overseas cryptocurrency exchanges that provide service to residents in mainland China, making clear that it is illegal for an overseas exchange to:

1. provide cryptocurrency transaction services to mainland Chinese residents;
2. employ individuals physically in mainland China; or
3. engage corporations, unincorporated organizations and individuals in mainland China to provide advertisement and marketing services, payment, clearing and settlement services or offer technical support.

Regarding the first restriction, overseas cryptocurrency exchanges should consider (i) conducting a review of KYC policies and procedures for customer onboarding, including considering how to detect nominee arrangements involving underlying mainland Chinese residents, (ii) implementing necessary IP address blocks and including warning language in customer interface, and (iii) scrutinizing marketing materials and activities to ensure no active targeting of potential mainland Chinese customers.

As to the second restriction, the September 2021 Notice does not contain language making it illegal for Chinese nationals living outside mainland China to work for overseas exchanges.

Copyright 2021 Davis Polk & Wardwell LLP

As to the last restriction, overseas exchanges may consider reviewing their business relationships, in particular reviewing their service vendor list and third-party relationship onboarding procedures, to identify and risk-manage exposure generated by any mainland Chinese business partners.

Copyright 2021 Davis Polk & Wardwell LLP

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Martin Rogers
+852 2533 3307
martin.rogers@davispolk.com

Margaret E. Tahyar
+1 212 450 4379
margaret.tahyar@davispolk.com

Yuan Zheng
+852 2533 1007
yuan.zheng@davispolk.com

Zachary J. Zweihorn
+1 202 962 7136
zachary.zweihorn@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.

[1] The other government bodies include the Cybersecurity Administration, the Ministry of Industry and Information Technology, the Ministry of Public Security, State Administration for Market Regulation, China Banking and Insurance Regulatory Commission (CBIRC), China Security Regulatory Commission, the State Administration of Foreign Exchange, the People's Supreme Court, and the People's Supreme Procuratorate.

Copyright 2021 Davis Polk & Wardwell LLP