

The Current Status of Cryptocurrency Regulation in China and Its Effect around the World

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There is no single approach in the world regarding the legal regulation of cryptocurrency. Most countries are wary of legalizing this payment instrument, fearing problems associated with tax evasion, terrorist financing, fraud and other illegal transactions. Nevertheless, the issue of legalization of cryptocurrencies has recently moved to a different level as the market capitalization of cryptocurrencies grew to over USD 237 billion 2020, with several leading cryptocurrencies such as Bitcoin skyrocketing in value in 2021. The explosive growth has been lead in no small part by China, the world's largest and most important market for cryptocurrency in terms of mining, investing and research. This article reviews the current trends in cryptocurrency regulation with a particular focus on China, including an analysis of current cryptocurrency laws in China, as well as the new Chinese Cryptography Law. Also, it explains recent developments in Chinese regulation and policy will continue to shape the development of the global cryptocurrency markets.

Keywords: Cryptocurrency Regulation, Chinese Digital Currency, Digital Yuan, China's Cryptography Law, Bitcoin

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1. Introduction

A 2016 European Commission report estimated the market value of cryptocurrency to be above Euro 7 billion worldwide.¹ In 2018, the cumulative market capitalization of cryptocurrencies increased to USD128 billion, which has grown to over USD237 billion in 2020.² In the third quarter of 2020, the cryptocurrency Ethereum alone saw an average of over 1100 daily transactions.³ This explosive was lead in no small part by China, the world's largest and most important market for cryptocurrency in terms of mining, investing and research.⁴ For example, at its peak 90 percent of cryptocurrency exchanges originated in China and 75 percent of all crypto mining occurred in China due to local advantages in power costs, chip production and cheap labor.⁵

As a response to this explosive growth, the Chinese government began to severely restrict the expansion of this emerging market. For example, in 2013, the People's Bank of China (PBOC) banned financial institutions from engaging in Bitcoin-related businesses, which lead to a 50 percent decrease in the value of Bitcoin.⁶ As discussed more-fully below, in 2017, the Chinese government banned cryptocurrency exchanges and initial coin offerings (ICOs).⁷

Despite stricter regulations, China's market remained attractive for cryptocurrency transactions. After China cracked down on Bitcoin exchanges and ICOs in September 2017, Bitcoin's price dropped, but only temporarily. Not long after, Bitcoin entered a bull market, and Chinese Bitcoin investors turned to over-the-counter (OTC) trading, i.e., trading between two parties without an exchange.⁸ According to Canaan's IPO prospectus filed last year (one of China's largest manufacturers of blockchain servers), sales of blockchain hardware used primarily for cryptocurrency mining in China were worth RMB8.7 billion (USD1.30 billion) in 2017, 45 percent of global sales by value. The prospectus forecasted that sales in China would rise to RMB35.6 billion in 2020.⁹ Moreover, there is ample evidence that the Chinese government is optimistic about the potential of blockchain to serve as the fundamental infrastructure for the global economy and is eager to dominate innovation in this market.¹⁰ One example is that the PBOC has conducted one of the largest real-world trials for cryptocurrency in the world, e.g., by issuing digital currency in various test cities, including Shenzhen, where nearly 50,000 were issued its new digital currency through a public lottery system,

and are able to use the currency in over 3,000 stores within Shenzhen.¹¹ Moreover, for approximately 10 days in December 2020, China gave 100,000 residents of Suzhou 200 digital yuan as part of a pilot program for citizens to spend cryptocurrency in traditional brick and mortar stores.¹²

Due to these recent developments and China's relative importance to the future of blockchain, this article will review the current trends in cryptocurrency regulation with a particular focus on China, and how recent developments in Chinese regulation and policy will continue to shape the development of the global cryptocurrency markets. This paper is composed of six parts including short Introduction and Conclusion. Part two will examine legal definitions of cryptocurrency. Part three will discuss regulatory approaches to cryptocurrency. Part four will analyze cryptocurrency laws in China. Part five will introduce the new Chinese Cryptography Law.

2. Legal Definitions

There are many forms of cryptocurrencies which are based on the same type of decentralized technology known as blockchain.¹³ Blockchain utilizes advanced cryptography (mathematical algorithms) and distributed ledger technology that allows for any digital transactions to be recorded transparently and verifiable by anyone on a distributed network of computer servers called nodes, which are incentivized to support the network by being rewarded with a new coin and/or transactional fees.¹⁴ Prior to the development of blockchain, in particular Bitcoin, the Internet commerce relied on financial institutions to serve as trusted third-party intermediaries between merchants and consumers which resulted in "inherent weaknesses" such as the non-reversibility of transactions (because third parties cannot avoid mediating disputes), increased transactional costs (due to third-party involvement), excessive collection and storage of a customer's personal information (because payments can be reversed), and a certain level of unavoidable fraud.¹⁵

Prior to Bitcoin's creation, meanwhile, electronic transactions remained problematic without a trusted third-party intermediary.¹⁶ Because transactions are "publicly announced" in a P2P system in which consensus is required in

determining the order and verification of payments, thereby effectively eliminating security breaches, Bitcoin's key innovation is that it allows a payment system to operate without a trusted third-party intermediary in a decentralized manner through publication of all transactions on distributed ledger.¹⁷ Although commonly associated with Bitcoin and payment systems, blockchain covers a wide array of systems that range from being fully open to private, and has the power to transform record-keeping for a wide variety of applications, including smart contracts, smart property, multi-signature software and many other applications.¹⁸

While the underlying technology is basically the same, the terms used to describe blockchain varies greatly from country to country, such as: digital currency (Argentina, Thailand, and Australia), virtual commodity (Canada, China, Taiwan), crypto-token (Germany), payment token (Switzerland), cyber currency (Italy and Lebanon), electronic currency (Colombia and Lebanon), and virtual asset (Honduras and Mexico).¹⁹ Similarly, a crypto-asset, according to the European Securities and Markets Authority (ESMA), is a private asset that relies primarily on cryptography and distributed ledger technology as part of its perceived or inherent value.²⁰ The ESMA refers to "virtual currencies" and "digital tokens" as crypto-assets, which are traditionally not issued by a central bank.²¹

Perhaps the simplest definition of cryptocurrency was issued by the Bank of England, which can be helpful to recall as it is referred to throughout the paper:

The first part of the word, 'crypto', means 'hidden' or 'secret' reflecting the secure technology used to record who owns what, and for making payments between users. The second part of the word, 'currency,' tells us the reason cryptocurrencies were designed in the first place: a type of electronic cash. But cryptocurrencies aren't like the cash we carry. They exist electronically and use a peer-to-peer system. There is no central bank or government to manage the system or step in if something goes wrong.²²

3. Regulatory Approaches to Cryptocurrency

Currently there are a wide variety of legal regimes regulating cryptocurrency around the world. Beyond protection for investors, some countries have included cryptocurrency markets within newly promulgated regulations related to taxation, money laundering, counterterrorism, and organized crime, requiring financial

institutions to conduct due diligence on their customers.²³ For example, Australia and Canada recently enacted laws to bring cryptocurrency transactions and institutions that facilitate them under the ambit of money laundering and counter-terrorist financing laws.²⁴ The US Federal government considers virtual currencies property,²⁵ with certain agencies proposing comprehensive regulations for digital wallets and exchanges,²⁶ while other agencies have maintained a softer approach to the trading of cryptocurrencies.²⁷ State regulation varies, with some jurisdictions such as New York taking a ‘tough’ approach to cryptocurrency regulation by imposing strict disclosure and consumer-protection requirements for any business that offers cryptocurrency-related services in New York.²⁸

Other countries such as Algeria, Bolivia, Morocco, Nepal, Pakistan, and Vietnam have banned all cryptocurrency activities.²⁹ Other countries allow citizens to engage in cryptocurrency but only outside of their borders (Qatar and Bahrain), while some allow private transactions as long as they are not facilitated by licensed financial institutions (Bangladesh, Iran, Thailand, Lithuania, Lesotho, China, and Colombia).³⁰ Some economies such as China, Macau and Pakistan have completely banned initial coin offerings, which are essentially the offer of a new cryptocurrency in order to raise capital similar to an initial public offering of stock, while others strictly regulate them, *e.g.*:

- New Zealand regulations vary depending on whether the token offered is categorized as a debt security, equity security, managed investment product, or derivative.
- Netherlands regulations are applicable depending on whether the token offered is considered a security or a unit in a collective investment, an assessment made on a case-by case basis.³¹

For countries that are not yet recognizing cryptocurrencies as legal tender, many view the technology potential and are promoting crypto-friendly legal regimes to attract tech companies developing this nascent market (Spain, Belarus, the Cayman Islands, and Luxemburg).³² Other countries are currently develop their own system of cryptocurrencies (Marshall Islands, Venezuela, the Eastern Caribbean Central Bank member states, and Lithuania). Finally, for some countries that have previously warned citizens of cryptocurrency investment risks, several have also determined that the size of cryptocurrency market is too small to have specific regulation or to ban the market entirely (Belgium, South Africa, and the United

Kingdom).³³ Considering these varied and diverse approaches to the regulation of cryptocurrencies, this paper will now focus on the legal developments in China.

4. Cryptocurrency Laws in China

Since 2014, the PBOC has been developing a digital fiat currency fully backed by the government, which is expected to become one of the first digital currencies launched by a central bank.³⁴ The PBOC began conducting studies of digital currency several years ago when it established an Institute of Digital Money within the PBOC that has employed approximately 1000 researchers.³⁵ Despite its apparent interest in developing a digital currency, the government has taken a very cautious approach. In March 2018, citing prudence, the need to avoid excessive speculation, and the country's desire for the financial sector to serve the "real economy," Xiaochuan Zhou, the then head of the PBOC, cautioned that China was in no hurry to develop digital currency.³⁶ According to Zhou, Chinese regulators do not recognize virtual currencies such as Bitcoin as a tool for retail payments like paper bills, coins, or credit cards, and that banking system are not accepting any existing virtual currencies or providing relevant services.³⁷ Likewise, in 2017, several other government agencies³⁸ issued statements announcing the ban of initial coin offerings (ICOs) in China, warning that tokens or virtual currencies involved in ICO financing were not issued by monetary authorities and could neither be accepted legal tender, nor circulated and used as a currency in the markets.³⁹ Therefore, despite its interest in developing a fully-backed digital currency, cryptocurrencies are not accepted by the relevant agencies nor utilized by the banking system to provide relevant services.⁴⁰

Moreover, the Chinese government has severely cracked down on the private trading of cryptocurrencies in the name of protecting investors and reducing financial risk. Such restrictions have included the prohibition of ICOs, restricting cryptocurrency trading platforms, and discouraging the country's massive Bitcoin mining market, which sent ripples throughout the global cryptocurrency markets.⁴¹ For example, in response to nearly USD400 million raised by Chinese investors, in September 2017, the PBOC declared ICOs illegal and required refunds to investors for any amounts raised through an ICO, resulting in a USD200 drop

in the value of Bitcoin.⁴² Moreover, in early 2018, the government banned all offshore cryptocurrency trading platforms after it was unable to eradicate trading following the shutdown of all domestic websites.⁴³

This strict regulatory approach fits within the context of China's overall economic growth and financial markets over the past 20 years. In particular, China's rapid development has come at the cost of over-leverage in the financial system, which the government seeks to correct:

In the past two years, control of financial risks and stabilization of the financial system has become the top priority of PBOC. Before ICOs, internet platforms providing P2P loans and micro lending had been targeted by PBOC and other financial regulators and are still in the process of cleansing and rectification. It is no surprise that ICOs, due to the sheer increase both in numbers and in the amount of funds raised, as well as some socially chaotic events caused by ICOs, were banned by the PBOC.⁴⁴

In response to these restrictions, market participants changed tactics away from engaging in ICOs and began focusing on the sale of mining equipment to investors who were then awarded with tokens for mining activities, commonly referred to as Initial Miner Offerings (IMOs).⁴⁵ In an IMO, companies sell mining equipment to generate a particular cryptocurrency or token that are then rewarded to contributors, essentially disguising an ICO as an IMO.⁴⁶ In 2018, the National Internet Finance Association of China (NIFA), the national-level self-regulatory body for China's internet finance industry, recognized this subversion and issued a warning to potential investors claiming that IMOs were just a disguised form of ICOs and were therefore prohibited.⁴⁷ Shortly after its release, the IMO market in China collapsed.⁴⁸

Notwithstanding this tough approach, the Chinese government has supported the development of the underlying blockchain technology to help modernize China's financial system and to become a global leader in this cutting-edge technology, which it believes will have a similar economic and technological impact as the development of artificial intelligence. In 2019, President Xi Jinping stated that China needed to "seize the opportunities" presented by blockchain because it represents an "important breakthrough in independent innovation of core technologies."⁴⁹ The economic fallout from the COVID-19 pandemic further pushed the government to focus on the development of digital technologies,

with China's Ministry of Industry and Information declaring that blockchain is one of the core technological developments that has "played a crucial role in both epidemic control and prevention, alongside the resumption of industrial production."⁵⁰

While these development have led to renewed investment in blockchain technologies within China, the government continues to take a cautious approach to limit potential social problems associated with the development of blockchain:

The endorsement of blockchain technology is not without reservation. In the view of PBOC, blockchain technology and digital currency should be researched for the goal of better service to the real economy. PBOC believes that blockchain technology can be developed without the use of tokens, which are believed to have been the roots of various social problems such as illegal fundraising and fraud.⁵¹

Prohibitions on the issuance and sale of tokens are regulated in the Law of the People's Republic of China on the People's Bank of China (amended in 2003) and is administered under the supervision of the PBOC.⁵² Article 20 states that "[n]o units or individuals may print or sell promissory notes as substitutes for Renminbi to circulate on the market."⁵³ Individuals and institutions that issue and sell tokens illegally will be required to cease such acts immediately and face fines amounting to up to RMB200,000.⁵⁴ In 2018, NIFA urged investors to use the utmost caution when reviewing ICOs that may contain misleading or fraudulent claims. Moreover, NIFA stated its intention to enhance security measures. Further, while the warning does not ban overseas cryptocurrency trading itself, policymakers may possibly introduce stricter regulatory measures in the future.⁵⁵

More recently, China passed the country's long-awaited civil code and expanded the scope of inheritance rights to include cryptocurrency, which are now protected under the new law.⁵⁶ While attempts to legalize cryptocurrency have been made, cryptocurrency transactions continue to be heavily restricted by the government. Most likely, China will move towards the creation of the world's first digital currency controlled and backed by a central bank, which has already finished building the infrastructure for its Digital Currency Electronic Payment system and laying the groundwork for providing the digital yuan the same legal status as the physical yuan.⁵⁷

As noted above, the PBOC has recently conducted one of the largest real-

world trials for cryptocurrency in the world, e.g., by issuing digital currency in various test cities, including Shenzhen, where nearly 50,000 were issued its new digital currency through a public lottery system, and are able to use the currency in over 3,000 stores within Shenzhen.⁵⁸ Additionally, China also gave 100,000 residents of Suzhou 200 digital yuan as part of a pilot program for citizens to spend cryptocurrency in traditional brick and mortar stores.⁵⁹ Therefore, despite its tight control of unregulated instruments like cryptocurrency, the government will likely continue to lead in the development of blockchain technology and, when it deems prudent, the development of digital currencies managed through centralized control. Other public and private development projects utilizing blockchain technology include:

- A cross-border financing platform administered by the State Administration of Foreign Exchange, which facilitates financing and information verification for cross-border transactions used in 19 provinces throughout the country.
- Smart contracts that assist in the automation of contracts and adjudication of cases introduced by the Hangzhou Internet Court;
- An identification system for the use of government services in Shenzhen;
- A logistics application introduced by Customs in Tianjin Province that facilitates transactions;
- A number of public projects expected to be developed in fields such as anticorruption, security, translation, and criminal investigations; and
- A number of private use cases including: product certification and verification, invoicing, e-billing, recording of intellectual property rights, and management of pharmaceutical supply chains.⁶⁰

In addition to these legislative and administrative policy developments, the Chinese courts have also recently issued a series of decisions regarding cryptocurrency. In particular, Chinese courts have recognized the validity of cryptocurrency as legal property worthy of protection. For example, in July 2019, the Hangzhou Internet Court, which has subject matter jurisdiction for e-commerce cases in the city of Hangzhou, the largest e-commerce city in China and home to many such companies as Alibaba,⁶¹ became the first court in China to uphold the legality of Bitcoin ownership and was protected under China's General Civil Law.⁶² In 2013, the plaintiff Wu purchased 2.675 Bitcoins for approximately RMB 20,000 from the store FXBTC, which was hosted on Taobao, Chinese largest online

marketplace. However, when the plaintiff tried to logon to the FXBTC website in 2017, he found that the online store was close and that there was no way to contact the operator and gain possession of his Bitcoin. Plaintiff alleged that prior to the website's closure the defendant did not provide any notice, resulting in damages from being unable to retrieve the Bitcoin.⁶³ Before the closure of the store, digital currencies such as Bitcoin and Litecoin and related products were prohibited by the Chinese government, leading to the sudden closure by Taobao. As such, the plaintiff claimed that Taobao and its parent company were jointly and severally liable for plaintiff's losses amounting to RMB76,000, i.e., transaction price of 2.675 Bitcoins at the time of the complaint was filed.⁶⁴ The court held that the plaintiff had insufficient grounds for claiming tort liability against the defendants because Taobao was fulfilling its legal responsibility to not facilitate the trading of Bitcoin and, therefore, dismissed the plaintiff's claims.⁶⁵ Regardless of the result, the decision is meaningful in that it was the first time a Chinese court identified the attributes of virtual property in digital currencies such as Bitcoin, stating that they possess the value, scarcity, and dominance required of property as an object of rights, and should be recognized as virtual property.⁶⁶

Other Chinese courts made similar decisions in 2020 with the Taobao case regarding the analysis and recognition of digital currency. For example, the Shanghai No. 1 Intermediate People's Court held that Bitcoin is an asset protected by law.⁶⁷ In that case, plaintiffs sued defendants alleging the theft of 18.88 Bitcoins and 6,466 Skycoins.⁶⁸ The defendants argued that Bitcoin and Skycoin were not legal property under Chinese law, and therefore should be ordered to return the coins to the plaintiffs.⁶⁹ The chief judge, Liu Jiang, held that Bitcoins were assets deserving of protection because the government had never explicitly rejected defining Bitcoin as an asset, nor did the law prohibit Chinese citizens from owning digital currencies.⁷⁰

Likewise, the Shenzhen District People's Court recently held that Ethereum is legally protected property with an economic value.⁷¹ In this case, a disgruntled blockchain engineer stole his company's private key and payment password, allegedly stealing Ethereum and other digital coins. In holding that Ethereum is lawful property, the court ordered the defendant to pay plaintiff damages, in addition to imposing a fine and a seven-month prison sentence on the defendant.⁷² These decisions indicate a willingness on the part of the Chinese courts to deal

with and recognize ownership rights in cryptocurrencies.

5. China's New Cryptography Law

On January 1, 2020, the Cryptography Law of the People's Republic of China entered into force "for the purpose of regulating the application and administration of cryptography, promoting the development of cryptography work, ensuring cyber and information security, safeguarding national security and public interests, and protecting the legitimate rights and interests of citizens, legal persons and other organizations."⁷³ Chapter III of the Cryptography Law regulates Commercial Cryptography and requires the government to encourage "the research, development, academic exchange, transfer and application of commercial cryptography technology, facilitates a unified, open, competitive, and orderly commercial cryptography market environment, encourages and promotes the development of commercial cryptography industry."⁷⁴ Articles 22-25 require the government to adopt appropriate standards in the area of commercial cryptography.⁷⁵ Cryptography administrative departments shall establish supervisory control over commercial cryptography including routine and randomized inspections; creating a unified information platform to supervise and manage commercial cryptography; coordinating the supervision mechanism and social credit system; as well as strengthening self-regulation by cryptography businesses and the public.⁷⁶

Despite the lack of clear definitions regarding cryptocurrencies, the Cryptography Law provides the foundation for the further development of this area. Even a cursory review of the new law indicates that the Chinese government intends to tightly administer and control cryptographic activities based on the text of the law although it seems obvious that the government wants to support its growth. While the issue of regulating cryptocurrency transactions remains unclear, perhaps the government will develop appropriate rules and a control mechanism for this activity. However, many questions remain open as to how the Chinese government will promote the development of blockchain technologies without losing its ability to control and regulate decentralized cryptocurrencies such as Bitcoin that lack central monetary authority. Regardless, due to the size

and influence China has in the cryptocurrency markets, other countries will be watching carefully in developing their own policies not to lose out on leading the development of this cutting-edge technology.

6. Conclusion

As shown above, there is no single approach in the world regarding the legal regulation of cryptocurrency. Most countries are wary of legalizing this payment instrument, fearing problems associated with tax evasion, terrorist financing and other illegal transactions. Nevertheless, the issue of legalization of cryptocurrencies has recently moved to a different level. Governments realize that despite the lack of legal instruments, transactions with cryptocurrencies are carried out on the black market, and the turnover from these transactions is significant. As such, attempts are being made to define the rules by which transactions with cryptocurrency can occur. China will not stand on the sidelines as other countries move forward. Due to recent developments and its massive influence in the blockchain economy, China's regulation and policies are expected to continue to shape the development of the global cryptocurrency markets.

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