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Han Kun Newsletter

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Legal Updates

1. New Rules for Bond Lending – A Comparation with Bond Repos
2. Highlights on the Draft HGR Regulations Implementing Rules
3. Metaverse: A Rational View of How New Rules against Illegal Fundraising Affect the Virtual Currency Industry

1. New Rules for Bond Lending – A Comparation with Bond Repos

Authors: TieCheng YANG | Eryin YING | Krystal HE[1]

China's unified bond market now comprises the inter-bank market, exchange market, and commercial bank counter market; among these, the inter-bank market serves as the principal market with more than 85% of the total bond custody balance by the end of 2021[2]. Bond transactions in the inter-bank market include cash bond transactions, bond repo transactions (including pledged bond repo transactions and outright transfer bond repo transactions), bond lending transactions, and bond forward transactions, of which the transaction volume of cash bond transactions and bond repo transactions accounts for more than 90%. Bond lending business has facilitated the needs of market participants to borrow bonds and improved liquidity and stability of the overall bond market. With the rapid growth of the transaction volume of bond lending business since 2015, the settlement volume of bond lending business in 2021 has increased about sixfold compared to 2015, making bond lending the third largest business in the inter-bank bond market after pledged bond repo transactions and cash bond transactions[3]. In response to the rapid development of bond lending business and in order to further enhance regulation and market activity of bond lending business, the People's Bank of China (the "**PBoC**") has recently promulgated the *Measures for Administration of Bond Lending Business in the Inter-bank Bond Market* (the "**2022 Measures**"), which will take effect from July 1, 2022, and the *Interim Provisions on Administration of Bond Lending Business in the National Inter-bank Bond Market* (the "**2006 Provisions**") promulgated in 2006 will be invalidated accordingly on the same date.

As for the implications of these two rules on the inter-bank bond market, in comparison to the 2006 Provisions, the 2022 Measures further facilitate the conducting of bond lending business by market participants and improve the efficiency of the bond lending market. For instance, each market participant has to formulate its own bond lending agreement under the 2006 Provisions, which is time-consuming and inefficient when negotiating transaction documents with different counterparties. By contrast, the 2022 Measures will require market participants to sign a unified bond lending master agreement, which is likely to significantly save time in negotiations and facilitate transactions. In addition, the 2022 Measures newly introduce a centralized bond lending mechanism, which may help to avoid the risk of settlement failure under bond transactions and improve market efficiency.

In light of the issuance of the 2022 Measures, this newsletter briefly introduces the differences between bond lending and bond repo business in the inter-bank market as well as the main changes between the 2022 Measures and 2006 Provisions.

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[1] Shirley Liang and Lin Zhu have contributions to this article.

[2] PBoC, Financial Market Operation in 2021 (中国人民银行《2021 年金融市场运行情况》) (http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4463448/index.html).

[3] CCDC, Bond Market Statistical Analysis Report 2021 中央结算公司《2021 年债券市场统计分析报告》 (https://www.chinabond.com.cn/cb/cn/yjfx/zzfx/nb/list.shtml).

Transaction type / Element	Bond lending	Outright transfer bond repo	Pledged bond repo
Definition	"Bond lending" refers to bond financing whereby the bond borrower borrows the underlying bonds from the bond lender by providing a certain amount of performance assurance assets and both parties agree that on a future date the underlying bonds shall be returned and the bond lender shall return the performance assurance assets.	"Outright transfer bond repo" refers to a transaction wherein the bond holder (repo party) sells bonds to the bond buyer (reverse repo party) and both parties agree that, on a future date, the repo party shall buy back bonds of the same type and quantity from the reverse repo party at an agreed price.	"Pledged bond repo" refers to the financing transaction where the funds receiver (repo party) receives the funds by pledging bonds to the funds provider (reverse repo party), and both parties agree that, on a future date, the repo party shall return the funds to the reverse repo party at the amount calculated at a stipulated interest rate and the reverse repo party shall release the pledge on the pledged bonds.
Transaction mechanism	Transactions are concluded at the China Foreign Exchange Trade System ("**CFETS**") through bilateral negotiation or centralized lending mechanism. The 2022 Measures newly introduce a centralized bond lending mechanism. Centralized lending refers to the matching and concluding of bond lending transactions by bond settlement service institutions (i.e., China Central Depository & Clearing Co., Ltd. ("**CCDC**"), Shanghai Clearing House ("**SHCH**") and custodian banks), pursuant to their prior agreements with the market participants that have insufficient bonds for delivery on any bond settlement date and on their	Transactions are concluded at the CFETS through bilateral negotiation.	

Transaction type / Element	Bond lending	Outright transfer bond repo	Pledged bond repo
	behalf, with other market participants at CFETS. Centralized lending service may effectively avoid the risk of settlement failure. The specific centralized bond lending mechanism is still subject to the implementation rules to be stipulated by CCDC, SHCH, CFETS and other financial infrastructures.		
Collateral	The 2022 Measures change references to collateral from "pledged property" to "performance assurance asset", which indicates that the form of security will no longer be limited to pledge. The 2022 Measures also provide room for the introduction of all types of performance assurance (such as "transfer by way of security") as permitted under the PRC Civil Code and relevant security-related regulations, and even the performance assurance in the form of outright transfer which commonly used under derivatives master agreements. That said, in practice, implementing new forms of performance assurance is still subject to the bond lending master agreement and other relevant documents, as well as further observation of the market.	Applicable law does not impose restrictions on the form of performance assurance, so parties can at their discretion determine the form of performance assurance based on their commercial needs. According to the form of the NAFMII Bond Repurchase Master Agreement (2013 version), under outright transfer bond repo transactions, parties may adjust the net risk exposure via cash margin or collateral securities; under pledged bond repo transactions, parties may adjust the net risk exposure by creating or releasing the pledge on the underlying bonds. In addition, the parties may also agree on other forms of performance assurance.	

<table>
<tr><th>Transaction type / Element</th><th>Bond lending</th><th>Outright transfer bond repo</th><th>Pledged bond repo</th></tr>
<tr><td rowspan="2">Function</td><td>■ Lending bonds to earn a yield.
■ Exchanging bonds to reduce funding costs; for example, a borrower can reduce its funding costs if it borrows funds through a pledged repo transaction by pledging interest bonds which are borrowed in by collateralizing credit bonds under a bond lending transaction, and the interest rate in the bond lending transaction is lower than the differences of funding rates between the pledged bond transaction with credit bonds being pledged collateral and those with interests bonds being pledged collateral.</td><td colspan="2">■ Financing - repo party borrows funds by using bonds in its possession.</td></tr>
<tr><td colspan="2">■ Short selling bonds - borrowing bonds and selling them when the bond price is expected to go down, and buying the bonds of same issue and return them when the price goes down, so as to earn a spread gain.
■ Borrowing bonds for delivery purposes in other businesses (such as cash bond transactions, pledged bond repo transactions, and physical delivery to settle treasury futures short positions).</td><td>N/A</td></tr>
<tr><td>Market participants</td><td>■ Various types of onshore financial institutions that satisfy bond market access requirements and non-legal person products they issue.
■ Offshore institutional investors may engage in</td><td colspan="2">■ Various types of onshore financial institutions that satisfy bond market access requirements and non-legal person products they issue.
■ Offshore central banking institutions, offshore RMB clearing banks, and offshore participating banks that satisfy bond market access requirements; other types of offshore commercial institutions cannot currently engage in bond repo transactions.</td></tr>
</table>

Transaction type / Element	Bond lending	Outright transfer bond repo	Pledged bond repo
	bond lending transactions for hedging purposes.		
Underlying bonds/repo bonds	Bonds traded in the inter-bank market. The 2022 Measures delete the requirement in the 2006 Provisions that underlying bonds must be self-owned by the bond lender. This can solve the practical problem where the manager is acting as the nominee holder for non-legal person products while the product is the transacting counterparty. In addition, diversified bond lending needs can be satisfied; for example, institutions holding underlying bonds may be entrusted as agents to conclude bond lending transactions.	Bonds traded in the inter-bank market.	
Transaction period	The maximum period shall be no more than 365 days.		
Settlement institutions	Bond registration and settlement institutions and custodian banks recognized by PBoC, i.e., CCDC, SHCH and recognized custodian banks. Compared with the 2006 Provisions, the 2022 Measures add SHCH and custodian banks as the settlement institutions of bond lending business.	CCDC and SHCH.	
Agreement form	There is currently no applicable standard agreement form, and each participant formulates its	NAFMII Bond Repurchase Master Agreement (2013 version) issued by NAFMII in January 2013.	

Transaction type / Element	Bond lending	Outright transfer bond repo	Pledged bond repo
	own bond lending (master) agreement. The 2022 Measures newly provide that market participants shall sign a master agreement recognized by PBoC, which is formulated by the self-disciplinary organization in the inter-bank market (i.e., the National Association of Financial Market Institutional Investors ("**NAFMII**")) and filed with PBoC for record.		

The 2022 Measures provide a framework and foundation for a more efficient bond lending market that is more consistent with international practice. In comparison with the 2006 Provisions, the 2022 Measures newly add a bond lending master agreement, allow the use of various forms of performance assurance, and introduce a centralized bond lending mechanism. As early as 2017, the staff of NAFMII's Secondary Market Surveillance and Development Department (whose functions include regulating transactions and formulating standard agreement forms and transaction term documents) published an article entitled "Title Transfer Bond Lending Transactions: Experience, Status and Development", in which they suggested introducing title transfer bond lending business in the inter-bank market and publishing a standard agreement form for bond lending business, and mentioned the Global Master Securities Agreement (the "**GMSLA**") and the Master Securities Loan Agreement (the "**MSLA**") prevalent in the international bond lending market. We understand NAFMII will draft a Chinese counterpart to the bond lending master agreement by reference to the GMSLA and MSLA, and we will continue to closely monitor the publication of this master agreement and provide timely updates on how the master agreement implements the innovative points of the 2022 Measures (e.g. the performance assurance mechanism and centralized lending mechanism) as well as on the similarities and differences between the Chinese counterpart master agreement and those agreements prevalent internationally.

2. Highlights on the Draft HGR Regulations Implementing Rules

Authors: Aaron GU | Min ZHU | Pengfei YOU | Ruohong YAO

China began legislating the protection of human genetic resources in 1998, at which time the Ministry of Science and Technology (***MOST***) and the Ministry of Health jointly formulated the *Interim Measures for Administration of Human Genetic Resources*; however, there had been no corresponding implementing rules to implement it in practice. That was until 2015, when the Ministry of Science and Technology issued the *Service Guide for Administrative Licensing Items for the Collection, Collection, Trading, Export, and Exit of Human Genetic Resources*. This guidance caused the gradual application of the *Interim Measures for the Administration of Human Genetic Resources*, which had been dormant for many years. In 2019, the State Council promulgated the current *Regulations on the Administration of Human Genetic Resources* (the ***HGR Regulations***), which replaced the *Interim Measures for the Administration of Human Genetic Resources*. In 2020, the Standing Committee of the National People's Congress adopted the *Biosecurity Law of the PRC*, which officially came into force in 2021 and serves as the fundamental law in the field of biosecurity. So far, China's regulatory framework for the protection of human genetic resources has been established, but more implementing measures are needed to refine these laws and regulations.

On March 22, 2022, the MOST issued for public comments the *Rules for Implementation of the Regulations on Administration of Human Genetic Resources (Draft for Comments)* (the ***Draft Rules***). The Draft Rules contains certain highlights, such as the administrative system, subject qualifications (especially the recognition of foreign entities), international cooperation in intellectual property sharing, security reviews, and administrative enforcement procedures. This article aims to preliminarily interpret the Draft and analyze its potential impact.

Administration system

Article 3 of the Draft Rules **[Central management system]**: The MOST is responsible for the administration of human genetic resources approval, supervision, and sanction nationwide. Relevant institutions may be entrusted by the MOST to undertake specific support work in licensing acceptance, professional support, supervision and management, etc.

Article 4 of the Draft Rules **[Local management system]**: The science and technology departments (commissions and bureaus) of provinces, autonomous regions and municipalities directly under the Central Government, and the Science and Technology Bureau of Xinjiang Production and Construction Corps are responsible for the administration of human genetic resources in their respective administrative region:

- Routine management and supervision of human genetic resources;
- Accepting the entrustment of the MOST to organize the investigation of human genetic resources in the corresponding region;
- Investigation and sanction of violations in the scope of authority, and to organize and carry out the investigation of violations in the region as entrusted by the MOST;

- Accepting the entrustment of the MOST for implement matters related to human genetic resources.

The *Draft Rules* specify that the MOST is, once again, responsible for the national human genetic resources approval, supervision, sanction and other administration work, but further proposes that relevant institutions can be entrusted by the MOST to undertake part of the specific work of licensing and supervision. The administration of supervision and enforcement authorities at provincial level have been further refined. Notably, the MOST has not yet delegated the approval authority for human genetic resources to the provincial level.

Recognition of foreign entities

Article 12 of the Draft Rules **[Foreign Entity]:** "Foreign entity" refers to an institution established by overseas organization(s) or an institution which is actually controlled by overseas organization(s) or individual(s).

The above-mentioned "actually controlled" includes the following status:

- An overseas organization or an individual directly holds or indirectly holds more than 50% of the shares, equity, voting rights, property shares or other similar rights and interests of the institution;
- Although the shares, equities, voting rights, property shares or other similar rights and interests of the institutions directly held or indirectly held by an overseas organization or an individual do not reach 50%, the voting rights, other rights and interests of the decision-making bodies they owned are sufficient to have a significant impact on the resolution, decision-making and internal management of the institution;
- The agreement or other arrangement by the overseas organization(s) or individual(s) is sufficient to have a significant impact on the decision-making, operation and management and other major matters of the institution;
- Other status identified by the MOST.

Pursuant to the *HGR Regulations*, any foreign entity [foreign organizations and institutions that are established or actually controlled by foreign organization(s) or individual(s)] is prohibited from collecting or preserving China's human genetic resources within China. If the foreign entity does need China's human genetic resources to conduct scientific research, it would be required to cooperate with Chinese entities (such as Chinese scientific research institutions, colleges and universities, medical institutions, enterprises) so as to conduct scientific research. Besides this, the above international cooperation would require approval by the MOST *Human Genetic Resources Office*.

As to the definition of foreign entities, there was a gap between the regulation and legal practice when China began to supervise and regulate related human genetic resources activities. The Interim Measures for Administration of Human Genetic Resources (1998) once used the terms "foreign cooperative entity" and "foreign (overseas) entity", but did not explain or distinguish them. However, in our experience, the MOST has always regarded entities with any foreign capital as foreign entities, not merely entities registered outside China. Although Article 21 of the current *HGR Regulations*, expressly defines a

"foreign entity" as a "foreign organizations and institutions that are established or actually controlled by foreign organizations or individuals", the definition of "actual control" remains unclear.

The definition of "actual control" has been controversial in practice, especially with use of the VIE structure. Some companies believe that the domestic companies in their VIE structure are not recognized as foreign entities as they do not hold any foreign capital in terms of equity, while some companies clearly disclose that domestic companies under their VIE structure still have risks to be recognized as foreign entities by the MOST in their prospectuses. Based on our experience, the MOST has already identified domestic companies in VIE structures as foreign entities in their approval practices. This regulatory practice is further clarified and confirmed in Article 12 of the Draft Rules which clearly includes the application of the VIE structure, that is, "agreements or other arrangements by an overseas organization(s) or individual(s) is sufficient to have a significant impact on the decision-making, operation and management and other major matters of the institution."

In contrast to the above-mentioned explicit incorporation of the VIE structure into supervision, another striking breakthrough in the *Draft Rules* is that the definition of foreign entities may be loosened. The Draft Rules clearly emphasize the concept of "50%" ratio for the first time, and stipulate that "actual control" includes "(1) an overseas organization or an individual directly holds or indirectly holds more than 50% of the shares, equity, voting rights, property shares or other similar rights and interests of the institution" or "(2) although the shares, equities, voting rights, property shares or other similar rights and interests of the institutions directly held or indirectly held by an overseas organization or an individual do not reach 50%, the voting rights, other rights and interests of decision-making bodies they owned are sufficient to have a significant impact on the resolution, decision-making and internal management of the institution". If the Draft Rules are finalized in this form, entities with less than 50% foreign shares which have no significant impact on their decision-making and internal management, may no longer be recognized as foreign entities. This would be advantageous for companies with only limited foreign ownership.

Additionally, interpreted literally, if an institution is **established** by an overseas organization or individual, it would be recognized as a foreign institution regardless of its shareholding ratio. In this way, there is a certain lack of logic in the disparity between the two types of enterprises in which foreign organizations and individuals hold minority ownership through establishment and **through share transfer**. The MOST should further clarify this issue.

International cooperation in intellectual property sharing

Article 16 of the Draft Rules **[International cooperative patent sharing]**: If the results of international cooperative scientific research by using China's human genetic resources could be used to apply for a patent, the patent application shall be jointly filed by both parties, and the patent shall be jointly owned by both parties.

Article 17 of the Draft Rules **[International cooperation rights and interests sharing]**: The use rights, transfer rights, and benefit sharing methods of *copyright, data, standards, technological processes and other scientific and technological achievements produced using China's human genetic resources in the international cooperative scientific research* are agreed by both parties through the cooperation agreement.

If there is no agreement or the provisions in the agreement are not clear, both parties have the right to use, but transfers to a third party must be agreed by both parties, and the transfer-benefit will be shared according to each party's contribution; if each party's contribution cannot be determined, both parties share the benefit equally.

Regarding the sharing of patent rights, the Draft Rules are consistent with the *HGR Regulations*. That is, Chinese and foreign entities are required, under relevant laws and regulations on human genetic resources, to jointly apply for and share patents produced by using China's human genetic resources in international cooperation scientific research. Regarding IP rights other than patents, the *Draft Rules* firstly specify that rights to use, transfer and share benefits of "copyright, **data**, standards, technological processes and other scientific and technological achievements" resulting from international cooperative scientific research may be agreed through an agreement of both parties.

In the legal practice of human genetic resources, in addition to patents, the ownership of corresponding **data** was often required to be jointly owned by both Chinese and foreign parties. The provisions of Article 17 of the Draft Rules might change this situation and give more autonomy to both Chinese and foreign parties regarding the ownership of data.

Data backup

Article 30 of the Draft Rules **[Data backup]**: If the human genetic resources information will be provided to or be opened to overseas organizations, individuals and institutions for utilization, the backup information must be submitted to an information backup institution designated by the MOST, and it must be filed to the MOST.

According to the definition of "actual control" discussed above, in the future, it may not be necessary to go through the backup and filing process for data sharing if the human genetic resources information is provided or opened to entities with less than 50% foreign shares which have no significant impact on their decision-making and internal management, may no longer be recognized as foreign entities. However, this needs to be further confirmed by the MOST in practice.

International cooperation filing

Article 41 of the Draft Rules **[Conditions for International Cooperation filing]**: If the international cooperation party wishes to obtain marketing authorization in China for relevant drugs and medical devices or to cooperate with a Chinese entity to conduct international cooperative clinical trials by using China's human genetic resources in clinical institutions, and the cooperation does not involve the exportation of human genetic resource materials and complies with the following requirements, the party shall file with the MOST the types, quantities and uses of human genetic resources that are desired to be used for each cooperation party; approval is not required in this case:

- The collection, testing, analysis and processing of remaining samples of the human genetic resources are carried out in clinical institutions;

- The human genetic resources are collected in a clinical institution, and the testing, analysis and remaining sample processing are conducted in the domestic entity designated by the clinical-trial-protocol in the relevant drug and medical device marketing authorization clinical trial.

Clinical institutions refer to medical institutions, disease prevention and control institutions, etc. that are registered with relevant departments and can carry out clinical research.

If the exploratory research part is involved in the clinical research in order to obtain the marketing authorization of the relevant drugs and medical devices in China, it shall be submitted separately in accordance with the requirements of the administrative license for international cooperative scientific research.

Compared with the *HGR Regulations*, the Draft Rules expand the scope of application of international cooperation filing. In addition to the two conditions for clinical trials that "is to obtain marketing authorization for related drugs and medical devices in China" and "does not involve exportation of human genetic resources materials", the Draft Rules expand the scope of the other condition, "**utilization (samples) in clinical institutions**" to "testing, analysis and processing of remaining **samples in domestic entities designated by the clinical-trial-protocol** in the relevant drug and medical device marketing authorization clinical trials."

We understand that the **scope of domestic entities** (i.e. third-party laboratories) that are designated by the clinical-trial-protocol **will not be limited to** the "**entities** entrusted by clinical institutions to conduct testing, analysis and processing of remaining samples" and "**entities** that clinical institutions shall sign formal agreements with" stipulated in the current administrative guidelines issued by the MOST, **rather**, the "domestic entities" in the Draft Rules would more likely refer to current practices in actual operations in the clinical trial industry.

Security review

Article 48 of the Draft Rules **[Security Review System]**: The provision or open utilization of human genetic resources information to overseas organizations, individuals and institutions that they have established or actually control which might affect China's public health, national security and social public interests shall pass a security review organized by the MOST.

Article 49 of the Draft Rules [**Scope of Security Review]**: The circumstances of security review include the provision or open utilization of the following information:

- Information on human genetic resources of important genetic families;
- Information on human genetic resources in a specific area;
- Human exome sequencing and genome sequencing information resources of more than 500 individuals;
- Other information that might affect public health, national security and public interests of China.

Since the *HGR Regulations*, China has established the security review system for the external provision

or open utilization of human genetic resources information, but we have not yet observed relevant practices of such security review from official announcements or public reports. Given that the Draft Rules specify the provision of the security review and clearly mention the application of "human exome sequencing and genome sequencing information resources of more than 500 individuals", we expect that the MOST is likely to impose a security review in the near future. However, this security review has yet to be implemented; we will continue to observe as the review develops.

Major changes/non-major changes in the license for international cooperation

Article 62 of the Draft Rules **[Non-major changes to the license for international cooperation]**: During the process of using China's human genetic resources to conduct international cooperative scientific research, the party does not need to apply for a change-license in the following circumstances, but it should submit relevant documents to the MOST for illustration and filing:

- It only involves a change in which the cumulative number of cases does not exceed 10% of the approved number while the research protocol remains unchanged;
- Participating parties other than the cooperative parties, and the names of the legal entities of all participating parties listed in the first paragraph of Article 61;
- The research plan changes, but it does not involve changes in the type, quantity, and use of human genetic resources, or the changed content still falls into the approved scope.

Before the Draft Rules, the *HGR Regulations* did not delineate a specific scope for non-major changes of the international cooperation approval. The Draft Rules offers relevant standards, particularly specifying that "change-license is not needed when it only involves a change in which the cumulative number of cases does not exceed 10% of the approved number while the research protocol remains unchanged"; the party need only submit relevant documents to the MOST for clarification and notification. This provision has significant value for practice.

Administrative sanction

Article 83 of the Draft Rules **[Subjects of administrative sanction]**: The MOST, the science and technology departments (commissions, bureaus) of provinces, autonomous regions, and municipalities directly under the Central Government, and the Science and Technology Bureau of Xinjiang Production and Construction Corps shall, in accordance with statutory authorities and procedures, impose administrative penalties on natural persons, legal persons or other organizations pursuant to these Rules if they violate laws and/or regulations in the administration of human genetic resources. Except as otherwise provided by laws and administrative regulations.

Article 117 of the Draft Rules **[Determination of illegal income]**: Illegal income is calculated according to the value of human genetic resources that are illegally collected, illegal preserved, human genetic resources illegally used while participating in international cooperation, and illegally provided foreign entities. Or, the illegal income is calculated as the amount of money invested in human genetic resource.

Lastly, the Draft Rules detail the procedural requirements for administrative sanction, such as jurisdiction,

filing, hearing opinions and hearings, review, decision-making, and enforcement. This is also in line with the increased supervision and enforcement of human genetic resources compliance by the MOST in recent years.

In addition, it is worth mentioning that the current *HGR Regulations* do not give a specific definition of "illegal income", while the Draft Rules refine this and use "the value of human genetic resources" as one of the calculation methods for illegal income. At the beginning of this article, we mentioned the *Biosecurity Law of the PRC*, which stipulates that "the state shall have sovereignty over China's human genetic resources and biological resources". We speculate that the value of human genetic resources is "immeasurable", from the perspective that China attaches great importance to human genetic resources. Therefore, in the future, it would be another major focus and questions will arise such as: Who *should assess the value of these resources in practice? How are they to be assessed?* In any case, it is foreseeable that if this provision is implemented, the potential risks and fines may greatly increase.

3. Metaverse: A Rational View of How New Rules against Illegal Fundraising Affect the Virtual Currency Industry

Authors: Wei QUAN | Kanxi LIAO | Bo ZHENG | Haowen WANG[4]

On February 24, 2022, the Supreme People's Court ("**SPC**") issued its *Decision on Revising the Interpretations of the Supreme People's Court on the Specific Application of Law in the Trial of Criminal Cases involving Illegal Fundraising* (Fa Shi [2022] No. 5, the "**New Rules**"). The addition of "virtual currency trading" related content in the New Rules has aroused waves of guesswork, inundating the market with eye-grabbing headlines such as "crypto trading defined as illegal fundraising" and "virtual currency traders to be sentenced to fixed-term imprisonment". Why do the New Rules touch on virtual currency? Will it substantially affect the risk of virtual currency practices? This commentary seeks to answer these questions.

Changes made in the New Rules – not all virtual currency trading constitutes illegal fundraising

The New Rules make quite a number of amendments to the previous *Interpretations of the Supreme People's Court on the Specific Application of Law in the Trial of Criminal Cases involving Illegal Fundraising* (Fa Shi [2010] No. 18). However, only one of these amendments concerns virtual currency, as specified in the following table.

Original description in the New Rules	Item 8 of Article 2 is revised to read "illegally taking in deposits by means of online lending, equity investment, virtual currency trading, or otherwise."
Before revision	[Article 2] Whoever commits any of the following acts, which meets **the conditions stipulated in Article 1, paragraph 1 hereof,** shall be convicted of the crime of illegally taking in deposits from the general public and be punished in accordance with Article 176 of the Criminal Law: 1. legally taking in deposits without the true substance of a housing sale or not primarily for purposes of a housing sale, such as rebate sales, after-sale leases, agreed repurchases, selling shares in housing, and other means; …… 8. **illegally taking in deposits by means of equity investment;** …… 11. Any other acts by which deposits are illegally taken in.
After revision	[Article 2] Whoever commits any of the following acts, which meets **the conditions stipulated in Article 1, paragraph 1 hereof,** shall be convicted of the crime of illegally taking in deposits from the general public and be punished in accordance with Article 176 of the Criminal Law: 1. Illegally taking in deposits without the true substance of a housing sale or not primarily

[4] Hong Song, a Han Kun intern, also contributed to this legal commentary.

	for purposes of a housing sale, such as rebate sales, after-sale leases, agreed repurchases, selling shares in housing, and other means; …… 8. **illegally taking in deposits by online lending, equity investment, virtual currency trading, and other means;** …… 12. Any other acts by which deposits are illegally taken in.

Meanwhile, in his response to media inquiries concerning the New Rules, the relevant principal of the 3rd Criminal Division of the SPC stated that "Article 2 of the initial Interpretations set forth ten categories of illegal fundraising activities along with a miscellaneous provision. The revised Interpretations, taking into consideration new situations in judicial practice and newly arising forms of crime, **include new types of illegal deposit-taking activities such as online lending, virtual currency trading, and financial leasing** as Items 8 and 9 of this Article 2, and introduce as Item 10 a new category of "illegally taking in deposits by providing 'elderly care services', investing in 'elderly care projects', selling 'products for the elderly' or otherwise", **which provides a legal basis for criminalizing and punishing illegal fundraising activities in such areas as P2P, virtual currencies, and elderly care**.

Given the above, the New Rules mainly specify the market status quo where "virtual currency" is used as a vehicle for illegal fundraising, and by no means indicate that all forms of virtual currency trading are indistinguishably criminalized as illegal fundraising. Notably, in as early as January 2021, the State Council indicated in its *Regulations on Prevention and Disposition of Illegal Fund-raising* (the "**Regulations**") that virtual currency trading is prone to involving illegal fundraising and should be an investigation focus. Article 19 of the Regulations reads: "**For any of the following suspected illegal fundraising practices within a local administrative region**, the leading department for dealing with illegal fundraising practices shall organize the competent administrative authorities and regulators of the industry, as well as the branch or dispatched office of the financial administrative department under the State Council, to carry out investigation and identify such practices: …… (II) pooling funds in the name of offering or transferring equity or creditor's rights, raising funds, selling insurance products, or **engaging in various asset management, virtual currency, or financial leasing business, etc. ……**". Therefore, the New Rules are not the first effort made by regulators to legislate against illegal fundraising via virtual currency trading.

The same approach should be adopted to understand other illegal fundraising scenarios added in the New Rules. That is to say, although activities such as "online lending", "financial leasing", "equity investment" and "elderly care projects" may become a vehicle for illegal fundraising, such activities do not naturally constitute illegal fundraising. If the concept applies that "virtual currency trading equals illegal fundraising", all other activities set forth in the above laws and regulations would also be identified as illegal fundraising. Such way of thinking, which is promoted by a small number of self-media, is more or less for clickbait and lacks a legal basis.

What types of virtual currency trading constitute illegal fundraising – the key lies in "general public involvement" and "luring with promised gains"

The New Rules do not broaden or replace the established scope and elements for identifying illegal fundraising. Examination of the following four core elements is still required to determine whether a trading activity constitutes illegal fundraising:

- **Illegality:** pooling funds without the legal approval of competent authorities or in the form of lawful business operations;
- **Publicity:** carrying out public promotions via media, promotional events, leaflets, cellphone messages, and other means;
- **Inducement with promised gains:** promising to repay the principal with interest accrued thereon or to pay returns in such forms as cash, in-kind, and equity within a given time limit; and
- **Sociality:** pooling funds from the general public, namely unspecified targets in society.

A person who raises funds in a manner that meets these four elements may be considered to have committed the crime of "illegally taking deposits from the general public"; if the foregoing fundraising activity is carried out for the purpose of illegal possession by means of fraud, it may also be found to constitute the crime of "fundraising fraud". Among the foregoing elements, the key to identifying the risk of illegal fundraising is whether the activity in question involves the "general public" (i.e., whether a public promotion is carried out and caters for unspecified targets), and whether the activity "lures the targets with promised gains" (e.g., establishing a fixed-return mechanism, a dividend payout mechanism, or a repurchase mechanism).

How should market players respond?

Marked by the *Notice on Further Preventing and Resolving the Risks of Virtual Currency Trading and Speculation*, which was jointly issued on September 15, 2021 by the People's Bank of China and nine other national-level departments and commissions, Chinese regulators are currently tightening their overall crackdown on illegal activities in China's virtual currency industry. Admittedly, the New Rules do not increase the legal risks faced by market players, meaning that "activities that were legal before the issuance of the New Rules remain legal after their issuance, and activities that were illegal remain illegal". Nevertheless, the New Rules indeed demonstrate that regulators have attached greater importance to illegal fundraising activities conducted via virtual currency trading, which is also a response to the large number of illegal virtual currency fundraising cases arising in judicial practice over the past few years.

Given the current regulatory landscape, market players in industries related to the metaverse, non-fungible tokens, and blockchain are advised to defuse illegal fundraising risks in the following respects:

- **Metaverse:** "virtual currencies" under metaverse business models mainly appear as "currency units". Market players should position the function of virtual currencies under metaverse as similar to "in-game currencies" and follow regulatory requirements related to in-game currencies.

They should strictly prevent two-way exchanges between virtual currencies and legal currencies, so as to avoid any association or link with substantive rights and interests offline.

- **Non-fungible tokens (NFTs):** It is advisable to set up certain access permission mechanisms to attenuate the general and public nature of NFT products. Meanwhile, NFT sellers should downplay the "investment" and "speculative" attributes of their products in their promotional activities and trading mechanisms, avoiding expressions such as "principal and benefits guaranteed", "lucrative returns", and "unlimited future earnings" in their advertisement and issuance rules. Also, it is not advisable for now to formally open a secondary market for NFT transfers.
- **Overseas projects:** With respect to the various blockchain business forms located purely overseas (e.g. overseas exchanges, overseas mining farms, and overseas crypto funds), market players are advised to adhere to the compliance redlines set out in the *Notice on Further Preventing and Resolving the Risks of Virtual Currency Trading and Speculation* and to take proper measures to block any publicity and promotional endeavors targeting residents in the PRC, so as to ensure that such projects will not have a public impact in the PRC market.

Conclusion

The tightening crackdown on illegal activities in the virtual currency industry by Chinese regulators has greatly increased compliance pressure on market participants, who now turn pale even at the mere mention of new government policies. Nonetheless, in our opinion, blockchain, a business form supported and encouraged by national policies, remains a promising field with a large development space, as long as relevant business activities are carried out in compliance with regulatory requirements. Meanwhile, market players should treat relevant news and voices with calm and maintain stable operations and performance, seeking to understand the real regulatory purposes and compliance redlines underlying applicable rules and provisions in a rational manner.

Important Announcement

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