Does China's announcement threaten the future of cryptocurrencies?

Teneo Insights / November 2021

Over the past few years, the Chinese authorities have become increasingly concerned about the rise of cryptocurrencies and have gradually tightened the controls they have in place. Do their concerns have merit? Will other regulators follow their lead? Does this mean that cryptocurrencies are set to die?

China has been a leader in the adoption of cryptocurrencies in terms of both trading and mining. It is also a leader in Central Bank Digital Currency (CBDC), launching its digital yuan or e-CNY in 2020. The Chinese government will showcase the digital yuan by enabling athletes and spectators to use it at the 2022 Winter Olympics. Note that the e-CNY is not a decentralised cryptocurrency; it is backed and controlled centrally by the Chinese government. China's restrictions are focussed on decentralised cryptocurrencies such as Bitcoin, Ether and Monero.

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The Chinese authorities' concerns relate to organisations raising funds through an Initial Coin Offering (ICO), which it thinks give **"rise to speculation and…suspicion of illegal financial activities."[1]** It believes that **"such offerings… are unauthorised and illegal public fundraising. These are suspected of being involved in criminal activities such as illegal selling of tokens, illegal issuance of securities, illegal fundraising, financial fraud and pyramid schemes."** As for the currencies themselves, it states that **"The token or 'virtual currency' used in coin offerings are not issued by the monetary authority. Such currency does not have characteristics of money such as legal tender status and mandatory use, has no legal status equivalent to money, and cannot be circulated or used as currency in the market."** It has made its position clear.

In their 8 September 2021 announcement[1], the Chinese authorities:

- **Banned** any platform or servicer from:
  - Fundraising through coin offering
  - Exchanging between legal tender and cryptocurrencies
  - Undertaking proprietary trading activities
  - Trading as a central counterparty of cryptocurrencies
  - Providing pricing services
  - Acting as an information intermediary for cryptocurrencies
- Stated that they will **shut down** website platforms and mobile apps related to any trading platforms with activities that have violated laws or regulations.
- **Banned** institutions from providing products or services such as account opening, registration, trading, clearing and settlement for fundraising through coin offering/virtual currencies.

They have also instructed all individuals or organisations that have completed fundraising through coin offering to return the funds raised. Of course, returning monies may be easier said than done.

For those coin holders who are using a non-custodial wallet, they can be, and may remain, pseudonymous. Even those with custodial wallets will probably prefer to simply transfer their wallet to another provider outside of China, if such a provider can be found. Will we see the Chinese take a leaf from the Americans with their US-Swiss programme of offshore asset tracking and Foreign Account Tax Compliance Act (FATCA) reporting?

Prior to these recent bans, in May 2021, China effectively banned Bitcoin mining, at which point it was the world's leader. However, this appears to have been triggered by concerns over energy consumption rather than regulation.

China's new controls are extensive; but are they justifiable and/or premature? Regulators around the globe are becoming increasingly nervous as cryptocurrencies become more ubiquitous. There is widespread concern around the principal regulatory issues from a conduct perspective:

- **Money laundering and Know Your Customer (KYC)** – A central tenet of regulatory control in recent years has been the obligation laid on banks to know who their customers are, where their money has come from, and where it is going. Whereas this control can continue at the crypto/fiat exchange points, transfer of cryptocurrency between anonymous parties, albeit fully visible in the blockchain record, can be achieved across international borders rapidly and with ease. If an entire parallel global crypto economy were to emerge, those looking to avoid scrutiny would be able to conduct their business entirely pseudonymously. But remember, domestic black-market economies based on cash are strong today, with the primary difference being the internet-enabled international nature of cryptocurrencies. On the positive side, the authorities would, in theory, have a far better picture of how big the parallel economy was, as all activity would be *"hiding in full sight."*

1 Public Notice of the PBC, CAC, MIIT, SAIC, CBRC, CSRC and CIRC on Preventing Risks of Fundraising through Coin Offering

- **Mis-selling** – In the UK, we have seen many situations where banks have been sanctioned for mis-selling; PPI sales to retail customers and interest rate swaps to small businesses being two notable examples. As the awareness of, and access to, cryptocurrency "investment" is increasing rapidly, there will be opportunities for individuals and companies to sell ultra-high-risk products to naïve customers. It won't be long before the *"CryptoPension"* is launched (and it has probably already happened somewhere); *"Astronomical returns, invest your current pension at 40, retire in luxury at 45(!)."* It could make the British Steel pension scandal pale into insignificance. Given the international nature of cryptocurrencies, such sales pitches could be cross border, making them even more difficult to regulate.
- **Decentralised Autonomous Organisations (DAOs)** – A DAO is an organisation with no corporate structure/centralised leadership, which exists outside of any specific jurisdiction and is owned by holders of governance tokens granting voting rights. Although there are many good reasons why DAOs can be established (e.g. crowdfunded international research), its non-jurisdictional nature and the anonymity of its owners must raise a red flag for regulators. Imagine the *"CryptoPension"* salesman was from a DAO. Which regulator has control? And how/where could sanctions be applied? Legislation of the players would require something akin to international maritime law. Managing the global crypto/fiat interface effectively would be essential to have any chance of regulating the situation. Will a DAO running a cryptocurrency replace the eponymous Swiss Bank account. Indeed, has the recent US-Swiss Bank Program, FATCA, increased KYC and Source of Wealth (SOW) checks, and Automatic Exchange of Information (AEI) at Swiss banks left a gap in the market?

China's concerns are valid and are mirrored by regulators globally. Consequently, the steps taken by the Chinese government may be considered to be proportionate given the magnitude of the potential issues. Whereas the underlying blockchain technology has many positive and unique attributes, cryptocurrencies could present an existential risk to the world economy. By acting rapidly, regulators may avoid the emergence of a parallel cryptocurrency-based economy in which individuals and groups can trade amongst themselves, unregulated and out of reach (albeit pseudonymously in sight) of regulators and tax collectors. This approach could also facilitate the exploitation of the positive attributes of blockchain technology cryptocurrencies.

The immediate effect is that many crypto exchanges are removing their Chinese users, but with varying degrees of rigour. In the short-term, cryptocurrency associated companies will simply transfer jurisdictions, away from China or go further underground (or should it be *"become ethereal?"*) as DAOs. Chinese *"speculators"* will either tow the party line and exit the market, or simply hide in pseudonymity offshore.

If all regulators took the same approach as the Chinese government, the legitimate market would surely die. This would have a knock-on effect on consumers and crypto businesses alike and would raise many unanswered questions. What would happen to all the miners' computing capacity, presumably purchased with debt? Where would all the "speculators" go to complain? Who would the

defendants in class action suits be? Would clawback claims be made on all those individuals who had extracted *"fictitious profits"* from cryptocurrencies in the meantime, as was the case with Madoff? Could a global ban cause another banking crash? If all the major economies banned cryptocurrencies, would we see the rise of crypto activity in countries with lower levels of regulatory control or would cryptocurrencies simply move to the dark web? Or, fundamentally, is it already *"too big to kill?"*

What is clear is that the adoption of and participation in cryptocurrencies is growing exponentially. There is a danger that if the regulators do not act rapidly, a parallel economy could emerge which is too big to kill and, if and when a market collapse does occur, would take many individuals down with it and cause a dramatic setback to a technology which may well have a part to play in the future of finance. We believe that rapid global collaboration between regulators is required to understand the risks and to establish how to regulate to mitigate those risks. China has taken a lead which others may wish to follow. A complete ban, or a ban on specific cryptocurrencies, may even be required in the short-term. In the meantime, a suitable regime would need to be established to avoid an unregulatable cryptocurrency-based black-market economy emerging.

This doesn't necessarily mean that cryptocurrencies are set to die. Firstly, a regulatory regime may be possible which could control them sufficiently to enable them to exist in parallel with fiat currencies and CBDCs. Secondly, the legitimate opportunities to materially improve the financial services industry may be too great. Thirdly, it may already be too late to kill them off.

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