LLINKS Law Offices
通力律师事务所

上海
上海市银城中路 68 号
时代金融中心 16 楼和 19 楼
邮编 : 200120
电话 : +86 21 3135 8666
传真 : +86 21 3135 8600

SHANGHAI
16F/19F, ONE LUJIAZUI
68 Yin Cheng Road Middle
Shanghai 200120 P.R.China
T: +86 21 3135 8666
F: +86 21 3135 8600

北京
北京市建国门北大街 8 号
华润大厦 4 楼
邮编 : 100005
电话 : +86 10 8519 2266
传真 : +86 10 8519 2929

BEIJING
4F, China Resources Building
8 Jianguomenbei Avenue
Beijing 100005 P.R.China
T: +86 10 8519 2266
F: +86 10 8519 2929

香港
香港中环皇后大道中 5 号
衡怡大厦 27 楼
电话 : +852 2969 5300
传真 : +852 2997 3385

HONG KONG
27F, Henley Building
5 Queen's Road Central
Central, Hong Kong
T: +852 2969 5300
F: +852 2997 3385

伦敦
1F, 3 More London Riverside
London SE1 2RE
United Kingdom
T: +44 (0)20 3283 4337
D: +44 (0)20 3283 4323

LONDON
1F, 3 More London Riverside
London SE1 2RE
United Kingdom
T: +44 (0)20 3283 4337
D: +44 (0)20 3283 4323

www.llinkslaw.com
master@llinkslaw.com

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What does the Block-chain Rule tell us? From denial to limited permission

By Xun Yang | Jianqi Yang

Cyberspace Administration of China (“**CAC**”) issued on October 19 2018 the *Administrative Rule on Block Chain Information Services* (the “**Block-chain Rule**”) for public consultation. The Block-chain Rule does not supersede the ban on issuance and trading of coins within the territory of China, which ban is imposed under the *Announcement on Preventing Token Fundraising Risks* (the “**Risks Announcement**”) issued by the People’s Bank of China collectively with other government authorities in 2017. However, the Block-chain Rule does provide a legal framework which block-chain service providers can follow in China. In other words, the issuance of Block-chain Rule is a positive signal for all the practitioners of block-chain industry in China.

1. Scope of application

The Block-chain Rule adopts a territorial based jurisdiction. Article 2 of the rule stipulates that “the provision of block-chain information services within the territory of PRC is subject to the Block-chain Rule.” CAC explained that the provider of block-chain information service is defined as *“any entity or* ***node*** *which provides block-chain information service to the public (in China), as well as any institution or organization which provides*

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请与下列人员联系:

郭建良: (86 21) 3135 8756
Publication@llinkslaw. com

If you would like other Llinks publications, please contact:

Roy Guo: (86 21) 3135 8756
Publication@llinkslaw. com

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www. llinkslaw. com

technical support to such provider of block-chain information service." In our view, by using the terms 'entity, node, institution and organization', the Block-chain Rule will likely regulate all the service providers which may have any relation to block-chain information services.

Firstly, the Block-chain Rule includes 'Node' in the definition of "block-chain information service provider". There is no definition of or interpretation on the term 'node' in the PRC legal regime. In practice, the term 'node' as used in the Block-chain Rule refers to a unique technical architecture applied in the block-chain. One of the most significant technical characters embodied in block-chain is 'decentralization', which means each 'node' distributed on the block-chain will have the right to access the all information recorded in the block-chain with no restriction. In other words, each node, as an information terminal, will be considered a 'server' hosted all the information stored in the block-chain. Therefore, theoretically speaking, in the event that one of the 'nodes' is distributed in China, even if its provider of the block-chain service do not have any entity or office in China, such node will be able to access all the information on the entire block-chain. As such, the inclusion of 'node' in the definition of block-chain information service provider is an reaction to the foresaid technical character of block chain.

Secondly, in practice, it is a customary business model to establish a overseas entity to operate the block chain business and to use a Chinese entity to provide technical support such block chain business. On this regard, the Block-chain Rule requires that all the entities and organizations which provide technical support to block chain business operations are subject to the Block-chain Rule. In particular, quite a number of block-chain service providers were no longer able to trade coins due to the issuance of Risk Announcement in 2017. Therefore, most of bitcoin (or other coins similar in nature) business operators move the business outside of China to avoid PRC law implications. Nevertheless, if the Block-chain Rule is adopted in its current form, the said business structure will still be regulated by the Block-chain Rules.

2. Overview of Obligations

The Block-chain Rule regulates the block-chain information services mainly based on filing requirement and supplemented by approval requirement.

2.1 Filing Requirement

Article 4 of Block-chain Rule requires that all the block-chain information service providers file a registration form via an online management system developed by CAC within 10 days as of their provision of service. For the purpose of filing, block-chain information service provides must submit the information relating its shareholders, its operation of business and the address of servers etc.

Moreover, the block-chain information service providers must renew its filing information annually in accordance with article 5 of Block-chain Rule.

However, it remains uncertain under Article 4 as to the date of the provision of service. Especially, block-chain information service providers usually adopt different testing phases such as "closed testing," "internal testing" and "public testing" to review their services and it requires further clarification as to whether such testing is considered commencement of services. In addition, it is also not clear whether the date of provision of service refers to the date on which the technical service is provided to the SPVs, or refers to the date on which the recipient (e.g. the SPVs) of such technical services provides the block-chain information service to the public.

2.2 Approval Requirement

Though, 'traditionally', the block-chain technology is mainly used in the financial sector, especially in the context of issuing and trading 'coins.. However, such technology can also be used in other scenarios, such as preservation of electronic evidence. According to Article 7 of Block-chain Rule, the block-chain information service provider must apply for an approval from the relevant government departments if the service to be provided falls within the scope of restricted industry. In other words, the pre-approval requirement in restricted industries still applies to the block-chain related services in such areas.

2.3 Cyber Security Requirement

The 'network security' has been considered a national strategy formulated by PRC government since 2015. Unsurprisingly, the Block-chain Rule provides for a number of cyber security requirements, which including real name registration (corresponding to Article 24 of *PRC Cyber Security Law*), content censorship (corresponding to Article 47 of Cyber Security Law), formulating a emergence plan (corresponding to Article 25 of Cyber Security Law), establishing a channel for reporting (corresponding to Article 49 of Cyber Security Law), security protection and cyber logs retention requirement (corresponding to Article 21of Cyber Security Law), as well as prohibition of illegal information requirement (corresponding to Article 12 of Cyber Security Law).

It is worth noting that the Block-chain Rule amphsizes the requirement of 'real name registration.' However, 'anonymization' has long been viewed as one of the most important technical characters of block-chain technology. A number of block-chain information services are developed based on the 'anonymized function' derived from such technology, for example 'express delivery service' (for protection of privacy) and anonymized financial trading service. The "real name" requirement may trigger customers' a concerns about their privacy.

2.4 Eliminating Illegal Information Requirement

Block-chain information service providers are required to eliminate all the illegal information on their 'block-chain' according to Article 11 of Block-chain Rule, which will be a tremendous challenge for the block-chain information service providers in China. The block-chain technology enables a community of users to record information or transactions in a 'ledger' that is public to such community. Mo information or transaction can be changed once published. In other words, illegal information will be immutable once it is recorded into block-chain unless hacking the block-chain with enough computing power, which power is almost impossible to be generated by any commercial entities currently. Therefore, it would be a difficult mission for block chain information service provider to perform the obligation under Article 11.

Recently, a new technology has been created in order to solve with the above difficulties in the block-chain industry, which technology is called 'sovereign block-chain' by some scholars. According to a documents released on Oct 4 2018 by the U.S Patent and Trademark Office (the "**USPTO**"), Chinese tech giant Alibaba has applied for a patent for block-chain system that allows a third-party administrators to perform special transactions or instructions, e.g. stopping smart contracts or freeze accounts which suspicious of illegal activities. According to Alibaba's proposed block-chain system, dedicated administrators will be able to send special processing instructions to each nodes, making smart contracts perform corresponding operations on specific accounts. If such technology can be implemented as Alibaba's description, it will enable the block-chain information service providers to perform the obligation under Article 11 of Block-chain Rule.

2.5 Security Assessment Requirement

For the purpose of prudential regulation, Article 16 of Block-chain requires that all block-chain information service provides apply to CAC or its local offices at provincial level for a security assessment prior to any development or operation of new product, new application and new function of its services, which requirement is quite similar to the security assessment review requirement applicable to network products and services. On May 2 2017, CAC issued the *Measures on Security Examination for Network Products and Service (Provisional)*, under which the procurement of network products or services for important networks that may have influence on national security is subject to a cyber security review. Additionally, the Ministry of Industry and Information Technology (the "**MIIT**") issued *Measures on Security Assessment for New Internet Service* for public consultation in June 2017, by which the MIIT would be able to establish a pre-approval system for any new internet service in order to mitigate the potential network security risks associated with such service. However, given the complexity and diversity of block-chain technology, it requires further clarification as to how the security assessment requirement will be performed.

3. A Perspective Vision

The public consultation for Block-chain Rule more or less reflects that Chinese government holds a contradictory view on the block-chain technology. On the one hand, the government has a serious concern on the issuance and trading of coins through block-chain information services which may distort the financial market, bypass foreign exchange controls and exaggerate financial risks. On the other hand, the government recognizes that the block-chain technology has unique merits and any excessive intervention may deter its application and development.

From a legal aspect, although the Risk Announcement has imposed a ban on the initial coin offerings, the application of block-chain technology itself is not prohibited in China. In this September, according to media report, the famous bitcoin enterprises “Huobi China” officially established a WFOE in Hainan Province, which has been interpreted as a symbol of legalization of block-chain technology in China.

Existing cases relating to bitcoins or other coins generated by block-chain technology indicate that, Chinese courts uphold the position that bitcoins are a type of property protected under the PRC laws. With the issuance of Block-chain Rule for public consultation, we are of the view that Chinese government will encourages the development and application of block-chain technology in China but the prohibition on initial coin offerings will still exist.

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Contact Details

If you would like to know more information about the subjects covered in this publication, please feel free to contact the following people or your usual Llinks contact.

Author	
Xun Yang Tel: +86 21 3135 8799 xun.yang@llinkslaw.com	

Shanghai	
David Yu Tel: +86 21 3135 8686 david.yu@llinkslaw.com	**Bernie Liu** Tel: +86 21 3135 8678 bernie.liu@llinkslaw.com
Selena She Tel: +86 21 3135 8770 selena.she@llinkslaw.com	**Nicholas Lou** Tel: +86 21 3135 8783 nicholas.lou@llinkslaw.com
Dali Qian Tel: +86 21 3135 8676 dali.qian@llinkslaw.com	**Kenneth Kong** Tel: +86 21 3135 8777 kenneth.kong@llinkslaw.com
David Wu Tel: +86 21 6043 3711 david.wu@llinkslaw.com	**David Pan** Tel: +86 21 3135 8701 david.pan@llinkslaw.com
Elyn Jiang Tel: +86 21 6043 3710 elyn.jiang@llinkslaw.com	
Beijing	
David Yu Tel: +86 10 8519 2266 david.yu@llinkslaw.com	**Bernie Liu** Tel: +86 10 8519 2266 bernie.liu@llinkslaw.com
Yuhua Yang Tel: +86 10 8519 1606 yuhua.yang@llinkslaw.com	
Hong Kong **(in Association with Vivien Teu & Co LLP)**	
David Yu Tel: +86 21 3135 8686 david.yu@llinkslaw.com	**Sandra Lu** Tel: +86 21 3135 8776 sandra.lu@llinkslaw.com
London	
Yuhua Yang Tel: +44 (0)20 3283 4337 yuhua.yang@llinkslaw.com	