

# Localization Construction of Security Token Offering

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**Abstract.** The Security Token Offering (STO) embodies a convergence of traditional securities and blockchain token issuance, categorized into asset-based STO, derivatives-based STO, and payment-based STO, establishing a unique tripartite legal relationship among the issuer, trading platform, and subscriber. This essay commences by defining the essence of STOs, delving into the foundational legal principles, and scrutinizing the primary challenges in localizing construction, specifically the limitations of the conventional civil law system and the complexities in establishing a rights bundle paradigm. In accordance with prevailing regulations, it advocates for a localized construction approach, involving an expanded interpretation within the criminal law and civil law systems. The adaptation within the criminal law system involves recognizing the property attributes to prevent classification as illicit tokens or other violations. The adaptation within the civil law system entails endorsing the legalization of security token trading and validating the legitimacy of entrusted investment and trading activities involving security tokens.

**Keywords:** Security Token Offering; Securities.

## 1. Introduction

The Security Token Offering (STO) is a financial mechanism that leverages distributed ledgers to create digital assets. It involves converting tangible and financial assets into encrypted digital equity tokens that represent ownership of companies and their assets. Essentially, STO can be viewed as a fusion of traditional securities and blockchain token issuance.

At present, STO has not been officially introduced into the domestic financial market due to challenges related to the intricate nature of fundamental relationships, ambiguous legal status, and an unclear rights framework. This study centers on examining the asset attributes of it, evaluating the obstacles in localizing its development, and endeavoring to identify a rational and lawful positioning as well as potential trading opportunities.

## 2. Legal Relationships of STOs

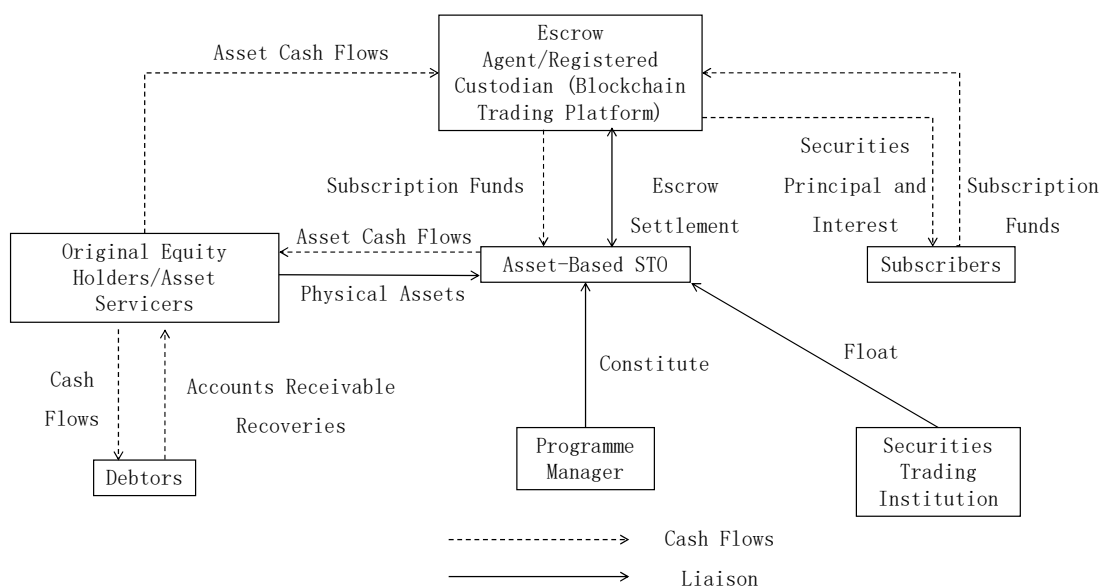
STO was initially introduced as a response to the fraudulent activities prevalent in Initial Coin Offerings (ICOs), as proposed by the United States Securities and Exchange Commission (SEC). [1] The emergence of STO was driven by the risks associated with ICOs, such as low issuance barriers and the flexibility of circulation on blockchain networks. Unlike ICOs, STO requires entities to be registered as corporate entities, making it easier for authorities to intervene in case of infringements.

STO has evolved into a distinct form of digital asset that utilizes distributed ledger technology to enable fractional ownership. This allows issuers to tokenize illiquid assets like real estate and determine the level of asset subdivision. By offering a publicly traded investment vehicle, STO has reduced investment thresholds, challenged entry standards, and enhanced asset autonomy in existing markets. Additionally, STO has prompted markets to improve transparency by transitioning from static disclosure to real-time web-based disclosure.

STOs enable the transformation of property rights into tradable digital assets, providing owners with immediate liquidity benefits and accelerated returns, facilitating the transition of blockchain projects from virtual to tangible assets. STOs can be classified into three main categories based on the underlying assets: asset-based STOs, derivative-based STOs, and payment-based STOs. Asset-based STOs operate similarly to asset securitization, utilizing cash flows from underlying asset pools for

repayment, while integrating blockchain technology and distributed ledgers along with risk mitigation strategies such as credit enhancements and cash flow aggregation mechanisms. Derivative-based STOs resemble depositary receipts, where a depository institution issues transferable certificates representing financial derivatives held in custody, prompting the issuance of corresponding STOs on the blockchain. Payment-based STOs function akin to programmable currency or perpetual bonds, with the issuance of digital currency by The People's Bank of China (PBC) involving the conversion of circulating cash into programmable code, enhancing cryptocurrency functionality. STOs with fixed maturity periods and predetermined returns are comparable to fixed-duration currencies with fixed interest rates, while those with variable maturity periods and yield options resemble currencies with variable durations, embedded options, or perpetual bonds with fluctuating interest rates.

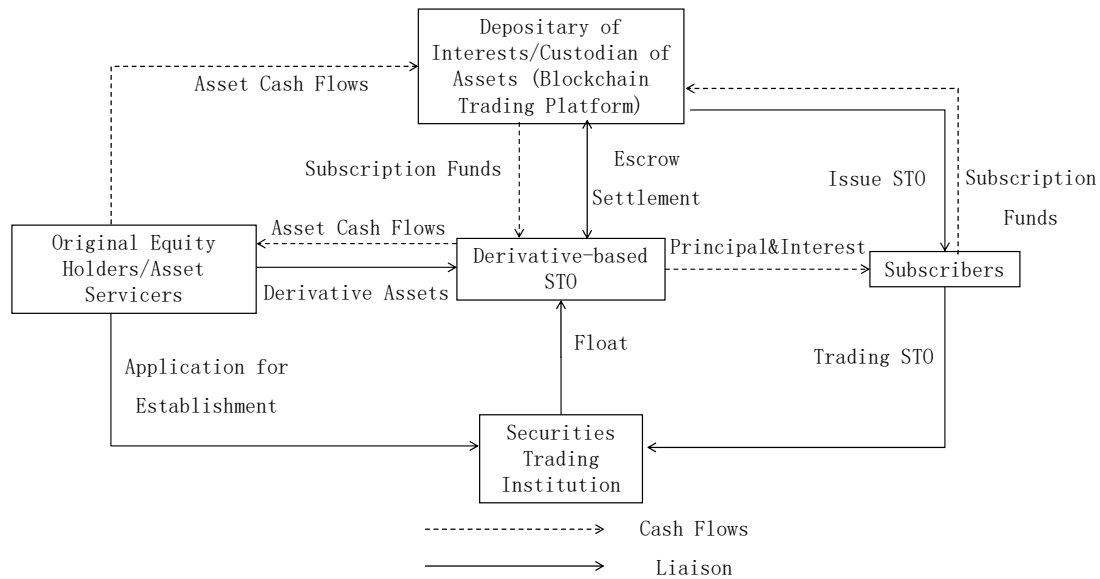
Current blockchains are categorized into three main types: public chains, consortium chains, and private chains. These classifications reflect varying degrees of decentralization, with public chains embodying complete decentralization, consortium chains demonstrating weak centralization, and private chains exhibiting strong centralization. [2] In the context of token issuances leveraging blockchain technology, private chains or consortium chains are predominantly utilized. In the process of STO issuance, the initial step involves the issuer or a specialized third-party institution establishing a trading platform. Through this platform, the issuer introduces the security token project and sells corresponding assets, while subscribers participate in investment activities. This dynamic establishes a legal tripartite relationship of "issuer-trading platform-subscriber" in security token issuance, supplanting the traditional tripartite relationship of "issuer-underwriter-investor" observed in conventional securities issuance. Notably, the underwriter's role is marginalized within this framework, with the trading platform facilitating communication of the issuer's financing requirements to subscribers, thereby acting as the intermediary between the two parties. [3]



**Fig 1.** Transaction Structure of an Asset-Based STO

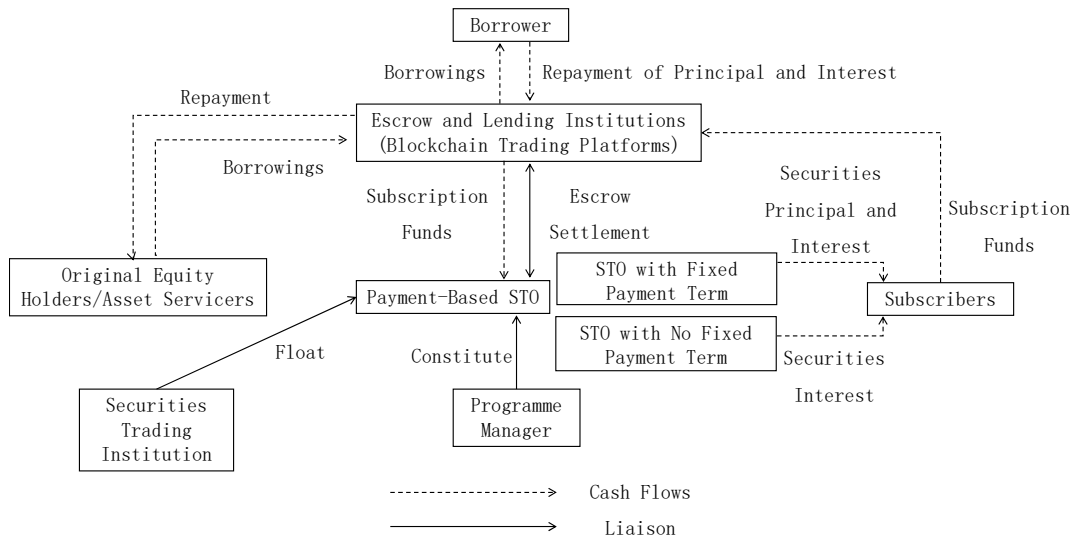
Asset-based STOs are initiated by fund managers, creating a subscription-based investment arrangement between initial equity stakeholders and subscribers. The blockchain exchange platform assumes the dual roles of trustee and registrar, functions typically fulfilled in asset-backed programs. In this framework, the original equity stakeholders and asset managers commit to responsibilities concerning the tangible assets being subscribed to and retain the entitlement to receive STO subscription funds. Subscribers commit to transferring subscription funds and have the right to request securities and returns from the blockchain exchange platform. The blockchain exchange platform becomes an aestimatio entity in the transaction structure, establishing custodial agreements

with STO initiatives. It receives cash flows based on tangible assets provided by the original equity stakeholders or asset management entities, facilitating purchase or consignment transactions for both parties, and generates revenue through custodial settlements.



**Fig 2.** Transaction Structure of a Derivative-Based STO

Derivative-based STOs are initiated by initial equity holders or asset service entities through submissions to securities trading organizations. In this framework, the securities trading entity consolidates the functions of both domestic and international exchanges found in conventional global depository receipts, with the blockchain trading platform taking on the responsibilities of domestic depositories and international custodians. The original equity holders and asset service entities assume responsibilities concerning the subscribed derivatives and actively seek establishment, retaining the privilege to receive subscription funds for STOs. Subscribers are tasked with transferring subscription funds to the on-chain asset custodian and have the right to request on-chain equity depositories to issue STOs and partake in STO transactions with securities trading organizations. The blockchain trading platform is responsible for informing the issuer to issue the corresponding amount of STOs on-chain and distribute them to subscribers, while also having the right to receive custodial fees.



**Fig 3.** Transaction Structure of a Payment-Based STO

Payment-Based STOs are initiated by plan managers, with the blockchain trading platform serving as both custodian and lending institutions, akin to traditional currency transaction structures. Under this framework, the original equity holders and asset service entities commit to providing the necessary funds for lending and have the authority to demand repayment of principal and interest at the end of the term. Subscribers contribute funds to the lending pool through subscriptions. If there is a fixed maturity period, subscribers can request repayment of securities and interest upon maturity; if the maturity period is open-ended, they can request repayment of securities and interest when due. The blockchain trading platform acts as an intermediary between the STO project and the borrower, responsible for presenting opportunities for loan contract agreements and facilitating the signing of such contracts. It also serves as an aestimatio entity between the original equity holders and subscribers, retaining the right to collect custodial fees.

### **3. Identification of the Characteristics of STOs**

The relationship between the market and regulatory frameworks is closely interconnected. To facilitate the issuance and legitimate trading of STOs in the domestic market, it is essential to consider their alignment with existing regulatory structures. The classification of these tokens should be based on the characteristics of basic financial derivative warrants. Consequently, there are two primary considerations in determining the nature of STOs. The first pertains to whether tokens on the blockchain are considered traditional assets, while the second involves assessing whether security tokens fall under the category of securities and are subject to relevant securities regulations.

#### **3.1. Asset Nature during Token Circulation**

Three criteria must be satisfied in discerning the asset nature during token circulation: the digital asset must possess a tangible valuation foundation, ownership must be clearly identifiable, and asset transfers must be unambiguous.

The requirement for a genuine valuation basis can be traced back to the "Notice on Guarding Against Bitcoin Risks" jointly issued in 2013 by the People's Bank of China, the Ministry of Industry and Information Technology, and other relevant authorities. This directive categorized virtual currencies as a distinct virtual commodity with the aim of mitigating the speculative bubble phenomenon associated with them. Stringent regulatory measures were implemented due to the significant disparity between the prices of virtual currencies and the intrinsic value of their underlying assets, which posed challenges in safeguarding the interests of subscribers. Consequently, adherence to regulatory standards in the circulation of tokens on the blockchain is imperative to facilitate the implementation of preemptive measures against unlawful activities.

In the context of ownership differentiation, transactions facilitated through distributed ledgers necessitate the provision of proof, within legal and regulatory frameworks, showcasing the transfer of ownership of asset-backed tokens from one identifiable entity to another. Efforts must be implemented to address the circumvention of regulations pertaining to the transfer of ownership through procedural means.

Regarding asset transfer, the process entails analyzing the transition of tangible assets into tradable capital within the confines of legal and compliant frameworks. This analysis encompasses factors such as priority, sustainability, liquidity, and convertibility. [4] In terms of priority, if the underlying asset is identified as ownership, the ownership right of the original obligee shall have priority over other creditors. If the underlying asset is confirmed as a secured claim, it takes precedence over ordinary claims. If the underlying asset is identified as a bundle of rights, precedence is determined by the order of precedence. In terms of sustainability, it is necessary to examine whether there is a special property relationship, such as a trust, in specific STO issuances, which extends the duration of priority rights to create opportunities for the appreciation of underlying assets or STOs, sacrificing time for the flow of space. Regarding liquidity, it involves examining whether the jurisdiction allows for bona fide acquisitions of financial derivatives. In terms of convertibility, it involves considering

whether it's permissible, through private law, to convert held STOs into safer assets with clear ownership, allowing STO holders to convert asset forms to lock in previous gains.

### **3.2. Securities Classification of STOs**

The classification of security tokens as securities is not definitively addressed in the Securities Law of the People's Republic of China (2019 Revision), presenting a lack of clarity on this matter. Furthermore, challenges arise when seeking to subject STOs to regulatory oversight within the framework of securities law.

Firstly, the existing legal framework exhibits deficiencies in its provisions, leading to limitations in the interpretative capacity of the definition of securities to encompass evolving financial instruments within society. The Securities Law employs a specific definition of securities, encompassing various instruments such as stocks, corporate bonds, depository receipts, government bonds, securities investment fund shares, and other securities sanctioned by the State Council. However, general tokens do not directly align with the aforementioned securities categories, posing challenges in their classification. While there are resemblances between security tokens and depository receipts, this categorization primarily accommodates derivative-based STOs, thereby failing to address asset-based and payment-based STOs. The restrictive delineation of securities hampers the regulation of novel financial products that should fall under the purview of securities under the legal framework. The absence of comprehensive provisions further results in a rigid interpretation of securities terminology, impeding the integration of new financial products into the legal system through expanded interpretations. To encompass security tokens with asset characteristics under the regulatory ambit of securities laws, there is a necessity to broaden the statutory scope of securities and enhance the criteria for recognizing security tokens during issuance.

Secondly, there is a lack of comprehensive guidance pertaining to tokens and encrypted assets beyond ICOs, as other types of tokens or encrypted assets have not been clearly defined or regulated. STOs are still in the nascent stages of development, resulting in varying and sometimes conflicting definitions and legal frameworks for security tokens across different countries and regions. In jurisdictions where security tokens are acknowledged and regulated, they are typically classified as securities and are subject to pertinent securities laws. However, the legal landscape has yet to address key questions such as the equivalence of security tokens to encrypted assets, the ability of digital assets utilizing distributed ledger or blockchain technology to represent value or contractual rights, and the interpretation of security tokens as forms of "programmable ownership". [5]

## **4. Challenges in Localizing Construction**

As previously addressed, existing security tokens encounter challenges in obtaining recognition as securities and gaining access to legitimate trading platforms within the financial market. Expanding the legal definition of securities could serve as a foundation for security tokens; however, the immediate likelihood of legislative modifications is minimal. According to data sourced from the prominent platform STOScope [6] as of November 19, 2023, there were a total of 85 security token offerings available for purchase, with real estate markets emerging as a prevalent application, suggesting a potential increase in substantial capital embracing security token frameworks within this sector. In 2019, the Bank of Communications (BOCOM) successfully issued securities backed by a considerable volume of residential mortgage loans through blockchain networks. Consequently, the domestic development of security tokens presents an inevitable challenge for China within the global financial landscape, necessitating prompt advancements in the legal framework.

The core principle of localizing construction involves redefining security tokens as a method of funding. Given the lack of established precedents for security tokens, it is crucial to initially address the entitlements to the assets they represent. This includes determining how to clearly outline the entitlements of token holders to assets such as ownership, income, and disposal rights within the existing legal framework. The entitlements to the underlying assets raise two primary considerations:

firstly, whether the assets represented by security tokens can be categorized as traditional property rights or creditor's rights, and whether there is a necessity for introducing bundled rights. Secondly, if classified as property rights, creditor's rights, or bundled rights, the allocation of sub-rights within each category needs to be established.

#### **4.1. Insufficient Explanatory Power of Traditional Civil Law Systems**

The civil law system, which primarily focuses on ownership as a means of safeguarding property rights in tangible assets, encounters limitations in adequately elucidating the issuance of security tokens. In China, where the civil law system traditionally upholds the distinction between property rights and creditor's rights, this dichotomy is not clearly delineated within securities law. Consequently, discerning between property rights and creditor's rights poses a challenge in the formulation of securities legislation. Only can identified certain norms pertaining to rights alignment within the civil law system, such as regulations concerning the creation of guarantees for creditor's rights, equity, intellectual property, etc.

Initially, ascribing all legal associations within security tokens to the property rights framework may overly depend on the ownership structure. While the establishment of legal connections involves the rights assets within security tokens ultimately being linked to a specific tangible form of wealth, or currency as a distinct form of movable property, the ownership system is crucial for establishing all transactional relationships. However, in the context of the three transactional frameworks previously discussed, the transfer of rights emerges as a pivotal element in security token issuance. Despite the civil law system providing assurances for creditor's rights, equity, intellectual property, among others, the trend of broadening the scope of collateralized rights objects falls short in encompassing all underlying assets.

Assets that are easily securitized typically exhibit characteristics that support the generation of consistent cash flows, such as mortgage-backed loans, fixed-income loans, accounts receivable, and business loans. In the context of asset securitization, the process of transferring rights through the issuance of security tokens presents challenges in aligning with the fundamental principles and frameworks of creditor's rights in civil law. It is necessary to establish specific transfer regulations through dedicated legislation, with some of these regulations bearing similarities to the principles governing the transfer of bill rights. For example, debtors are unable to contest prior rights against holders. Viewing the issuance of security tokens as a specialized trust arrangement based on a custody agreement, the trust relationship formed cannot be fully elucidated by the property rights framework. The bankruptcy isolation structure serves to segregate the underlying assets from the rights of the originator and the trustee. However, as rights holders do not possess usage rights, they are unable to attain complete ownership, thereby leaving the disposal right in a state of uncertainty within the realm of ownership authority.

Furthermore, if all legal relationships are attributed to the creditor's rights system, it becomes imperative to implement the collateralized property rights framework. In the case of creditor's rights associated with security tokens, in the event of the debtor's default, holders of security tokens are expected to prioritize the settlement of claims using collateralized property, as per the collateral system. Additionally, within the property rights system, the transfer of collateralized rights typically occurs concurrently with the transfer of the primary creditor's rights. In the scenario of endorsing the transfer of security tokens, the transfer of token rights through endorsement results in the corresponding shift of collateralized rights. Upon acquiring token shares, the entitlement to pursue legal action against the debtor should also be secured.

Security tokens integrate tangible assets with intangible property rights or creditor's rights assets using specific structural mechanisms, which involve segregating and reorganizing the components of revenue and risk within assets to convert them into exchangeable financial instruments. Within the current property rights framework, collateralized creditor's rights can also be tokenized, particularly in cases where the tokenized assets encompass mortgages linked to real estate loans.

In civil law jurisdictions, the claims doctrine pertains to the mechanism of securities rights derived from debt relationships, where holders of security tokens are considered to possess creditor's rights to the underlying assets. These rights are typically categorized as either member rights or contractual creditor's rights. However, there is a nuanced distinction in how Germany and Switzerland interpret these rights, particularly in terms of whether they are solely economic in nature. The German regulatory agency Bafin contends that holders' member rights encompass not only entitlements to interest and repayment but also voting privileges akin to shareholders. Conversely, the Swiss regulatory authority FINMA views security tokens as primarily representing economic rights to underlying assets, akin to stocks, bonds, or derivatives. The divergence in perspectives centers on the recognition of additional economic rights in security tokens that may manifest through the issuer's debts or shareholder member rights. The transaction structure diagram presented earlier illustrates a rational investment relationship in security tokens issuance. However, the absence of a valid digital identity poses challenges in accommodating non-economic rights using private chain platform technology, hindering the seamless evaluation of execution conditions, such as verifying subscribers' authorization documents, discerning the voting rights of restricted stocks without formal cancellation procedures, or validating the genuine intent behind waiving voting rights voluntarily. Consequently, advocating for a stance that emphasizes purely economic rights appears more justifiable.

#### **4.2. Construction Challenges of the Rights Bundling Paradigm**

The trend of transforming underlying assets from tangible to intangible necessitates a shift in viewpoints and analytical approaches. The focus lies on maintaining the liquidity of security tokens, ensuring their adherence to legal and regulatory standards during issuance and trading, minimizing regulatory obstacles, and addressing oversight gaps as key considerations in the development of property rights.

By utilizing the concept of "rights bundling" and commencing from the fundamental components of developing rights aggregation, it is feasible to circumvent the phases of rights maturation and formal legal rights validation. This approach has the potential to address the challenge posed by the dichotomy between property and creditor's rights systems. Specifically, ascribing to the property rights system may result in a deficiency in disposal rights, whereas aligning with the creditor's rights system could preclude the utilization of collateral. Moreover, safeguarding this form of rights aggregation can be achieved through legal presumptions, thereby diminishing the need for extensive legislative endeavors.

The concept of a "rights bundle" involves acknowledging the various rights associated with a particular resource, encompassing elements such as profitability, enjoyment, and exclusivity. The consolidation of rights into a bundle is primarily motivated by the pursuit of profitability. Failure to prioritize profitability as the primary objective of rights may result in the dilution of the bundle. Challenges may arise when delineating boundaries for rights bundle points, often stemming from complexities in accurately identifying the underlying assets.

When confirming the underlying assets in security tokens, it is crucial to uphold the key characteristic of rights bundling, which entails demonstrating the profitability associated with the exercise or non-exercise of rights to optimize or potentially maximize benefits. Individuals, as owners, should be entitled to various benefits, including personal utilization, benefits derived from others' usage, and credit benefits from guarantees. Within a diversified property rights framework, holders should have the ability to partition the entire set of benefits into multiple sub-rights bundles to align with their expectations of attaining surplus profits from the market. By transforming the enjoyment of property interests into a delineated territory with clearly attributable rights, it serves as a safeguard against infringements by others on the property that is already owned or possessed. The exclusivity of these rights necessitates a precise demarcation of the "boundaries" of different types of rights within a set of "rights bundling."

The essence of security tokens does not primarily lie in interpersonal or physical relationships, but rather in the legal connections between holders and issuers. These tokens represent a combination of property rights that encompass requests, privileges, powers, and exemptions. Leveraging blockchain technology facilitates the conversion of underlying assets into security tokens, leading to a significant reduction in transaction costs associated with dividing and transferring property rights. In cases where multiple rights are associated with a single asset, they are more likely to form a cohesive set of interconnected relationships that do not neatly align with conventional property and creditor's rights frameworks. By adopting the rights bundling paradigm, the emphasis shifts towards addressing specific property-related issues in security tokens, such as the partitioning of real estate, intangible assets, and emerging forms of property on the blockchain. This approach helps elucidate the amalgamation of diverse non-physically exclusive interests in security tokens, managing the intricate interplay of multiple rights assertions, and facilitating the effective facilitation of property rights division and circulation within security tokens.

The difficulty arises from the strict categorization of real estate within the existing legal framework, which complicates the establishment of boundaries for rights bundling when verifying underlying assets. If real estate is considered off-limits in the verification of underlying assets, the issuance of security tokens loses significant innovative potential. This ambiguity in property rights foundation leads to a superficial design of rights bundling.

Moreover, the hybrid paradigm exemplified by Hong Kong, the UK, and the US appears inappropriate for direct incorporation. This paradigm integrates elements of property rights and creditor's rights within the civil law framework, recognizing that individuals holding security tokens possess ownership entitlements to the underlying assets, with additional economic rights being achieved through profit distribution with the issuers. Nevertheless, it encounters difficulties in definitively establishing these rights.

In practice, the Securities and Exchange Commission (SEC) in the United States has consistently maintained stringent oversight over STOs without establishing specific legislation for security tokens, treating them akin to regulations governing private offerings. However, a notable development occurred in the case of Blockvest, a blockchain asset trading company, where Judge Gonzalo Curie in the Southern District of California ruled against the classification of security tokens as collateral relationships under the US Securities Act. The challenge in definitively categorizing digital securities during regulatory processes has resulted in a departure from traditional supervision and regulation of securities laws, prompting regulators to interpret existing regulatory authority expansively to encompass novel forms of securities. Nevertheless, there is a matter of contention regarding whether this approach more effectively safeguards the concerns of subscribers.

## **5. The Path of Localizing Construction**

In the context of the German legal system operating within the continental framework, the regulatory body Bafin, recognises security tokens as securities or financial instruments. It asserts that security tokens should be categorized as a form of security if they possess characteristics such as the ability to confer equity, shareholder rights, or obligations akin to those of a shareholder or bondholder. Additionally, these tokens should be transferable and have liquidity on financial markets, while also embodying rights comparable to those associated with traditional securities.

In the common law framework, the SEC in the United States classifies securities into two main categories: one being stocks, notes, bonds, other forms of equities, and debt instruments; the other being any form of investment contract that passes the Howey Test. The definition of the Howey Test reflects a principle of flexibility rather than static criteria, capable of adapting to numerous and variable schemes designed to utilize other people's funds, thus placing security tokens under the ambit of investment contracts and regulatory oversight.

The UK regulatory authority, the Financial Conduct Authority (FCA), assesses securities primarily based on the Regulated Activities Order (RAO) and the Markets in Financial Instruments Directive II (MiFID II). Specifically, under the specific investments section, it is outlined that stocks may encompass transferable shares issued by various entities, deferred shares, or other financial products similar to stocks; warrants include options, warrants granting subscription shares, warrants granting alternative bonds, warrants granting bonds, and warrants granting government and public securities. Certificates representing securities include certificates of entitlements linked to shares and debt securities, depositary receipts, or other similar financial instruments.

In China, there are no explicit legal regulations governing the issuance of security tokens. Through previously released documents such as the Notice on Prevention of Risks of Bitcoin, the Announcement on Prevention of Risks of Token Issuance and Financing, the Announcement on Prevention of Risks of Speculation on Virtual Currency Transactions, the White Paper on the Development of the Blockchain Industry in China and the Guiding Opinions on Accelerating the Promotion of the Application of Blockchain Technology and the Development of Industry, it is evident that the general attitude towards the STOs is on the sidelines. Chinese regulators are encountering challenges in ensuring legal compliance with the introduction of new financial technology products. To facilitate the implementation of security token issuance, it is necessary to expand interpretations within both the criminal law system and the civil law system.

### **5.1. Adaptation of the Penal System**

In the realm of criminal law, a pivotal aspect to consider is the Announcement on Preventing the Risks of Token Issuance and Financing released on 4 September 2017. This announcement classifies all forms of tokens as virtual currencies, deeming them as illicit and criminal undertakings. It is imperative to steer clear of engaging in activities that could be construed as illegal token and ticket offerings, unauthorized issuance of securities, or unlawful fundraising, unless there is a subsequent regulatory directive explicitly endorsing STOs and denouncing financial deceit and pyramid schemes. STOs may run afoul of criminal law restrictions due to their classification under virtual currencies, potentially leading to violations such as illegal issuance-related offenses (e.g., unlawfully soliciting public deposits, fraudulent fundraising, and illicit business operations) and illegal transaction-related offenses (e.g., money laundering, aiding criminal activities on information networks, and concealing illicit gains). To prevent stringent criminal law measures from impeding the legitimate progression of STOs, it is essential to tailor the corresponding criminal law regulations during the localization process.

The limitations placed on STOs within the criminal justice system stem from the uncertainty surrounding their legal characteristics. Should the property aspects of STOs be disregarded, prosecuting and penalizing individuals who utilize STOs as both the target of criminal activity and the method of payment would prove challenging. Nevertheless, security tokens represent a subset of tokens and are inherently distinct from digital currencies. Consequently, they are not conducive to direct application of the legal framework governing virtual currencies, thereby complicating the ability to anticipate the criminal law framework applicable to STOs.

#### **5.1.1. Clarifying the Legal Nature of Security Tokens in Criminal Law**

The initial measure in adapting the criminal justice system should be to define the legal characteristics of security tokens within the realm of criminal law. By examining the process of security token issuance and their associated rights structure, it is essential to establish their classification as property under criminal law, rather than merely considering them as electronic data resembling virtual currencies. This assertion is supported by two main justifications.

Firstly, security tokens are deemed to hold property interests within the realm of criminal law, with potential offenses arising from illegal issuance falling into two distinct scenarios. The first scenario pertains to the collection of legal tender from unspecified subscribers by issuing security tokens, with promises of principal and interest repayment. The second scenario involves the illicit exchange of

unlawfully issued tokens for legitimate security tokens belonging to subscribers. These actions have the potential to breach laws concerning the unauthorized absorption of public deposits, fraudulent fundraising, and illicit operations. Regarding criminal activities associated with unlawful transactions, the widespread circulation and swift nature of transactions globally may facilitate extensive and intricate cross-border fund transfers or the rapid conversion of assets into tangible forms within a brief timeframe, potentially resulting in offenses like money laundering, aiding internet-based criminal activities, and the concealment or obfuscation of criminal proceeds. Given that security tokens possess objective and authentic valuation foundations, as opposed to being deceptive and worthless tokens utilized to defraud individuals, proving fraud offenses in transactions or acquisitions involving them poses a considerable challenge.

Secondly, security tokens demonstrate characteristics of property, as they are not solely dynamic data amalgamations but also possess three fundamental property features: manageability, transferability, and value. Despite China's macroeconomic financial policies not endorsing financial engagements involving virtual currencies, they have not explicitly refuted the value of blockchain financial technology products.

### **5.1.2. Circumvention of the Elements of the Illicit Distribution Category of Offences**

The second step in the adaptation of the criminal law system involves refraining from categorizing security tokens as illicit tokens, thereby evading the aspects of unlawful fundraising and unauthorized business operations. By avoiding the elements of the offense of illegal distribution, this approach aims to address offenses such as illegal absorption of public deposits and fundraising fraud, which are classified as illegal fundraising crimes based on criteria such as illegality, publicity, social impact, and inducement. The Announcement on Preventing the Risks of Token Issuance and Financing categorizes financial activities related to virtual currency as illegal financial activities, thereby associating token-based issuance with illegality. However, the Announcement does not explicitly clarify whether tokens in a broader sense or security tokens are subject to regulation if viewed as payment-type tokens. The fifth point of the announcement emphasizes that the primary emphasis of prevention efforts is on illicit financial activities conducted using various "coins" as opposed to STOs which are not transacted in the form of currency but rely on payment mechanisms. STOs are akin to debt derivatives and exhibit notable distinctions from virtual currencies that lack a tangible basis for valuation.

The illegal business offense is considered a statutory violation that pertains to the breach of "state regulations," necessitating the application of administrative law to address any missing elements. If STOs do not contravene state regulations, then the offense is not deemed to have occurred. As per Article 96 of the Criminal Law, "state regulations" encompass laws and decisions established by the National People's Congress and its Standing Committee, administrative regulations set forth by the State Council, administrative measures specified, as well as decisions and orders issued. The entities responsible for the issuance of the Announcement on Preventing the Risks of Token Offering and Financing are the People's Bank of China, the Office of the Central Leading Group for Cybersecurity and Informatization, and the Ministry of Industry and Information Technology. These entities produce departmental normative documents, which do not hold the same weight as state regulations in criminal law. Consequently, even if STOs are viewed as similar to the issuance of virtual currencies, it does not automatically constitute the offense of illegal business operation.

### **5.1.3. Circumvention of the Elements of the Illicit Trading Category of Offences**

The third phase in the adaptation of the criminal justice system involves preventing security tokens from meeting the essential criteria for money laundering offenses, aiding criminal activities in the digital realm, disguising illicit proceeds, and evading the identification of elements constituting illegal trading offenses. In cases of money laundering, the perpetrator's awareness remains a crucial element. [7] Only when the degree of infringement of legal interests warrants punishment under the criminal law and when the constituent elements are satisfied, [8] can the offence of money-laundering be finally found to be established. Hence, in cases where the involved party in a transaction is unaware

that the security tokens possessed by others are derived from a predicate offense and its proceeds, the act of exchanging these security tokens, providing payment and settlement services, or engaging in transactions between two parties will not be deemed as constituting the offense of money laundering.

In cases involving aiding internet criminal activities, it is essential to adopt a narrow interpretation of the term "etc." in the relevant provision. This provision delineates assistance into two distinct categories: technical aid and payment and settlement support, necessitating a direct causal link to the infringement of legal rights. Given the transparent nature of blockchain technology, unless the entity providing technical assistance actively facilitates and directly contributes to the criminal process, enabling the cybercriminal to achieve the unlawful outcome, or the act of aiding in payment and settlement directly benefits from the cybercrime, it would not be subject to regulation under the offense provision.

In cases involving the concealment or disguise of illicitly obtained funds, STOs may play a role in regulating the acceptance and sale introduction processes. The act of acceptance highlights the buyer's initiative and the seller's passivity, while the act of procurement underscores the intermediary's role in connecting the buyer. Thus, unless there is evidence demonstrating a pre-existing agreement between the original asset holder and the subscriber to transfer ownership via security tokens prior to the transaction, the offense cannot be established. Similarly, in scenarios involving intermediary blockchain or securities trading platforms, the offense is not deemed to have occurred if there is no prior knowledge that the underlying security tokens or assets being transacted are proceeds of criminal activities.

## **5.2. Adaptation of the Civil Law System**

In the context of the civil law system, there is a need to establish the permissibility of utilizing tokens resembling securities as contractual assets. Recent legal conflicts concerning contracts involving virtual currency transactions have highlighted a discrepancy. While the engagement of individuals in investing and trading virtual currency is generally viewed as a personal liberty, courts frequently interpret such activities as lacking legal protection, thereby deeming them as null and void civil transactions.

### **5.2.1. Affirmation of the Legalisation of Trading in Security Tokens**

The initial measure in adapting the civil law framework involves the legalization of security tokens trading, specifically acknowledging the legitimacy of transactions involving STOs. Instances where agreements for the exchange of digital currencies have been invalidated are commonly perceived by courts as breaches of essential legal statutes and regulatory requirements, leading to the nullification of such transactions as civil acts. Consequently, both the buying and selling practices and the consequent agreements are deemed void.

In this regard, it should be clarified that what provisions of the substantive law in China are considered mandatory provisions as referred to in Article 143(3) of the Civil Code? The legislation does not offer a clear definition of this concept; however, the Supreme People's Court has addressed this issue in its document "On Several Issues Concerning the Application of Law in Foreign-Related Civil Relations" by identifying six categories that encompass mandatory provisions. These categories include matters related to safeguarding workers' rights, ensuring food and public health safety, environmental protection, foreign exchange control and financial security, as well as regulations pertaining to anti-monopoly and anti-dumping practices. In the absence of explicit regulations on security tokens within existing laws and administrative provisions, it is essential to consider the theoretical framework governing the legality of contractual agreements. According to legal principles, the subject matter of a sales contract must align with legal permissibility, thereby prohibiting transactions involving restricted or prohibited goods. Notably, the circulation of security tokens does not fall under any explicit prohibition or restriction within the legal hierarchy. The fundamental tenets of private law emphasize principles of equality and freedom, suggesting that actions not expressly prohibited by law

are permissible. Consequently, the legitimacy of contracts involving the sale and transfer of security tokens should be acknowledged from this perspective.

### **5.2.2. Affirmation of the Validity of the Relevant Transactional Act**

The next stage in the process of adapting the civil law framework involves confirming the legitimacy of entrusted investment and trading activities within STOs. In general, private entrusted financial agreements should be deemed valid as long as they adhere to the principles outlined in the civil code and financial regulations, without contravening any prohibited provisions. Consequently, the entrusted investment and trading practices within STOs should be recognized as legitimate. However, the following four points should still be noted.

Initially, if the terms of the agreement indicate that the trustee will repay the principal and fixed income at the conclusion of the contract term, and there is no indication of financial management in terms of investment, operation, and risk-sharing between the two parties, but rather, one party receives a fixed return while the other party assumes all risks, then it deviates from the fundamental characteristics of an entrusted financial management contract. In accordance with the ruling of the Supreme People's Court in case (2009) No. 83 of the Second Civil Trial Chamber, the relationship between the parties should be classified as a loan relationship rather than an entrusted financial relationship. Secondly, STOs, being a negotiable financial instrument, are not conducive to agreements with guaranteed terms. If an entrusted contract includes guaranteed terms leading to a significant imbalance in the rights and obligations of the parties, such terms are deemed void. Given that guaranteed terms are considered pivotal in the contract, their invalidity renders the entrusted financial contract void as well. Thirdly, in the context of entrusted security token investment transactions, the entrusted financial contract should be considered terminated upon the contract's expiration if the parties fail to reach a new agreement regarding contract performance, even if the principal has not been entrusted for handling. Lastly, concerning liability assumption following the invalidation of the contract, if the trustee lacks the qualifications for entrusted financial management, resulting in the contract's invalidity, the trustee is deemed subjectively at fault and is obligated to reimburse the principal and any interest losses to the principal.

## **6. Afterthought**

Currently, Security Token Offerings (STOs) are still in the nascent stages of development, highlighting the imperative to enhance standards and constraints within the practical implementation process. The legal academia is called upon to assume a pivotal role in navigating the implications of the latest wave of technological advancements, addressing challenges related to local infrastructure, the limitations of conventional civil law system interpretations, and the complexities in formulating frameworks for rights and obligations. To remain competitive internationally, there is a need to rethink the concept of security tokens as a financing tool and overcome constraints in both criminal and civil law systems. In the realm of criminal law, it is crucial to clarify the legal status of STOs and differentiate between legitimate security tokens and illegal tokens to prevent issues like illegal fundraising and money laundering. Regarding the civil law system, it is imperative to recognize the validity of STO transactions and affirm the legitimacy of investment and trading activities involving STOs.

The primary emphasis should be placed on elucidating the rights linked to the fundamental assets in STOs, with a specific focus on delineating ownership, revenue, transferability, and additional privileges for stakeholders. The inclusion of real estate as underlying assets presents a challenge in establishing rights in a rational manner. The lack of universally accepted legal digital identity and regulatory alignment among different jurisdictions remains an unresolved issue. Nevertheless, these obstacles do not impede the potential growth of STOs within the blockchain finance sector. This article aims to serve as an initial exploration and aims to offer insights for the integration of STOs into the domestic market.

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