



HKMA Issues Proposals for Regulating Payment-related Stablecoins

On 12 January 2022, the Hong Kong Monetary Authority (the **HKMA**) published a [Discussion Paper on Crypto-assets and Stablecoins](#)¹ seeking feedback on its proposed regulation of “payment-related stablecoins”, being those crypto-assets most likely to become widely accepted as a means of payment and thus most likely to intersect with mainstream finance² (the **HKMA Stablecoin Discussion Paper**). The proposed regulatory framework aims to address the risks posed to users and the financial system by the increasing use of crypto-assets while encouraging the potential benefits of financial innovation.

The HKMA has identified two main areas in need of review: (i) the HKMA’s regulation of Authorised Institutions’ (**AIs**)³ interface with crypto-assets and their provision of crypto asset-related services to customers; and (ii) the adequacy of existing regulations to deal with the risks arising from the growing use of stablecoins and other crypto-assets. The first area has now been addressed in the HKMA’s circular “[Regulatory approaches to Authorized Institutions’ interface with Virtual Assets and Virtual Asset Service Providers](#)”⁴ issued on 28 January 2022. The second area, and the need to regulate stablecoins in particular, are the subject of the HKMA Stablecoin Discussion Paper.

AIs intending to offer investment services in relation to crypto-assets are already required to notify the HKMA and the Securities and Futures Commission (the **SFC**) in advance. In respect of non-payment-related (including unbacked) crypto-assets, the HKMA has been working with the SFC on their regulatory expectations for the investor protection to be provided by AIs offering crypto asset-related services as intermediaries. On 28 January 2022, the HKMA and SFC published a [Joint circular on intermediaries’ virtual asset-related activities](#) setting out their requirements for intermediaries conducting virtual asset-related activities, such as providing virtual asset advisory and dealing services and distributing virtual asset-related products, replacing the SFC’s requirements set out in its 1 November 2018 circular to intermediaries on the distribution of virtual asset funds.

The HKMA Stablecoin Discussion Paper sets out the HKMA’s proposed regulatory regime for entities conducting activities in relation to payment-related stablecoins in Hong Kong. Responses should be submitted on or before 31 March 2022 by email to stablecoin_feedback@hkma.gov.hk.

Hong Kong’s Current Regulatory Regime for Crypto and Regulatory Gaps

The HKMA notes that while stablecoins may be or become an accepted means of making payments, they may fall outside the scope of current Hong Kong regulation.

SFC Licensing Regime under the Securities and Futures Ordinance (SFO)

The SFC published its [Position Paper](#)⁵ on the regulation of virtual asset trading platforms in November 2019 introducing a licensing regime for the operators of centralised virtual asset trading platforms which trade at least one virtual asset which is a security as defined under the SFO. To date, the SFC has licensed just one virtual asset trading platform. Once a platform operator becomes licensed, the SFC will monitor its trading activities in relation to all virtual assets traded, not only those that are securities.

Proposed Licensing Regime for Virtual Asset Service Providers (VASPs)

In May 2021, the Financial Services and Treasury Bureau (the **FSTB**) published consultation conclusions on proposals to require the licensing under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance of operators of centralised virtual asset trading platforms as VASPs. When implemented, the new regime will require exchanges providing trading in virtual assets which are not subject to the SFO licensing regime to apply to the SFC for a licence. Operators of platforms already providing trading services will have 180 days to obtain the new licence. The licensing regime will extend only to the operators of virtual asset exchanges and not to other types of VASPs such as custodians and crypto wallet providers. The FSTB has said that the law drafting exercise would be commenced with a view to introducing the necessary legislation to the Legislative Council in 2022. For further information on the proposed regime, please see Charltons' newsletter "[FSTB Concludes on Licensing Regime for Virtual Asset Exchanges](#)"⁶.

The HKMA notes in the Discussion Paper that various key functions involved in typical stablecoin arrangements may not be covered by the proposed VASP licensing regime. These functions include: (i) the issue and redemption of tokens; (ii) transaction execution; (iii) token custody and operation; (iv) value stabilisation and reserve management; (v) transaction validation; and (vi) fund transmission.

HKMA Regulation of Payment Systems and Stored Value Facilities

The HKMA regulates: (i) stored value facilities, such as e-wallets and pre-paid cards; and (ii) clearing and settlement systems and retail payment systems under the Payment Systems and Stored Value Facilities Ordinance (Cap. 584) (the **PSSVFO**).

Under the PSSVFO, a facility is a stored value facility if:

- (a) the facility may be used for storing the value of an amount of money that:
 - (i) is paid into the facility from time to time; and
 - (ii) may be stored on the facility under the rules of the facility; and
- (b) the facility may be used for either or both of the following purposes:
 - (i) as a means of making payments for goods or services under an undertaking (express or implied) given by the issuer of the facility;
 - (ii) as a means of making payments to another person (other than payments mentioned in subparagraph (i)) under an undertaking (express or implied) given by the issuer of the facility.

A stablecoin or any other crypto-asset which meets the above criteria and constitutes the issue of a stored value facility in Hong Kong is required to apply for a licence from the HKMA and comply with the PSSVFO and other requirements set out in the guidelines, practice notes and supervisory requirements issued by the HKMA for the purpose of licensing and ongoing supervision.

However, the HKMA notes that the PSSVFO's definition of stored value facility may not cover certain types of stablecoins and/or their activities in the market. For a facility to be a stored value facility, the two limbs of: (i) taking stored value by a facility issuer; and (ii) the same issuer giving an undertaking for making person-to-merchant or person-to-person payments using the stored value, must be satisfied. In a stablecoin arrangement, different entities may perform the respective functions of stablecoin issuance and wallet operations, and the issuer will not necessarily undertake to use the stablecoin as a means of payment for a third party. This may mean that a stablecoin arrangement falls outside the scope of the stored value facility licensing regime, notwithstanding that it operates in a manner very similar to that of a stored value facility.

Rationale for Stablecoin Regulation

The HKMA discussion paper identifies seven key risks relating to stablecoins:

(i) Financial stability risks

a. Payment integrity – if stablecoins were to become widely used by individuals and businesses as a means of payment, operational disruptions or failures relating to stablecoins could significantly impact economic activity, normal functioning and public confidence in the financial system.

b. Banking stability – if financial institutions were to increase their exposure to stablecoins, and/or adopt multiple roles in the relevant ecosystem (e.g. acting as issuers or custodians), the integrity of the ecosystem and players might affect financial institutions' financial health, business model and stable operation. A significant shift from bank deposits to funds held in the form of stablecoins could affect banking stability.

(ii) Monetary stability risks

a. Currency substitution – stablecoins which are pegged to a single or a basket of fiat currencies might come to replace certain fiat currencies, particularly in jurisdictions where the domestic currency is volatile and payment infrastructures are underdeveloped.

b. Monetary policy transmission mechanism – the issuance and redemption of Hong Kong dollar-backed stablecoins may affect interbank Hong Kong dollar demand and supply. If there are rapid and massive redemptions of stablecoins for a foreign currency, the stablecoin operators may have to sell the backed Hong Kong dollar against the foreign currency to satisfy redemption requests.

(iii) Settlement risks

Settlement finality – “forks” in a stablecoin arrangement may reverse technical settlement and lead to a misalignment with legal finality.

(iv) User protection

a. Recourse – users could suffer losses from operation disruptions or failures of a stablecoin arrangement with little or no resource unless the recourse mechanism is legally stipulated.

b. Information adequacy – users may not fully understand the risks associated with stablecoins given their complexity and novelty.

(v) Financial crime and cybersecurity risks

Money laundering/terrorist financing (**ML/TF**) and other illicit activities – stablecoins may be the means of payment demanded in ransomware attacks, posing risks to both users and the broader society.

(vi) International compliance

As an international financial centre, Hong Kong is obliged to comply with internationally agreed standards and best practices where appropriate.

(vii) Regulatory arbitrage

Need to update the HKMA's regulatory regime – an update to the HKMA's regulatory framework is needed to prevent Hong Kong from becoming a safe haven for crypto-assets owing to under-regulation.

HKMA's Policy Objectives and Principles

Given the risks, the HKMA sees a need for an appropriate regulatory framework for stablecoins, the objectives of which would be maintaining monetary and financial stability, ensuring investor protection and minimising the risk of regulatory arbitrage. The regulatory regime would adopt:

(i) an agile regulatory approach to ensure the regime can accommodate evolving market developments and relevant international discussions; and

(ii) risk-based and proportionate regulation addressing the key risks presented by stablecoins and prioritising the areas posing greater risks, while allowing room for financial innovation.

HKMA Proposals for Regulating Stablecoins

Payment-related stablecoins

The HKMA proposes to regulate payment-related stablecoins only, at least initially. “Stablecoins” are crypto-assets whose values are linked or referenced to an underlying asset or assets, such as a security or fiat currency or a basket of securities of fiat currencies. They are typically described as being “pegged to” or supported by a single or a basket of fiat currencies or other assets. Depending on the referenced assets, stablecoins are used for investment or payment purposes. Given these characteristics, they are often differentiated from other types of crypto-assets with the result that they are more likely to be perceived as a widely acceptable means of payment and/or store of value (as compared to other crypto-assets) and thus have greater potential for being incorporated into the mainstream financial system or day-to-day commercial and economic activities. This explains why the Financial Stability Board (the FSB) has urged financial regulators to prepare to regulate stablecoins, particularly those with the potential to be applied to payments across jurisdictions, which the HKMA refers to as global stablecoins.

The market capitalisation of stablecoins has grown rapidly in the past two years and stood at US\$150 billion in December 2021, representing about 5% of the total crypto-asset market. Tether accounts for roughly half of stablecoins’ market capitalisation, while other major stablecoins include USD Coin, Binance USD, Dai, Terra USD and Fei.

1. Regulatory Scope of Stablecoin-related Activities

The Discussion Paper’s first discussion question is:

“Should we regulate activities relating to all types of stablecoins or give priority to those payment-related stablecoins that pose higher risks to the monetary and financial systems while providing flexibility in the regime to make adjustments to the scope of stablecoins that may be subject to regulation as needed in the future?”

The HKMA is proposing a risk-based approach, which will initially focus on activities relating to payment-related stablecoins. The regulatory emphasis will be on asset-linked stablecoins (e.g. a stablecoin whose value is linked to a specific fiat currency) rather than algorithm-based stablecoins which typically use protocols altering stablecoin supply in response to changes in demand to maintain a stable value. This is because most stablecoins are currently asset-linked and are mainly pegged to the US dollar. Asset-linked stablecoins also appear to be more popular than algorithm-based stablecoins and more likely to become widely adopted as a means of payment, therefore having greater potential for being incorporated into mainstream finance. Recognising the possibility that other types of stablecoins (e.g. algorithm-based stablecoins) may need to be regulated in future because of the potential risks they might pose to Hong Kong’s monetary and financial stability, the HKMA wants a flexible regime that can be modified in future as necessary.

2. Regulated stablecoin-related activities

The second discussion question raised is:

“What types of stablecoin-related activities should fall under the regulatory ambit, e.g. issuance and redemption, custody and administration, reserves management?”

The HKMA proposes that certain activities relating to stablecoins will require HKMA licensing. This would require expanding the scope of existing legislation (e.g. the PSSVFO) or enacting new law. Since stablecoin arrangements usually involve more than one entity, multiple entities in a stablecoin arrangement may need to seek HKMA authorisation.

The proposed regulated activities relating to stablecoins include:

(i) issuing, creating or destroying stablecoins (i.e. the issuer minting and burning stablecoins);

- (ii) managing reserve assets to stabilise the value of stablecoins (i.e. managing the reserve assets that back the value of the stablecoins and providing custody or trust for these assets);
- (iii) validating transactions and records (including authorising or verifying the validity of transactions and records);
- (iv) storing the private keys providing access to stablecoins (i.e. safe-keeping of the keys used to digitally sign transaction instructions on behalf of stablecoin holders);
- (v) facilitating the redemption of stablecoins (i.e. facilitating stablecoin holders' redemption of their stablecoins for fiat currencies or other assets);
- (vi) transmission of funds (i.e. ensuring the accurate and final settlement of transactions to minimise the risk of default by counterparties); and
- (vii) executing transactions in stablecoins (including conducting transactions on behalf of others).

3. HKMA authorisation and regulatory requirements

The HKMA's third discussion question is:

"What kind of authorisation and regulatory requirements would be envisaged for those entities subject to the new licensing regime?"

The HKMA proposes to apply high-level regulatory requirements to stablecoin-related activities. These would be applied using a risk-based approach, rather than on a one-size-fits-all basis. Since multiple entities are often involved in a stablecoin arrangement, the entities involved could be subject to part or all of the requirements, depending on the actual stablecoin-related services they offer.

Authorisation requirements

Under the new licensing regime, entities wishing to conduct certain activities crucial to the operation of a stablecoin arrangement will need to be authorised by the HKMA. The HKMA will develop these authorisation requirements in law, and relevant licensed institutions will be expected to comply with the authorisation requirements on an ongoing basis after authorisation to ensure the safety and soundness of the scheme at all times.

Regulatory requirements

The HKMA proposes to impose regulatory requirements on entities conducting stablecoin-related activities, which may be varied where appropriate, including:

(i) Prudential requirements

Licensed entities will be required to have adequate financial resources and liquidity and will be required to manage capital and liquidity adequately and effectively to protect users and financial stability.

(ii) Fit and proper test for management and owners

The controllers (including shareholder controllers and indirect controllers) and senior management of licensed entities will need to meet a fit-and-proper test.

(iii) Maintenance and management of reserves of backing assets

Licensed entities will be required to comply with requirements regarding the nature and sufficiency of the stablecoin arrangement's reserve assets to support and stabilise the value of the outstanding stock of stablecoins. They will also be subject to requirements to ensure the clarity and enforceability of legal claims, the titles, interests and other rights of stablecoin holders in relation to the stablecoin issuer and the reserve assets backing it.

(iv) Systems, controls, governance and risk management requirements

Licensed entities will be required to put in place a sound risk-management framework to comprehensively

manage legal, credit, liquidity, operational, AML and other risks of the stablecoin arrangement. The stablecoin arrangement's ownership structure and operation will need to feature clear and direct lines of responsibility and accountability, especially when it is owned and administered by one or more responsible legal entities.

(v) AML/CFT requirements

Licensed entities will be required to comply with AML/CFT rules.

(vi) Redemption requirements

Licensed entities will need to ensure the clarity, robustness, and timeliness of the process for redeeming stablecoins for other liquid assets.

(vii) Financial reporting and disclosure requirements

Licensed entities will be required to make disclosures to regulator(s) and users and grant specified rights to users.

(viii) Safety, efficiency and security requirements

Licensed entities will be required to put in place sufficient safeguards against cybersecurity, operational and business continuity risks.

(ix) Settlement finality

Licensed entities will need to ensure that a stablecoin arrangement provides for clear and final settlement irrespective of the operational settlement method adopted.

4. Licensing requirement

The HKMA's fourth discussion question is:

"What is the intended coverage as to who needs a licence under the intended regulatory regime?"

The HKMA is proposing that any entity wanting to conduct any of the regulated stablecoin-related activities (listed under paragraph 2 above) in Hong Kong will need to be incorporated in Hong Kong and licensed by the HKMA to conduct the relevant activity. Like section 115 of the SFO, the new regulatory regime will also prohibit the active marketing of stablecoin-related activities to the Hong Kong public by an unlicensed entity. Accordingly, a non-Hong Kong company will need to incorporate a Hong Kong company to apply for an HKMA licence to provide regulated stablecoin-related activities in Hong Kong. A mere Hong Kong branch or office of a foreign corporation will not be licensed by the HKMA.

5. Regime implementation and supervisory cooperation

The fifth discussion question raised is:

"When will this new, risk-based regime on stablecoins be established, and would there be regulatory overlap with other financial regulatory regimes in Hong Kong, including but not limited to the SFC's VASP regime, and the SVF licensing regime of the PSSVFO?"

Implementation of the HKMA stablecoin regulatory regime

After receiving feedback on the Discussion Paper, the HKMA will consider whether there is a need to issue additional documents on specific features of the regulatory framework in 2022/23. The HKMA aims to implement the new regime no later than 2023/24.

Potential overlap with other financial regulatory regimes

The HKMA notes the existence of multiple regulatory regimes in Hong Kong administered by various financial regulators which may apply to crypto-assets. In developing the stablecoin regulatory regime, the HKMA will therefore work with other interested parties (including stakeholders in the Hong Kong Government and other financial regulators) to avoid regulatory arbitrage and to determine potential areas for further collaboration and coordination.

6. Should stablecoin issuers be regulated as Authorized Institutions?

The Discussion Paper's sixth question is:

"Stablecoins could be subject to run and become potential substitutes of bank deposits. Should the HKMA require stablecoin issuers to be AIs under the Banking Ordinance, similar to the recommendations in the Report on Stablecoins issued by the US President's Working Group on Financial Markets?"

The HKMA proposes to draw reference from relevant international standards and recommendations such as those of the Financial Stability Board and the Bank of International Settlements. Given the payment-related nature of stablecoin arrangements, the HKMA expects that the proposed regime's rules and requirements would take relevant aspects of Hong Kong's current approach to SVF and payment regulation as a minimum to avoid regulatory arbitrage. Under a risk-based approach, the HKMA considers that stablecoin issuers should be required to be subject to higher prudential requirements to protect users.

7. Will the HKMA regulate unbacked crypto-assets?

The seventh discussion question is:

"Would the HKMA also have plan to regulate unbacked crypto-assets given their growing linkage with the mainstream financial system and risk to financial stability?"

The HKMA acknowledges the need for continued monitoring of the risks posed by unbacked crypto-assets and the possible need to regulate unbacked crypto-assets in the future. It also notes that certain activities in relation to unbacked crypto-assets will be covered by the new licensing regime for virtual asset service providers or VASPs to be implemented through amendments to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance. For details of the new licensing regime, please see Charltons' newsletter "[FSTB Concludes Consultation on Licensing Regime for Hong Kong Virtual Asset Exchanges](#)". The HKMA will continue to monitor the development of crypto-assets and will maintain dialogue with stakeholders in the Hong Kong Government, other financial regulators and international standard-setting bodies on the need to strengthen regulation of these assets as needed given international regulatory developments and the need to avoid regulatory arbitrage in these activities.

8. Responding to the HKMA Discussion Paper

The eighth question asks:

"For current or prospective parties and entities in the stablecoins ecosystem, what should they do before the HKMA's regulatory regime is introduced?"

The HKMA encourages those currently involved or considering involvement in stablecoin-related activities to submit their views on the Discussion Paper to the HKMA so that these can be taken into account in formulating the regulatory framework for payment-related stablecoins. The HKMA hopes to introduce the new framework no later than 2023/24. In the meantime, the HKMA will supervise AIs' activities in relation to crypto-assets and implement the SVF licensing regime according to its current supervisory powers and policies.

[1] HKMA "Discussion Paper on Crypto-assets and Stablecoins" (January 2022) at <https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2022/20220112e3a1.pdf>

[2] Discussion Paper at section 2.2

[3] Under section 2 of the Banking Ordinance (Cap. 155), an authorised institution means a bank, a restricted licence bank, or a deposit-taking company.

[4] HKMA. "Regulatory approaches to Authorized Institutions' interface with Virtual Assets and Virtual Asset Service Providers". (28 January 2022) at <https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2022/20220128e3.pdf>

[5] SFC. "Position paper: Regulation of virtual asset trading platforms" (6 November 2019) at <https://www.sfc.hk/-/media/EN/files/ER/PDF/20191106-Position-Paper-and-Appendix-1-to-Position-Paper-Eng.pdf>

[6] Charltons. "FSTB Concludes Consultation on Licensing Regime for Hong Kong Virtual Asset Exchanges" (May 2021) at <https://www.charltonslaw.com/fstb-concludes-consultation-on-licensing-regime-for-hong-kong-virtual-asset-exchanges/>

[7] Charltons. "FSTB Concludes Consultation on Licensing Regime for Hong Kong Virtual Asset Exchanges" (May 2021) at <https://www.charltonslaw.com/fstb-concludes-consultation-on-licensing-regime-for-hong-kong-virtual-asset-exchanges/>

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