RE: HKMA CONCLUSION OF DISCUSSION PAPER ON CRYPTO-ASSETS AND STABLECOINS

BACKGROUND & OVERVIEW

On 31 January 2023, the Hong Kong Monetary Authority ("**HKMA**") published the Conclusion of Discussion Paper on Crypto-Assets and Stablecoins (the "**Conclusion Paper**"), setting out its views and conclusions regarding the proposed regulation of activities relating to stablecoins in Hong Kong, taking into account feedback (including our submission) to its discussion paper on the subject released in January 2022 (the "**Discussion Paper**")[1], recent events in the virtual asset industry and global regulatory developments. In this Client Alert, we summarise the key messages of the Conclusion Paper and provide our observations on the HKMA's proposed framework of the stablecoin regulatory regime to be implemented in Hong Kong.

HKMA'S PROPOSES TO REGULATE STABLECOIN-RELATED ACTIVITIES

In the Conclusion Paper, the HKMA has confirmed its intention to introduce a mandatory licensing regime for the regulation of key activities relating to stablecoin arrangements in Hong Kong.[2] Whilst the precise details of the legislative proposals have yet to be determined, the Conclusion Paper provides important insights into the HKMA's views on the key aspects of the proposed stablecoin regulatory regime.

Scope of regulation

At the initial stage, the HKMA intends to give priority to the regulation of activities relating to stablecoin arrangements which *purport* to reference one or more fiat currencies (the "**In-Scope Stablecoin Arrangements**"), irrespective of the underlying stabilisation mechanism of the stablecoin (the "**In-Scope Stablecoin**"). The rationale is that such stablecoins are more likely to become widely accepted by the public as a means of payment, thus having greater linkages with the mainstream financial system. Nevertheless, the HKMA recognises that certain arrangements should be excluded from the scope of regulation, including arrangements which are already subject to another financial regulatory regime[3] and limited-purpose stablecoins circulated and used within a well-confined environment outside the reach of the general public.

Regulated activities

The activities proposed to be regulated (the "**Regulated Activities**") by the HKMA include the following:

(a) **Governance:** the establishment and maintenance of the rules governing an In-Scope Stablecoin Arrangement;

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[1] Discussion Paper on Crypto-assets and Stablecoins (12 January 2023), HKMA. The Discussion Paper was summarised and discussed in our Client Alert dated 17 January 2022.

[2] Although no definition of "stablecoin" is provided in the Conclusion Paper, the HKMA refers to the definition of the term adopted by the Financial Stability Board (the "**FSB**") and recognises that stablecoins could capture "a wide spectrum of crypto-asset structures that aim to maintain a stable value" (see para 1.3 of the Conclusion Paper).

[3] Such as the stored value facility ("**SVF**") licensing regime under the Payment Systems and Stored Value Facilities Ordinance (Chapter 584 of the Laws of Hong Kong) (the "**PSSVFO**") and the virtual asset service provider ("**VASP**") licensing regime under the recently passed Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Ordinance (the "**AMLO Amendment Ordinance**"). The treatment of tokenised deposits will also be considered by the HKMA given that deposit-taking activities are already regulated under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong (the "**BO**").

(b) **Issuance:** the issuance, creation and destruction of an In-Scope Stablecoin;

(c) **Stabilisation:** the stabilisation and management of the reserves backing an In-Scope Stablecoin Arrangement; and

(d) **Wallets:** the provision of wallets allowing users to store their cryptographic keys which enable access to and management of their holdings of In-Scope Stablecoins.

Thus, other activities such as the purchase or exchange of stablecoins with fiat currencies, provision of stablecoin lending services, the issuance of debit or credit cards denominated in crypto-assets and the operation of crypto-asset automatic teller machines or exchange shops will likely not be subject to the proposed stablecoin licensing regime at the initial stage.

Entities required to obtain a licence

Under the proposed stablecoin licensing regime, an entity will be required to obtain a licence from the HKMA if it:

(i) conducts a Regulated Activity in Hong Kong;

(ii) actively markets a Regulated Activity to the Hong Kong public; or

(iii) conducts a Regulated Activity in relation to a stablecoin arrangement which purports to reference the value of the Hong Kong dollar ("**HKD**").

In other words, an overseas entity which conducts a Regulated Activity outside Hong Kong but targets Hong Kong users <u>or</u> conducts a Regulated Activity relating to a HKD-linked stablecoin arrangement (with or without marketing to the Hong Kong public) will also be required to be licensed by the HKMA. Whilst the Conclusion Paper does not elaborate on the meaning of "actively markets", it is likely that, under the "same risk, same regulation" principle espoused by the Hong Kong financial regulators, a similar concept as that which applies to activities regulated under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) (the "**SFO**") will be adopted. In relation to the prohibition against active marketing of unlicensed investment products and services subject to regulation under the SFO,[4] the Securities and Futures Commission ("**SFC**") has explained that "actively markets" may include frequently calling on Hong Kong investors to market and offer to them such products and services as well as running a mass media programme or Internet activities targeting at the investing public in Hong Kong.[5] Therefore, if a similar interpretation is applied, an overseas stablecoin issuer or wallet provider which regularly conducts direct marketing to individuals in Hong Kong by such means as cold calls, emails or SMS messages or which runs a mass marketing campaign (including advertisements in local newspapers, television, public spaces, social media and other Internet-based marketing) aimed at the general public of Hong Kong will likely be caught under the proposed stablecoin licensing regime.

Key regulatory requirements

a. Comprehensive regulatory framework: The proposed stablecoin regulatory framework will cover a broad range of matters, including but not limited to ownership, governance and

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[4] See section 115 of the SFO.

[5] See the SFC's Frequently Asked Question titled '"Actively Markets" under section 115 of the SFO', available at https://www.sfc.hk/en/faqs/intermediaries/licensing/Actively-markets-under-section-115-of-the-SFO#9CAC2C2643CF41458CEDA9882E56E25B.

management, financial resources, risk management, anti-money laundering and counter-terrorist financing, user protection, auditing and disclosure, as well as management of concentration risks and conflicts of interest. However, in line with the risk-based approach, the standards and application of these requirements may differ amongst the different Regulated Activities as these will be covered by different licences.

b. Full backing and redemption at par: One key proposed requirement is that the value of the reserve assets of an In-Scope Stablecoin Arrangement should fully meet the value of the outstanding stablecoins (i.e. stablecoins in circulation) at all times. Additionally, the reserve assets should be of high quality and high liquidity, so that holders of the In-Scope Stablecoin should always be able to redeem the same at par within a reasonable period of time. Stablecoins which maintain their value by algorithmic or arbitrage mechanisms will likely not be accepted.

c. Principal business: The principal business of an entity regulated under the proposed stablecoin licensing regime should not deviate from the Regulated Activity for which it is licensed. For example, a licensed wallet operator should not provide lending services.

d. Place of incorporation: The HKMA has expressed its view that the imposition of a local incorporation requirement would be highly conducive to effective supervision and enforcement of the proposed stablecoin regulatory regime, particularly in relation to the segregation of assets and potential seizure of funds. However, the HKMA also indicates that it may be prepared to consider the alternative approach of allowing other risk mitigation measures in lieu of the local incorporation requirement.

Proposed timeline

The HKMA intends to implement the proposed stablecoin licensing regime by 2023/24. Further analysis and more detailed consultation will be conducted by the HKMA in due course with the aim of hammering out the key parameters to be covered by the draft legislation.

OUR OBSERVATIONS

We are happy to see that some of our comments on the Discussion Paper have been accepted by the HKMA as reflected in the Conclusion Paper, which provides much-awaited information about the proposed regulatory framework for stablecoin-related activities in Hong Kong. One interesting point of note is that, despite the focus of the Conclusion Paper being placed on stablecoins referencing the HKD, such HKD-linked stablecoins may be seen as competing with the central bank digital currency ("**CBDC**"), namely the e-HKD to be launched by the Hong Kong Government, and it remains questionable whether such stablcoins would be permitted.[6] As to the specific regulatory proposals contained in the Conclusion Paper itself, whilst it is essential to ensure the stability of a stablecoin arrangement and protect the interests of users, the requirement for 100% backing by reserve assets and the effective ban on any reliance on algorithm and arbitrage activities for value stabilisation may prove difficult for many existing and potential stablecoin issuers by severely limiting the sources of revenues available to issuers to sustain their businesses

[6] See "e-HKD: A Policy and Design Perspective" published by the HKMA dated 27 April 2022.

and thereby their available business models. The local incorporation requirement, if imposed, may also discourage foreign issuers and other stablecoin service providers to enter or to stay in the Hong Kong market due to operational complications and increased costs.

At the same time, it is uncertain how certain existing mainstream stablecoins (such as USDC, USDT, BUSD, DAI etc.) as well as wallet providers (whether providing hot or cold wallets, such as MetaMask, Trezor, Ledger etc.) would be treated under the proposed stablecoin regulatory regime, given that these stablecoins and digital wallets, which are issued or provided by foreign entities outside Hong Kong, have reached such global popularity and prominence that no further active marketing to the Hong Kong public may be necessary to promote their use in Hong Kong. Additionally, although the HKMA has stated in the Conclusion Paper that the exchange or trading of stablecoins with fiat currencies would not fall under the proposed regulatory regime, it remains to be clarified whether over-the-counter exchange providers would be allowed to continue to trade these stablecoins without any Hong Kong licence. Furthermore, if operators of any type of digital wallet (including both hot and cold wallets) allowing the storage and management of any amount of In-Scope Stablecoins (potentially including the above-mentioned stablecoins widely adopted by the Hong Kong public) are required to be licensed by the HKMA, many wallet operators may have little choice but to exclude such stablecoins from their services to Hong Kong users, which would impact the user-friendliness of stablecoins to Hong Kong users and would defeat the aim of "developing a vibrant sector and ecosystem for Virtual Assets" in Hong Kong as proclaimed in the statement of the Financial Services and the Treasury Bureau ("**FSTB**") released in October 2022.[7]

In view of the above uncertainties and concerns, it is hoped that further consultations and assessments to be conducted by the HKMA will assist the Hong Kong regulators in clarifying and making appropriate adjustments to the proposed regulatory regime to support financial innovation and the healthy development of the crypto-asset industry in Hong Kong.

Should you have any questions on the above, please do not hesitate to reach out to a member of us at hyu@lawoffice.com or at (+852) 2115-9525 to discuss further.

HENRY YU & ASSOCIATES
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Disclaimer: The information provided in this article is not intended to be, nor does it constitute, legal advice and is not a substitute for obtaining proper legal advice in respect of any specific issue.

[7] See "Policy Statement on Development of Virtual Assets in Hong Kong" published by the FSTB dated 31 October 2022.