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The HKMA sets out its plan to regulate stablecoins in consultation conclusions

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On January 31, 2023, the Hong Kong Monetary Authority published the conclusions to its earlier consultation on stablecoin regulations. The consultation conclusions set out the HKMA's high-level plans to create a mandatory licensing regime regulating certain financial activities relating to stablecoins. In this client update, we summarise the HKMA's proposed approach to regulating stablecoin-related activities and review other stablecoin-related regulations.

At the outset, it is important to note that this is a mandatory regime, and not an opt-in regime like that proposed in Singapore. Under the Singapore regime proposed by the Monetary Authority of Singapore (MAS), stablecoins that meet stablecoin-specific regulatory requirements will be allowed to refer to themselves as "regulated stablecoins", whilst those not meeting the requirements will still be allowed to operate, with related activities being regulated by the Digital Payment Token regime. In contrast, the HKMA's consultation conclusion to the discussion paper on crypto-assets and stablecoins ("Consultation Conclusions") proposed that all relevant activities relating to in-scope stablecoins falling within the jurisdictional reach of the proposed regime must obtain a licence.

1. In-scope stablecoins

To recap, stablecoins refer to crypto-assets that aim to maintain a stable value relative to a specified asset, or a pool or basket of assets, such as fiat currencies or commodities.

The HKMA will give priority to regulating stablecoins that purport to reference one or more fiat currencies ("in-scope stablecoin"), as these stablecoins are more likely to be used as means of payment or store of value, presenting more imminent monetary and financial stability risks than other types of stablecoins or crypto-assets.

A stablecoin that purports to reference fiat currencies through algorithms or arbitrage mechanisms (i.e. algorithmic stablecoins) will be in scope. However, as discussed below, algorithmic stablecoins are unlikely to meet the HKMA's licensing conditions.

Given the fast-moving nature of the industry, the proposed regulatory regime will be designed to allow appropriate flexibility to enable the HKMA to declare other stablecoin structures to be subject to regulation in the future. The HKMA has indicated that it may publish "guiding factors" which it would take into account in its determination.

The proposed definition of in-scope stablecoin is wide enough to capture a variety of assets, such as central bank digital currencies, certain closed loop limited purpose stablecoins, settlement tokens, and tokenized deposits. Further clarification is needed on whether these assets will be captured by the new regulatory regime. To that, the HKMA will conduct further analysis and consultations to identify if there should be any potential exclusions.

2. Jurisdictional reach of the proposed regulatory regime

The HKMA proposes that entities conducting any of the following activities will require a licence under the proposed regulatory regime:

1. conducting a regulated activity in Hong Kong concerning an in-scope stablecoin;
2. actively marketing such activities to the public of Hong Kong; or
3. conducting a stablecoin-related activity in which the stablecoin concerned purports to reference its value to the Hong Kong dollar, regardless of whether the relevant regulated activity is conducted in Hong Kong or actively marketed to the general public of Hong Kong; and
4. anything else that the HKMA considers should require licensing.

The first two and fourth categories are similar to the existing jurisdictional reach of the SFC under the Securities and Futures Ordinance. The third category is new, and specifically focused in Hong Kong dollar denominated stablecoins. The challenge may be enforcing against Hong Kong dollar denominated stablecoins operating overseas on a non-licensed basis. Typically, this requires cross-border co-operation, although it is possible that the HKMA will enforce effectively by a combination of adverse publicity and potentially barring access to the Hong Kong dollar clearing system, known as CHATS.

3. Local incorporation in Hong Kong for licences

The HKMA noted pushback on its proposal to require a local (Hong Kong) incorporated entity for licensing. However, importantly, the HKMA nevertheless is inclined to require local incorporation. Although it indicated, without any promises as to the outcome, that it will consider further whether different options, such as mitigation measures, could be adopted instead of local incorporation.

4. Regulated activities

The HKMA's key focus initially will be on regulating the following critical functions, with appropriate flexibility for the HKMA to include new types of regulated activities in the future:

- *Governance*: establishment and maintenance of the rules governing an in-scope stablecoin arrangement;
- *Issuance*: issuing, creating or destroying in-scope stablecoins;
- *Stabilisation*: stabilisation and reserve management arrangements of an in-scope stablecoin; and
- *Wallets*: provision of services that allow the storage of users' cryptographic keys which enable access to the users' holdings of an in-scope stablecoin and the management of such stablecoins.

Notably, the list of regulated activities in the Consultation Conclusions is wider than those intended for other non-stablecoin crypto-assets. The virtual asset service providers (VASP) regime to be supervised by the SFC (see here for our earlier coverage) only covers exchange activities for non-stablecoin crypto assets, at least initially. The regulation for wallets also appears to be broad enough to cover any blockchain wallet, provided that it allows the storage of in-scope stablecoins, even if they also allow storage of a variety of other crypto-assets.

The HKMA will adopt a ‘risk-based’ approach in forming the regulatory requirements, and is inclined to have different licences for different types of regulated activities instead of one type of licence covering various activities.

The HKMA has clarified that both authorised institutions (AI) under the Banking Ordinance and non-AIs should be allowed to issue stablecoins provided they can satisfy the relevant licensing and regulatory requirements.

Further, the HKMA has highlighted its concern over the concentration risks in the current crypto market, where multiple or bundled financial services are provided by the same entity or affiliated companies. This gives rise to user protection and conflict of interest risks. We expect the HKMA to issue more detailed guidance on how to manage the risks involved.

5. Key regulatory principles

Although the HKMA has not yet formulated exact and detailed regulatory requirements, it has set forth the following overarching elements for the proposed regulatory regime:

- *Comprehensive regulatory framework*: The regulatory requirements should cover a broad range of issues including but not limited to ownership, governance and management, financial resources requirements, risk management, anti-money laundering/counter-terrorist financing (AML/CFT), user protection, and regular audits and disclosure requirements.
- *Full backing and redemption at par*: The value of the reserve assets of a stablecoin arrangement should meet the value of the outstanding stablecoins at all times. The reserve assets should be of high quality and high liquidity. Stablecoin holders should be able to redeem the stablecoins into the referenced fiat currency at par within a reasonable period. We expect this to include requirements such as capitalisation, minimum reserve, segregation of assets, quality and liquidity of reserve assets, and auditing, similar to those proposed by the MAS.
- *Principal business restriction*: The regulated entities should not conduct activities that deviate from its principal business as permitted under their relevant licence. For example, wallet operators should not engage in lending activities. This is comparable to the current requirements under the Stored Value Facilities (SVF) regime.

The requirements for full backing and redemption at par effectively means that algorithmic stablecoins that derive their value based on arbitrage or algorithm will not be accepted.

6. The regulatory position on non-stablecoin crypto assets

In the Discussion Paper, the HKMA invited responses on whether it should regulate other, non-stablecoin, crypto assets (i.e. “unbacked crypto-assets”), given their growing linkage with the mainstream financial system and risk to financial stability. Considering that responses on this point are varied, and in line with global regulatory trends, the HKMA has decided to put on hold any plans to regulate unbacked crypto-assets for the time being, and to instead focus on the regulation on stablecoins. However, as further discussed in section 8 below, unbacked crypto-assets may be subject to other laws and regulations in Hong Kong. They may also constitute “securities” and be regulated under the Securities and Futures Ordinance.

7. Timeline and next steps

The HKMA has indicated that it will work to put in place the proposed regulatory regime by 2023/24. A more detailed consultation, with more granular information about the proposed regulatory regime, will be conducted by the HKMA in the future. This more detailed consultation will cover, among other things, whether to introduce new legislation or amend existing laws to implement the proposed regulatory regime, and a final position on the local incorporation requirement and possible different options.

8. Interactions with other regulatory regimes

Apart from the regulatory regime to be introduced, stablecoins may be subject to other laws and regulations in Hong Kong, some existing, some to be introduced. For example, the HKMA has expressed in the Discussion Paper that stablecoins may fall under the definition of SVF and its issuer required to be licensed under the Payment Systems and Stored Value Facilities Ordinance.

Further, depending on the operating mechanism, purchase and redemption of stablecoins may involve regulated Money Service Operator activities. Exchanges allowing the trading of stablecoins will also be regulated by the VASP regime supervised by the SFC to commence in June 2023.

Conclusion

The recent crash of algorithmic stablecoins has again brought the regulation of stablecoins to the forefront of financial regulations. As the HKMA stated in the Consultation Conclusions, most industry participants now support some form of regulations for stablecoins. Other leading jurisdictions like the United Kingdom and Singapore have also been mulling new stablecoin regulations.

These Consultation Conclusions represent a positive move, and is a logical next step to the Hong Kong government's policy statement on supporting the digital assets industry released as part of Hong Kong's Fintech week (see here for our earlier coverage) in October 2022. However, these Consultation Conclusions only set out high-level directions. More work has to be done, and in a very focused manner, on proposing and implementing a sensible regulatory regime by sometime in 2023 / 2024.

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