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Another Step Towards the Regulation of Cryptocurrency in Hong Kong: HKMA Releases Discussion Paper on Stablecoins

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Introduction

On 12 January 2022, the Hong Kong Monetary Authority (**HKMA**) released a Discussion Paper on the expansion of the Hong Kong regulatory framework to stablecoins (e.g. crypto-assets pegged to fiat currencies). The Paper considers the adequacy of the existing regulatory framework in light of the growing use of stablecoins and other types of crypto-assets in financial markets, and the challenges posed by this increase in their prevalence. It further poses eight questions for consideration by the industry, including the scope of a proposed new regulatory regime to cover what the HKMA describes as "payment-related stablecoins".

This client alert provides an overview of the HKMA's views on crypto-assets and stablecoins as outlined in the Paper, discusses the implications for players in the stablecoin ecosystem if the proposed changes are implemented, and suggested next steps for interested parties.

The HKMA has requested responses to the Paper by 31 March 2022, and has indicated that it intends to introduce this new stablecoin regulatory regime by 2023-2024.

HKMA's views on crypto-assets and financial stability

The Paper provides a valuable insight into the HKMA's views on crypto-assets in general, and stablecoins in particular, including their linkages to the traditional financial system and ramifications on financial stability.

In introducing its proposal to regulate payment related stablecoins, the HKMA has made it clear that while the current size and trading activity of crypto-assets globally may not pose an immediate threat to the stability of the global financial system from a systemic point of view, it does consider the increasing prevalence of crypto-assets to have the potential to impact financial stability. In particular, the HKMA has flagged that it considers the growing exposure of institutional investors, as well as certain segments of the retail public, to such assets as an alternative to, or to complement traditional asset classes, indicates growing interconnectedness with the mainstream financial system.

Further, as noted by the HKMA, it understands that while Hong Kong authorised banks (**Authorised Institutions** or **AIs**) currently undertake only limited activities in relation to crypto-assets, AIs are interested in pursuing these activities further, given that they face increasing demand from customers for crypto-related products and services. This is consistent with what we understand is a steady increase in high net wealth investors

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hungry for yield demanding access to crypto-assets through their private wealth managers, as well as an uptick in demand from retail investors in Hong Kong eager for the same exposure to upside. To this end, the HKMA has flagged that it will soon provide AIs with more detailed regulatory guidance in relation to their interface with and provision of services to customers in relation to crypto-assets.

Finally, the HKMA has also noted its concerns that the ease of anonymous transfer of crypto-assets may make them susceptible to the risk of illicit and money laundering / terrorist financing activities.

The HKMA's views on stablecoins

The Paper also flags the HKMA's view that stablecoins are increasingly viewed as a '*widely acceptable means of payment*' and that this, alongside the actual increase in their use, has increased the potential for their incorporation into the mainstream financial system. In the HKMA's opinion, this in turn raises broader monetary and financial stability implications and has resulted in the regulation of stablecoins becoming a key priority for the HKMA, which has stated in the Paper that it wishes to ensure that such coins "*are appropriately regulated before they operate in Hong Kong or are marketed to the public of Hong Kong*".

The Paper goes on to identify a number of potential risks that may arise in relation to the use of stablecoins, including, in summary:

- Payment integrity risks where stablecoins are commonly accepted as a means of payment and operational disruptions or failures occur in relation to the stablecoins;
- Banking stability risks if banks were to increase their exposure to stablecoins, particularly if stablecoins were viewed as a substitute for bank deposits;
- Monetary policy risks in relation to the issue and redemption of HKD-backed stablecoins, which could affect interbank HKD demand and supply; and
- User protection risks where a user may have no or limited recourse in relation to operational disruptions or failures of a stablecoin.

Given these potential risks, the HKMA has stated in the Paper that it considers it appropriate to expand the regulatory perimeter to cover payment-related stablecoins in the first instance, although it has not ruled out the possibility of regulating other forms of stablecoins as well.

The HKMA's discussion questions for industry consideration

The HKMA has noted in the Paper that it considers '*the need to regulate* [stablecoins] *is well justified and the tool to regulate...*[can] *be decided at a later stage*'. However, it has indicated that it wishes for feedback from the industry and the public on the scope of the regulatory regime applicable to stablecoins, and to this end has set out eight discussion questions for industry consideration. A summary of the key questions posed by the HKMA, as well as the HKMA's views on those questions, is set out below.

Question 1: *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?*

In posing this question, the HKMA has noted that it intends to take a risk-based approach focused initially on payment-related stablecoins at this stage given their predominance in the market and higher potential to be incorporated into the mainstream financial market (as discussed above). However, the HKMA has noted that it intends to ensure that whatever regime is introduced is sufficiently flexible that it could extend to other types of stablecoins in the future. As such, issuers and traders of other types of stablecoins should

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not expect to avoid regulatory scrutiny forever.

Question 2: *What types of stablecoin-related activities should fall under the regulatory ambit, e.g. issuance and redemption, custody and administration, reserves management?*

The HKMA has proposed regulating a broad range of stablecoin-related activities, including:

- Issuing, creating or destroying stablecoins;
- Managing reserve assets to ensure stabilisation of stablecoin value;
- Validating transactions and records;
- Storing private keys used to provide access to stablecoins;
- Facilitating the redemption of stablecoins;
- Transmission of funds to settle transactions; and
- Executing transactions in stablecoins.

This broad list is based on a list of activities in relation to stablecoins published by the Financial Stability Board[1] and as such may be viewed as in keeping with international standards. However, as discussed below in relation to Question 5, the breadth of this regime may raise concerns regarding the degree of overlap between this regime and others proposed by Hong Kong regulators, including the proposed VASP regime to be administered by the Securities and Futures Commission (**SFC**) (see our alert here).

Question 3: *What kind of authorisation and regulatory requirements would be envisaged for those entities subject to the new licensing regime?*

The HMKA has suggested that it considers that entities subject to the new stablecoin licensing regime would be subject to the following requirements:

- authorisation and prudential requirements, including adequate financial resources and liquidity requirements;
- fit and proper requirements in relation to both management and ownership;
- requirements relating to the maintenance and management of reserves of backing assets; and systems; and
- controls, governance and risk management requirements.

Further, given that it is common for multiple entities to be involved in different parts of a stablecoin arrangement, the HKMA has noted that such entities could be subject to part or all of the requirements, depending on the services they offer.

If requirements in relation to these matters are ultimately implemented by the HKMA, the stablecoin regime would cover some of the requirements of the proposed VASP regime, with the exception of requirements of reserves of backing assets, which will presumably only be applied to stablecoins given their nature.

Question 4: *What is the intended coverage as to who needs a licence under the intended regulatory regime?*

The HKMA has signalled that it believes that only entities incorporated in Hong Kong and holding a relevant licence granted by HKMA should carry out regulated activities, to enable the HKMA to exercise effective regulation on the relevant entities. As such, it has stated in the Paper that it expects that foreign companies / groups which intend to provide regulated activities in Hong Kong or actively market those activities in Hong Kong to incorporate a company in Hong Kong and apply for a licence to the HKMA under this regime.

If implemented, this would have significant ramifications for those global crypto-exchanges currently offering trading in stablecoins to Hong Kong users from offshore. These

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businesses would be faced with a choice between either incorporating in Hong Kong and seeking a licence, or discontinuing their trading for Hong Kong users.

Question 5: *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?*

The HKMA has stated that it will collaborate and coordinate with other financial regulators when defining the scope of its oversight and will seek to avoid regulatory arbitrage, including in relation to areas which '*may be subject to regulation by more than one local financial authority*'.

However, an HKMA-administered regime of the breadth proposed above would create a situation in which an exchange undertaking transactions in non-stablecoin crypto-assets would be regulated by the SFC under its proposed new VASP regime while being regulated by both the SFC and the HKMA under its stablecoin regime. In this respect, we note that the proposed definition of '*virtual asset*' under the proposed new VASP regime '*applies equally to virtual coins that are stable (i.e. the so-called "stablecoins")*'.[2] While the HKMA and SFC share regulatory responsibility for Registered Institutions (i.e. Authorised Institutions which are separately licensed by the SFC to undertake securities and futures business), that shared regulatory responsibility concerns distinctly different types of activities. In contrast, we consider that from an exchange's perspective, the act of executing transactions in stablecoins is substantially similar to executing transactions in non-stablecoin crypto-assets. As such, this approach may lead to unnecessary and undesirable regulatory inefficiencies if exchanges are required to be licensed under both the SFC and HKMA regimes to undertake transactions in crypto-assets.

Question 6: *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?*

While not expressly stating that it will not require stablecoin issuers to be regulated as AIs under the Banking Ordinance, the HKMA has indicated that it expects that the requirements applicable to stablecoin issuers will instead borrow from Hong Kong's current regulatory framework for stored value facilities (**SVF**). However, the HKMA has signalled that certain stablecoin issuers may be subject to higher prudential requirements than SVF issuers where they issue stablecoins of systemic importance.

Question 7*: [Does] the HKMA also have plan[s] to regulate unbacked crypto-assets given their growing linkage with the mainstream financial system and risk to financial stability?*

The HKMA has not expressly ruled out regulating unbacked crypto-assets, and has stated that it is necessary to continue monitoring the risks posed by this asset class. In stating this, the HKMA has also pointed to the VASP regime, suggesting that the HKMA's approach to this area is likely to depend on the success of that regime once implemented.

Question 8: *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 has advised current and prospective players in the stablecoin ecosystem to provide feedback on the proposals set out in the Discussion Paper, and has noted that in the interim, it will continue to supervise AIs' activities in relation to crypto-assets and implement the SVF licensing regime pending implementation of this new regime.

Conclusion

The Discussion Paper provides a valuable insight into the HKMA's plans for the future of stablecoin regulation in Hong Kong. While some concerns exist as to the potential overlap between the HKMA's new proposed regime and the SFC's VASP regime, it is clear that the HKMA intends to ensure that it is regarded as the primary regulator of stablecoins going forward, and that it sees the regulation of this asset class as closely linked to its key

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objective of ensuring financial stability.

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[1] See Financial Stability Board, *Regulation, Supervision and Oversight of “Global Stablecoin” Arrangements: Final Report and High-Level Recommendations*, https://www.fsb.org/wp-content/uploads/P131020-3.pdf, page 10.

[2] See Financial Services and the Treasury Bureau, *Public Consultation on Legislative Proposals to Enhance Anti-Money Laundering and Counter-Terrorist Financing Regulation in Hong Kong (Consultation Conclusions)*, https://www.fstb.gov.hk/fsb/en/publication/consult/doc/consult_conclu_amlo_e.pdf, paragraph 2.8.

Gibson Dunn’s lawyers are available to assist in addressing any questions you may have regarding these developments. If you wish to discuss any of the matters set out above, please contact any member of Gibson Dunn's Crypto Taskforce (cryptotaskforce@gibsondunn.com) or the Global Financial Regulatory team, including the following authors in Hong Kong:

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