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Hong Kong Monetary Authority Introduces Plans To Regulate Stablecoins

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In January 2022, the Hong Kong Monetary Authority ("**HKMA**") issued a discussion paper inviting feedback on the regulatory approach towards crypto-assets and stablecoins ("**Discussion Paper**").[1] We previously published an alert on this topic.[2] Following a feedback period that ended on 31 March 2022, on 31 January 2023, the HKMA issued its '*Conclusions of the Discussion Paper on Crypto-assets and Stablecoins*' ("**Consultation Conclusions**"), which proposes the introduction of a stablecoin licensing regime.[3]

Recent events in the crypto market have highlighted the vulnerabilities of the crypto ecosystem, in particular, failures concerning the governance, stabilisation mechanisms, and transparency of crypto service providers. As a response to such failings, the HKMA's proposals mirror international efforts to regulate stablecoin-related activities; for example, in October 2022, the Monetary Authority of Singapore proposed measures to regulate the issuance of stablecoins.[4]

Under the HKMA's proposed licensing plans, the HKMA will give priority to regulating stablecoins that purport to reference one or more fiat currencies, irrespective of the intended use or underlying stabilisation mechanism of that stablecoin ("**In-Scope Stablecoins**"). This means that, in theory, stablecoins that reference fiat currencies through algorithms or arbitrage mechanisms fall under the scope of the HKMA's proposals. However, for reasons explained in Section I below, such stablecoins are, in practice unlikely to meet the HKMA's requirements for regulation and as such will most likely continue to be unregulated in the near term. That said, the HKMA has left the door open to expand its regime to allow for future regulation of other types of stablecoin structures.

To preserve flexibility in its regulatory scope, the HKMA will publish "guiding factors" in the future, setting out the factors the HKMA could have regard to in considering whether a particular structure should be declared as stablecoin subject to the HKMA's regulatory oversight.

I. Key Features of the Proposed Stablecoin Licensing Regime

The HKMA's proposals follow a risk-based "same risk, same regulation" approach. Rather than introducing a single type of license, the HKMA envisages introducing different licenses targeting different regulated activities. While the HKMA is still formulating the details to its requirements, the table below sets forth a summary of the proposed regulatory parameters of the proposed licensing regime:

Key activities to be regulated	The HKMA proposes to regulate the following critical functions: • ***Governance***: establishment and maintenance of the rules governing an In-Scope Stablecoin arrangement; • ***Issuance***: issuance, creation or destruction of In-Scope Stablecoins; • ***Stabilisation***: stabilisation and reserve management arrangements of an In-Scope Stablecoin,

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	regardless of whether such arrangements are provided by the issuer; and • ***Wallets***: provision of services that allow the storage of users' cryptographic keys, access to the users' In-Scope Stablecoin holdings and the management of such stablecoins.
Entities that will require a licence	Entities that are involved in the following activities will require a licence under the proposed licensing regime: • Conducting a regulated activity concerning an In-Scope Stablecoin; • Actively marketing a regulated activity to the public of Hong Kong; or • Taking into account matters of significant public interest, the HKMA is of the opinion that the entity should be regulated. Special attention should be paid to regulated activities concerning a stablecoin that purports to reference its value to the Hong Kong dollar ("**HKD-backed Stablecoin**"). Entities dealing with HKD-backed Stablecoins will be required to apply for a licence and abide by regulatory requirements under the proposed licensing regime, irrespective of whether that the regulated activity is carried out in Hong Kong or actively marketed to the Hong Kong public. One of the suggestions made by the HKMA under the Discussion Paper is to impose a local incorporation requirement as one of the authorisation conditions. The HKMA's reasoning is that a local incorporation requirement will enable effective supervision over licensed entities, and, where necessary, facilitate seizure of assets to protect users in the event of business failures. Feedback received from the consultation show mixed views towards this suggestion. In light of this, the HKMA has decided to evaluate the alternative suggestions raised by the respondents (for example, imposing the local incorporation requirement only on entities engaging in critical activities in a stablecoin arrangement, such as the management of reserve assets for stabilisation of the stablecoin's value), and determine whether to go ahead with the local incorporation requirement. The HKMA has also clarified that both Hong Kong authorised banks ("**Authorised Institutions**" or "**AI**") and non-Authorised Institutions ("**non-AI**") are eligible to apply for a licence to issue stablecoins. This direction is in line with international standards and will be beneficial to the competitiveness of Hong Kong's crypto business environment. To ensure the fitness and properness of stablecoin issuers, the HKMA will calibrate the final regulatory requirements applicable to AI and non-AI based on the risks that each type of issuers present to the financial system. While it is acknowledged that AIs are already under stringent regulatory requirements compared to non-AIs, it remains to be seen whether requirements applicable to AI and non-AI stablecoin issuers will be similar or not.
Key regulatory principles	Although the HKMA has not released the details of its regulatory requirements in relation to each regulated activity, the HKMA has published some overarching guidelines which it considers to be the crucial elements of the proposed licensing regime: • ***Comprehensive regulatory framework***: the regulatory requirements will cover a broad range of issues, such as 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 will have to meet the value of the outstanding stablecoins at all times, and the reserve assets need to be of high quality and high liquidity, such that stablecoin holders should be able to redeem the stablecoins into the referenced fiat currency at par within a reasonable period; • ***Principal business restriction***: regulated entities should not conduct activities that deviate from their principal business as permitted under their relevant licence (for example, a wallet operator should not engage in lending activities). The significance of the requirement for a stablecoin arrangement to be asset-backed, effectively means

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	that stablecoins which derive their value based on arbitrage or algorithms are unlikely to be accepted under the proposed licensing regime. In other words, although such stablecoins qualify as In-Scope Stablecoins, the HKMA is unlikely to grant a licence for entities providing these stablecoin arrangements. Further, the HKMA has specifically highlighted an on-going concern over the concentration risks in the current crypto market – e.g. where multiple or bundled financial services are provided by the same entity or affiliated companies. This give rise to user protection and conflict of interest risks. While the HKMA is still exploring regulatory options to address this vulnerability at this juncture, this area is expected to become a core regulatory focus in the near future.

The HKMA stresses that it envisages a flexible approach which allows the HKMA to "scope in" regulated activities and entities not strictly captured above under the licensing regime. Therefore, the proposals above should be seen as a visualization of the initial phase of the licensing regime. The HKMA has stated that it will be publishing assessment criteria and guiding principles to support its flexible approach. As such, if unregulated stablecoin related activities and/or unlicensed entities prove to be pose a greater and more imminent threat to Hong Kong's financial and monetary stability than currently anticipated, the HKMA is open to expanding the licensing regime to cover these activities and entities.

II. The Regulatory Position on Unbacked Crypto-Assets

In the Discussion Paper, the HKMA invited responses on whether it should regulate 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 regulated unbacked crypto-assets for the time being, and to instead focus on the regulation on stablecoins. That said, the HKMA will continue to monitor the risks posed by unbacked crypto-assets to Hong Kong's monetary and financial stability.

III. Next Steps in the Stablecoin Regulations Roadmap

The HKMA aims to put in place the stablecoin regulatory regime by 2023/24. This timeline takes into account the need to align Hong Kong's local regulatory regime with international recommendations and standards, which are expected to be released over the next one to two years.[5] In view of the cross-border nature of stablecoins, the HKMA has suggested possible cooperation and coordination among relevant financial regulators .

The proposed timeline will allow the HKMA to consider how the stablecoin licensing regime can fit into the broader virtual assets regulatory framework in Hong Kong and in particular, the licensing regime for virtual asset service providers ("**VASPs**") administered by the Securities and Futures Commission ("**SFC**"). The SFC's licensing regime for VASPs will come into effect on 1 June 2023. Please refer to our client alert on the particulars of the SFC's licensing regime.[6]

It appears likely that the stablecoin regulations will be introduced either in the form of an amendment to the Payment Systems and Stored Value Facilities Ordinance or as new, standalone legislation. The HKMA has not committed to a transitional period in its Consultation Conclusions. However, in light of the substantial number of responses seeking a transitional period to provide sufficient time for existing service providers to make necessary adjustments to their internal policies, procedures and controls to comply with new regulations, it is possible that the HKMA may consider including a transitional period in the future.

In conclusion, the HKMA's proposals represent a significant first step towards stablecoin regulation in Hong Kong. It is expected that the HKMA will be conducting further consultations to map out the particulars of the regulations. We will continue to closely monitoring this space and will provide further updates on future developments.

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[1] "Discussion Paper on Crypto-assets and Stablecoins", published by the Hong Kong Monetary Authority (12 January 2022), available at https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2022/20220112e3a1.pdf.

[2] "Another Step Towards the Regulation of Cryptocurrency in Hong Kong: HKMA Releases Discussion Paper on Stablecoins", published by Gibson, Dunn & Crutcher (19 September 2022), available at https://www.gibsondunn.com/another-step-towards-the-regulation-of-cryptocurrency-in-hong-kong-hkma-releases-discussion-paper-on-stablecoins/.

[3] "Conclusion of Discussion Paper on Crypto-assets and Stablecoins", published by the Hong Kong Monetary Authority (31 January 2022), available at https://www.hkma.gov.hk/media/chi/doc/key-information/press-release/2023/20230131e9a1.pdf.

[4] "MAS Proposes Measures to Reduce Risks to Consumers From Cryptocurrency Trading and Enhance Standards of Stablecoin-related Activities", published by the Monetary Authority of Singapore (26 October 2022), available at https://www.mas.gov.sg/news/media-releases/2022/mas-proposes-measures-to-reduce-risks-to-consumers-from-cryptocurrency-trading-and-enhance-standards-of-stablecoin-related-activities.

[5] In particular, the Financial Stability Board published a proposed framework for international regulation of crypto-asset activities in October 2022, and has aimed to finalise the updated high-level recommendations by July 2023, with a view to implement the revised recommendations by end-2025.

[6] "Hong Kong Introduces Licensing Regime for Virtual Asset Service Providers", Gibson, Dunn & Crutcher (30 June 2022), available at https://www.gibsondunn.com/hong-kong-introduces-licensing-regime-for-virtual-asset-services-providers/; "Hong Kong Licensing Regime for Virtual Asset Service Providers Passed with Three-Month Delay to Implementation Timelines", Gibson, Dunn & Crutcher (8 December 2022), available at https://www.gibsondunn.com/hong-kong-licensing-regime-for-virtual-asset-service-providers-passed-with-three-month-delay-to-implementation-timelines/.

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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 Digital Asset Taskforce or the Global Financial Regulatory team, including the following authors in Hong Kong:

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