

RE: HKMA DISCUSSION PAPER ON CRYPTO-ASSETS AND STABLECOINS

WHAT YOU NEED TO KNOW – BACKGROUND & OVERVIEW

On 12 January 2022, Hong Kong Monetary Authority (“HKMA”) published the Discussion Paper on Crypto-assets and Stablecoins (the “**Stablecoin Discussion Paper**”) and seeks market feedback on HKMA’s thoughts on expanding the regulatory framework in relation to stablecoins, especially those activities related to payment-related stablecoins. The HKMA is inviting public responses to the discussion questions and the HKMA’s views on those questions until 31 March 2022.

What is Stablecoin?

Stablecoin is considered as a sub-set of crypto-assets. While there is no clear definition of crypto-assets, crypto-asset has been referred to “a type of private digital asset that depends primarily on cryptography and distributed ledger or similar technology” according to the Financial Stability Board.¹

Stablecoins can briefly be separated into two groups: asset-backed stablecoins and algorithm-based stablecoins. For the purpose of this Stablecoin Discussion Paper, the HKMA plans to focus on asset-backed stablecoins at this stage, because (i) existing stablecoins are mostly asset-backed stablecoins and predominantly pegged to the U.S. dollar; (ii) asset-backed stablecoins are more common in the market than algorithm-based stablecoins, thus asset-backed stablecoins have a higher potential to be a widely acceptable means of payment and to be brought into the mainstream financial system. It is estimated that the global market capitalisation of major stablecoins is about US\$ 150 billion in December 2021, representing around 5%² of the overall crypto-asset market.

Asset-backed stablecoin is perceived to be a relatively stable crypto-asset because it is backed by and linked to certain assets, e.g. fiat currencies (U.S. dollars), gold, or securities. Because of this feature, stablecoins can potentially become a widely acceptable medium of exchange for payment, i.e. “payment-related stablecoins”, which will bring broader monetary and financial implications. As such, the HKMA considers there is a need to regulate the payment-related stablecoins appropriately before they operate in Hong Kong or are marketed to the public of Hong Kong.³

HKMA’s view on stablecoin

Based on the current Payment Systems and Stored Value Facilities Ordinance (“**PSSVFO**”), the definition of Stored Value Facility (“**SVF**”) is a facility issuer that (i) takes stored value; and (ii) gives undertaking that it will or procure others to meet person-to-merchant (“**P2M**”) or person-to-person (“**P2P**”) payments up to the amount of the stored value (the “**Undertaking**”). A SVF is required to obtain a licence from the HKMA in order to operate in Hong Kong. Despite a

¹ See Pg. 5 of the Stablecoin Discussion Paper

² Source : CoinMarketCap at <https://coinmarketcap.com/>.

³ See Pg. 3 of the Stablecoin Discussion Paper

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stablecoin arrangement operates in the similar manner as the SVFs, certain stablecoin arrangements usually involve multiple entities (rather than single entity) to fulfil the two functions above and, therefore, may not be able to be covered by the PSSVFO at the moment.

The HKMA plans to adopt a risk-based approach with a focus on activities related to payment-related stablecoins at this stage.⁴ It proposes to either expand the scope of the PSSVFO or simply introduce a new legislation to regulate the following activities relating to stablecoins (the “Proposed Regulated Activities”):⁵

- (i) the activity of the issuer minting and burning of stablecoins
- (ii) the activity of managing the reserve assets that are backing the value of the stablecoins and providing custody/trust for these assets
- (iii) the activity of authorising or verifying the validity of transactions and records
- (iv) the activity of safe-keeping of private keys used to digitally sign transaction instructions on behalf of stablecoin holders
- (v) the activity of facilitating the stablecoin holders to redeem stablecoins for fiat currencies or other assets
- (vi) the activity of ensuring the correct and final settlement of transactions to minimise default risk of counterparties
- (vii) the activity of conducting transactions on behalf of others

The above Proposed Regulated Activities are not exhaustive. Flexibility will be put in place to provide rooms for adjustments if such needs arise in the future. It is expected that the Proposed Regulated Activities shall be conducted by an entity incorporated in Hong Kong with relevant licences granted by the HKMA.⁶ Merely a Hong Kong branch or office of a foreign corporation is not sufficient to fulfil the requirement of “an entity incorporated in Hong Kong”. As usually more than one entity will be involved in a stablecoin arrangement, multiple entities involved in a stablecoin arrangement should seek authorisation from the HKMA.

To obtain authorisation from the HKMA, high-level regulatory requirements will be applied. Higher capital and liquidity requirements will be imposed to protect the users under the stablecoin arrangement. The precise regulatory regime will likely draw reference from the current approach to the SVF based on the PSSVFO to avoid any potential legal arbitrage.⁷

Further details on specific aspects of this regulatory framework will be issued by the HKMA in 2022/23, so that the new regime can commence no later than 2023/24.⁸ In the meantime, the HKMA will, together with the Securities and Futures Commission of Hong Kong, provide guidance to authorised institutions (the “AIs”) e.g. banks from time to time on the provision of intermediary services to customers related to crypto-assets.⁹

⁴ See HKMA’s views on Q.1 in Pg. 25 of the Stablecoin Discussion Paper

⁵ See HKMA’s views on Q.2 in Pg. 26 of the Stablecoin Discussion Paper

⁶ See HKMA’s views on Q.4 in Pg. 28 of the Stablecoin Discussion Paper

⁷ See HKMA’s views on Q.6 in Pg. 29 of the Stablecoin Discussion Paper

⁸ See HKMA’s views on Q.5 in Pg. 28 and Q.8 in 30 of the Stablecoin Discussion Paper

⁹ See HKMA’s views on Q.7 in Pg. 29 of the Stablecoin Discussion Paper

OUR OBSERVATIONS

Under the current PSSVFO, there is a concept of “facilitator”¹⁰ which covers any person who provides value to a SVF Issuer which determines the extent to which the SVF Issuer could provide its customers with electronic value. An example can be seen in the Mondex Scheme¹¹ which is no longer in operation now. The concept of “facilitator” is very similar to the stablecoins and, based on our understanding, applications have been made in the past for such “facilitator” licence to operate stablecoins in Hong Kong, but so far the HKMA has been reluctant in granting the “facilitator” licence for the purpose of issuing stablecoins.

Thus, no matter which approach the HKMA ultimately decides to take, it remains to be seen whether the HKMA is willing to grant authorisations to private entities to issue stablecoins in Hong Kong, given that (i) it will likely be in direct competition with the e-HKD which has been researched by the HKMA since 2017;¹² and (ii) China has adopted a restrictive approach by totally banning all virtual currency-related activities regardless it is in China or to any Chinese residents via internet.

We intend to make a submission in response to the Stablecoin Discussion Paper. Please do get in touch with our members at hyu@lylawoffice.com or at (+852) 2115-9525 if you have any view on the above or would like to further discuss any of the issues raised in this client alert or the Stablecoin Discussion Paper more generally.

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¹⁰ According to section 2B of PSSVFO, a “facilitator” is a person who facilitates the issue of SVF by providing the SVF issuer with valuable consideration the value of which determines, in whole or in part, the extent to which the SVF Issuer may give an Undertaking.

¹¹ Under the Mondex Scheme (which is not in operation now), Mondex was the originator of Mondex values which were sold to Mondex member banks for onward selling to retail customers; Mondex values would be issued and backed by the fund received by Mondex through or via its member banks. Any Mondex values issued were stored in Mondex cards which could be used by retail consumers to pay the merchants for goods and services. The merchants could redeem Mondex value in cash from the member banks. The member banks could then redeem the Mondex value for funds from Mondex. Mondex therefore was within the definition of “facilitator” as it facilitated the issue of Mondex cards (which were issued and distributed by the member banks) by creating the electronic value (Mondex value) contained in the Mondex card in the first place.

¹² See HKMA’s technical whitepaper on retail central bank digital currency, titled “e-HKD: A technical perspective” dated 4 October 2021