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Discussion paper

**Legislative Council Subcommittee on Issues Relating to the
Development of Web3 and Virtual Assets**

Proposed Regulatory Regime for Stablecoin Issuers

Introduction

This paper briefs Members of the Subcommittee on the proposed regulatory regime for stablecoin issuers and the outcome of the public consultation, as well as the latest developments with regard to the stablecoin issuer sandbox.

Background

2. The Government issued the Policy Statement on Development of Virtual Assets (“VA”) in Hong Kong in October 2022, setting out the commitment to enhancing the VA regulatory framework under the principle of “same activity, same risks, same regulation”. In this regard, the Government has amended the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) to introduce a licensing regime for VA service providers, ensuring that VA trading platforms (“VATPs”) comply with relevant international requirements on anti-money laundering and counter-terrorist financing (“AML/CFT”) while protecting investors. The licensing regime commenced operation in June 2023¹.

3. Following the implementation of the licensing regime for VATPs, the Government and regulators will continue to enhance the regulatory framework for VA activities. In particular, in view of the important roles played by stablecoins in the Web3 and VA ecosystem, and the rising interconnectedness between the traditional financial system and

¹ A one-year transitional arrangement which ended on 31 May 2024, was put in place as part of the licensing regime.

the VA market, the Government considers it necessary to introduce a regulatory regime for fiat-referenced stablecoin (“FRS”) issuers to regulate them under a risk-based and agile approach. The formulation of a robust and fit-for-purpose regulatory regime may also create a facilitating environment for the sustainable and responsible development of the stablecoin ecosystem and related sectors, thereby enhancing efficiency of financial activities and facilitating innovation in the industry.

4. The Financial Services and the Treasury Bureau (“FSTB”) and the Hong Kong Monetary Authority (“HKMA”) jointly published a public consultation paper in December 2023, inviting feedback on the legislative proposal to implement the regulatory regime for stablecoin issuers. The consultation conclusions were published this month. In addition, the HKMA launched the stablecoin issuer sandbox in March this year, and will announce the first batch of participants as and when appropriate.

Proposed regulatory regime

Policy objectives

5. The key considerations from a regulatory standpoint concern the apparent and rising interconnectedness between the traditional financial system and the VA market, and the potential risks on monetary and financial stability as well as user protection. In this context, FRS could become a channel through which risks could spill over from the VA sector to the traditional financial system (and vice versa), potentially impacting daily commercial, financial and economic activities.

6. In view of the above, the major policy objectives of the proposed regulatory regime are as follows:

- (a) to address potential monetary and financial stability risks posed by FRS;
- (b) to provide adequate protection to FRS users;

- (c) to maintain Hong Kong’s status as an international financial centre by putting in place an appropriate regulatory regime for FRS issuers that is in line with international regulatory recommendations; and
- (d) to foster the sustainable and responsible development of the VA ecosystem in Hong Kong by providing legal and regulatory clarity.

Regulatory scope

7. We propose bringing FRS issuers within the regulatory remit². Under the proposed regulatory regime, issuers that conduct any of the following activities are required to obtain a licence:

- (a) issuing FRS in Hong Kong;
- (b) issuing a Hong Kong dollar-referenced stablecoin; and
- (c) actively marketing their issuance of FRS to the public of Hong Kong.

Regulatory requirements

8. To protect users and address the potential monetary and financial stability risks posed by FRS, we propose that issuers are required to fulfil a set of licensing criteria to be eligible for a licence. The key criteria are as follows:

- (a) Management of reserves and stabilisation mechanism
 - (i) **Full backing:** The FRS issuer must ensure that the value of the reserve assets backing an FRS is at least equal to the par value of the FRS in circulation at all times;

² We also propose including requirements on offering of FRS in the regulatory regime. Details are set out in paragraph 9.

- (ii) **Investment limitations:** The reserve assets must be of high quality and high liquidity with minimal market, credit and concentration risk. Reserve assets should be held in the referenced currency, with flexibility allowed on a case-by-case basis, subject to approval by the Monetary Authority (“MA”);
 - (iii) **Segregation and safekeeping of reserve assets:** The FRS issuer should put in place an effective trust arrangement to ensure that the reserve assets of the FRS are segregated from its other assets. The FRS issuer must establish segregated accounts for reserve assets with licensed banks or, under arrangements satisfactory to the MA, with other asset custodians;
 - (iv) **Risk management and controls:** The FRS issuer must have adequate policies, guidelines and controls for the proper management of all investment activities associated with the management of the reserve assets. The FRS issuer must also have in place comprehensive liquidity risk management practices; and
 - (v) **Disclosure and reporting:** The total amount of the FRS in circulation, the mark-to-market value of reserve assets and the composition of reserve assets must be disclosed regularly to the general public. The FRS issuer must engage a qualified independent auditor to perform an attestation at least on a monthly basis.
- (b) Redemption requirements
- (i) FRS users should have the right to redeem their FRS at par value with the FRS issuer and have a claim on the reserve assets. Redemption requests must be processed without undue costs and on a timely basis; and
 - (ii) The FRS issuer must draw up and maintain a contingency plan to enable orderly redemption of FRS by users when the

issuer is unable to meet redemption requests, including in the case of a suspension or revocation of the issuer's licence.

(c) Governance, knowledge and experience

Controllers, chief executives and directors of an FRS issuer must be fit and proper persons, and their appointment, together with any changes in ownership or management of the FRS issuer, would require the prior consent of the MA. The FRS issuer must have an adequate system of control for the appointment of the senior management team and a robust corporate governance structure staffed by personnel with the necessary knowledge and experience to enable the effective discharge of responsibilities.

(d) Other regulatory requirements

- (i) Restrictions on business activities;
- (ii) Physical presence in Hong Kong;
- (iii) Financial resources requirements;
- (iv) Disclosure and audit requirements;
- (v) Risk management requirements; and
- (vi) AML/CFT requirements

Requirements on offering of FRS

9. To ensure protection to FRS users, we propose that only the following entities³ may offer FRS in Hong Kong, or actively market such offering to the public of Hong Kong:

- (a) Licensed FRS issuers;
- (b) Authorized institutions (i.e. banks);
- (c) Licensed corporations; and
- (d) Licensed VATPs.

³ The Government is exploring the introduction of a licensing regime for VA over-the-counter ("OTC") service providers, and conducted a public consultation during February to April this year. Subject to the details of the licensing regime, we will explore the possibility of allowing licensed VA OTC service providers to offer FRS issued by licensed issuers in Hong Kong.

10. Authorized institutions, licensed corporations and licensed VATPs may offer FRS issued by entities not licensed by the MA only to professional investors, and must indicate clearly such FRS is not issued by a licensed FRS issuer.

Transitional arrangement

11. We propose that the regime would become effective one month after the gazettal of the proposed new ordinance. To facilitate smooth transition of pre-existing FRS issuers into the regime, pre-existing FRS issuers that are conducting FRS issuance activities with meaningful and substantial presence in Hong Kong prior to the commencement date of the regime may continue to operate under a non-contravention period of six months, on the condition that they have submitted a licence application to the MA within the first three months of the commencement of the regulatory regime, or else they will need to close down their businesses in an orderly manner by the end of the fourth month of the commencement of the regime.

Consultation conclusions

12. The public consultation on the legislative proposal to implement the regulatory regime for stablecoin issuers was completed in February this year. FSTB and the HKMA received a total of 108 submissions from a wide variety of respondents comprising market participants, industry associations, business and professional organisations and other stakeholders. Comments received indicated general support for the policy objectives and the key proposals. The majority of respondents agreed that a well-regulated environment is a prerequisite for the sustainable and responsible development of the stablecoin ecosystem in Hong Kong.

13. FSTB and HKMA published the consultation conclusions in July this year. Respondents provided feedback on the details of the proposed regulatory requirements for FRS issuers, while some sought further clarification on certain requirements. The key feedback from the public consultation and our responses are as follows:

- (a) **Reserve management and redemption:** Respondents sought clarification on the composition of reserve assets, frequency of disclosure, as well as the timeframe of redemption. We have set out further elaborations in the conclusion paper⁴, and will also provide more details through issuing guidelines;
- (b) **Financial resources requirements:** It was proposed in the consultation paper that the minimum paid-up share capital should be the greater of 2% of the total FRS in circulation and HK\$25 million. Some respondents highlighted the difficulty in maintaining sufficient capital with respect to changes in FRS circulation size in a timely manner, and proposed the adoption of alternative risk management measures. Taking into account the public's feedback and the risks of FRS issuance activities, we would adjust the 2% requirement to 1%. Meanwhile, we will retain the flexibility to impose additional capital requirements where necessary; and
- (c) **Offering channels of FRS:** Some respondents proposed that the scope of specified licensed entities allowed to offer FRS could be expanded to cover licensed VA OTC service providers, in addition to licensed corporations mentioned in the consultation paper. Subject to the formulation and implementation of the licensing regime for VA OTC services, we are exploring the possibility of allowing licensed VA OTC service providers to offer FRS.

⁴ Regarding the composition of reserve assets, the HKMA will take into account multiple factors. In general, high quality and high liquidity reserve assets may include (a) coins and banknotes, (b) deposits placed with licensed banks, (c) marketable securities representing claims on or guaranteed by governments, central banks or qualified international organisations with a rating of at least AA-, (d) overnight reverse repurchase agreements with minimal counterparty risk backed by these securities and (e) tokenised versions of the above assets. With regard to the frequency of disclosure, following consideration of the views shared by the respondents and industry feedback, the HKMA is inclined to reduce the frequency of public disclosure regarding FRS in circulation as well as the market value and composition of reserve assets, striking a balance between the operational burden on FRS issuers and the need for transparency and having regard to international developments in this respect. As for the redemption timeframe, the HKMA will require FRS issuers to fulfil redemption requests within one (1) business day in normal circumstances after the day on which a redemption request is received.

Stablecoin issuer sandbox

14. The HKMA launched the stablecoin issuer sandbox in March this year to allow institutions with plans to issue stablecoins in Hong Kong to conduct testing on their operational plans, as well as facilitate the two-way communication on the proposed regulatory requirements, with a view to ensuring the regulatory requirements are fit-for-purpose. The first batch of participants will be announced in as and when appropriate.

15. The sandbox aims to test out the operational flows of stablecoin issuers, and to explore ways for them to develop businesses in a compliant and sustainable manner. As such, applicants are required to demonstrate detailed business plans with concrete use cases, as well as explain how their businesses could practically address pain points in the real economy and bring benefits and new opportunities to the economic and financial activities of Hong Kong. At the same time, applicants also need to illustrate how their networks, supply chains or major partners could drive the long-term demand for their stablecoins in order to achieve business sustainability. In addition, applicants' sandbox plans will need to explain clearly how they will demonstrate robust and compliant stablecoin issuance operations via the sandbox.

16. During the testing within the sandbox, the HKMA will observe how participants plan to:

- (a) protect stablecoin holders;
- (b) implement robust AML/CFT measures;
- (c) adhere to the existing and developing laws and regulations in Hong Kong and other jurisdictions, in light of the evolving regulatory environment globally; and
- (d) develop stablecoin issuance businesses that bring benefits and new opportunities to the economic and financial activities of Hong Kong.

17. All operations under the sandbox will be conducted within a limited scope and risk-controlled environment. Depending on the plans of the participants and the progress of testing, the HKMA may fine-tune the operational parameters and testing scope as appropriate.

Potential use cases of stablecoins

18. The objective of the development of digital finance is to address the pain points in traditional finance through innovative technologies, bringing new opportunities to financial services. Based on information obtained from the engagement with the industry, the key potential use cases of stablecoins cover both real economy and the VA ecosystem. Examples include:

- (a) **Payment:** Enhancing efficiency and reducing costs of cross-border payment; enabling innovative payment solutions (e.g. enabling automatic or smart payment functions via programmability);
- (b) **Capital markets:** Facilitating settlement of tokenised assets; simplifying the operations of collateral management;
- (c) **Trade and supply chain:** Enhancing efficiency of trade and supply chain finance; supporting innovation in supply chain; and
- (d) **VA / Web3:** Serving as the medium of exchange in the VA and Web3 ecosystem.

Next steps

19. We will carefully consider the comments received from the consultation and incorporate them into the bill as appropriate. Taking into account market development, international discussion and the feedback received, we will strive to introduce the bill into the Legislative Council by end-2024 so as to implement the regulatory regime for stablecoin issuers as soon as possible. In the meantime, the Government and the HKMA will

continue to maintain dialogues with the industry to keep abreast of the latest market development and exchange views over the use cases as well as relevant regulatory requirements, with a view to facilitating the robust, compliant and sustainable development of the stablecoin ecosystem in Hong Kong.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
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