



Response to HKMA Discussion Paper on Cryptoassets & Stablecoins (March 31, 2022)



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The FinTech Association of Hong Kong (FTAHK) is a **member-driven, independent, not-for-profit, & diverse** organisation that is the voice of the FinTech community in Hong Kong. It is organised and led by the community, for the community, through a series of committees and working groups.

Our objective is to promote Advocacy, Communication and Education in the wider FinTech ecosystem.

Build the community.
Be the connector.

A. FOREWORD

The Hong Kong Monetary Authority (HKMA) released a Discussion Paper on Cryptoassets & Stablecoins on 12 January 2022¹, inviting ‘views from the industry and public on the relevant regulatory approach on the risks to the monetary and financial systems of Hong Kong posed by the increased adoption of cryptoassets and stablecoins.

The Discussion Paper set out the HKMA’s thinking on the regulatory approach for cryptoassets, and in particular, payment-related stablecoins. The HKMA indicated that they had taken into account, among other things, international recommendations and the characteristics of payment-related stablecoins, as well as the market and regulatory landscape locally and within other major jurisdictions. To facilitate the stakeholders in sharing their views, the HKMA highlighted certain issues in the form of questions and answers, which the FTAHK has used to structure its detailed responses.

The FinTech Association of Hong Kong (“**FTAHK**”) welcomes the endeavours of the HKMA to further enhance the regulatory regime governing virtual assets in Hong Kong and to facilitate transparency within the industry.

The FTAHK is a not-for-profit industry organisation that has over 1100 members representing 300+ firms and is the largest FinTech association in Hong Kong. Our wide-ranging membership comprises of global and domestic FinTechs, Financial Institutions, Technology Service Providers, Consultancies, Law Firms, Academia, and Students.

We are grateful to have the opportunity to respond to this public consultation; the scope of which is focused on the proposed regulatory regime for stablecoins.

This response has been prepared by members of FTAHK’s Blockchain committee, Digital Banking & Payments committee, and the Board of Directors, representing a broad range of experience and backgrounds, from FinTech start-ups to established financial services firms, as well as stakeholders such as virtual asset services providers (“**VASPs**”), consultancies, law firms, technology companies, and academia.

The FTAHK welcomes the opportunity to discuss any of the feedback provided in future follow up sessions with HKMA.

March 31st 2022

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¹ <https://www.hkma.gov.hk/eng/news-and-media/press-releases/2022/01/20220112-3/>

B. EXECUTIVE SUMMARY

In principle, the FTAHK is very supportive of the HKMA's proposed risk-based approach to regulating stablecoins and its focus on **payment-related stablecoins**, i.e., those stablecoins that are increasingly considered as an acceptable means to store value and/or make payments, and thereby have a higher potential for incorporation, on a global basis, into mainstream financial systems with its attendant risks.

In considering the extent of any proposed regulation (or amendment to existing regulation), we recommend that the HKMA adopt a “**substance (or function) over form**” approach as the primary guide to determining appropriate regulation of payment-related stablecoins, i.e., a review of the purpose for which an entity may create, hold, utilise, transfer, or distribute such a payment-related stablecoin and/or its use.

Adoption of this approach would allow the HKMA to understand whether such payment-related stablecoin should be regulated under existing or equivalent licensing regimes as:

- a stored value facility (“**SVF**”);
- a deposit-taking bank;
- a virtual asset service provider (“**VASP**”); or
- under any other relevant licensing regime.

We also recommend that the HKMA's proposed regime:

- (i) regulates “primary activities”, i.e., the issuance, creation, or destruction of payment-related stablecoins, or activities that are linked to the management of stabilisation activities in relation to stablecoin value (items (i) and (ii) of the HKMA's list of activities); and
- (ii) not regulate “secondary activities”, i.e., those activities that are merely ancillary or incidental to the primary activities (items (iii) – (vii) of the HKMA's list of activities).

Otherwise, the breadth of regulatory scope proposed by the HKMA may be greater than those under consideration by other regulatory bodies (both local and international) and may increase regulatory friction and stymie innovation and growth of Hong Kong's virtual asset ecosystem and competitiveness.

We urge the HKMA to continue to work alongside international and local regulators and standard-setting bodies to create a coordinated regulatory regime that is consistent with global standards in terms of minimum requirements to avoid overlap and confusion and prevent regulatory arbitrage while protecting stablecoin users and financial stability. In particular, we encourage the HKMA to continue to be actively involved in cross-border regulator discussions and consultations initiated by organisations such as the Financial Stability Board (“**FSB**”) and the Bank for International Settlements (“**BIS**”).

We welcome the opportunity to continue our collaboration with the HKMA and provide timely and relevant feedback on any proposed new and/ or amended legislation and/ or regulation as they are being drafted to ensure that Hong Kong's virtual asset industry continues to be globally competitive and responsible.

C. RESPONSES TO QUESTIONS

C.1 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 principle, the FTAHK agrees with the risk-based approach recommended by the HKMA in terms of initially focusing on activities related to payment-related stablecoins, and also agrees that a certain degree of flexibility should be built into the system to permit future regulation over different types of stablecoins. As a general comment, we urge the HKMA to prioritise international consistency when considering the scope of this and any future regulations on stablecoins.

However, as referenced in our call with the HKMA on February 21, 2022, we are of the view that, prior to any implementation of regulation, it is incumbent upon the HKMA to perform a “*substance (or function) over form*” assessment of stablecoins, with particular focus on payment-related stablecoins. In this regard, when considering a stablecoin in its strictest sense, we believe that it is most appropriate to consider the primary function of a stablecoin as being a digital representation of a claim on a ledger (the form of which is not relevant), which is then enforceable on an entity that has offered an undertaking to redeem the value of such stablecoin from their holdings in a range of backing assets. The simplest form of this would be a stablecoin that is backed 1:1 against the currency in which it is denominated.

We suggest a review of the purpose for which an entity may create, hold, utilise, transfer, or distribute a stablecoin and/or its use as the primary guide to determining appropriate regulation. Using this approach:

- (i) If the issuer or parties utilising an issued stablecoin are primarily intending the stablecoin to be a stored value facility utilised, and/ or it is used as such, and the funds are primarily to maintain the nominal value of the float, then the substance of that stablecoin can be considered analogous to that of a Stored Value Facility (“SVF”) and should be regulated under a regulatory regime equivalent to, or as part of the Payment Systems and Stored Value Facilities Ordinance (Cap. 584) (“PSSVFO”)².
- (ii) If the issuer is an entity primarily intending for the stablecoin to be an alternative to deposits as a form of providing funds to support a fractional lending business, and/ or is used as such, the full banking licensing regime may be more appropriate (please see our answers to Q6 below in respect of the appropriateness of requiring stablecoin issuers to be AIs under the Banking Ordinance).

² We note that certain risk-based adjustments may be required, especially to reflect the high value of amounts in consideration and to reflect certain current aspects of the SVF regime, for instance access to FPS, which may no longer be appropriate.

- (iii) In relation to parties that utilise payment-related stablecoins in their business for purposes that are analogous to activities captured under the Money Service Operators Licensing regime (e.g., over the counter exchange purposes or remittances), then we are of the view that the substance of that stablecoin may already fall under the supervision of the HKMA, or if not, would need to comply with the licensing rules as dictated by the Hong Kong Customs & Excise Department under the AMLO.

The recent issuance by banks (such as ANZ Bank) of stablecoins³ demonstrates the dynamism of stablecoin issuances globally, and the importance of the HKMA adopting a substance over form approach to regulation of payment-related stablecoins in Hong Kong.

In addition, provision by the HKMA of a clear definition as to what types of payment-related stablecoins are to fall within scope of any proposed or amended regulatory regime would allow participants to understand the extent of their regulatory obligations. We propose the HKMA adopt a balanced approach with consideration of the following:

- prescribe a specific definition of the types of stablecoins to be regulated (whilst maintaining flexibility to further expand such definition as required in the future);
- focus on those stablecoins that currently have a large market share, and are more likely to pose risks to the monetary and financial stability of Hong Kong;
- determine where there is a regulatory gap that requires oversight by the HKMA, in order to avoid regulatory overlap, or the creation of regulatory arbitrage opportunities as a result of differing regimes administered by different Hong Kong regulators;
- account for feedback and developments in other jurisdictions and the broader international context to maintain an appropriate level of consistency in regulatory oversight; and
- support innovation, whilst remaining mindful of appropriate levels of consumer and investor protection, as well as market integrity.

We also encourage the HKMA to be mindful of adopting a regulatory framework that is (to the greatest extent possible) technology agnostic, allowing for a flexible response to the rapid development of the underlying technology, as well as any potential emerging risks of a stablecoin over time.

In a recent report, the Financial Policy Committee of the Bank of England acknowledged that “...[a]round 75% of cryptoassets trading on centralised exchanges involves a stablecoin,”⁴. As to the types of **payment-related stablecoins** that should initially fall under the purview of the HKMA, with reference to the classification diagram provided at Annex A of the Discussion Paper, we propose that the new regime (or any amendment to the existing regime) should not cover:

- (i) cryptoassets that may fall within the scope of an existing or proposed regulatory regimes – such as virtual assets referenced in the Joint Circular on Intermediaries’ virtual asset-related activities issued by the Securities and Futures Commission (“SFC”) and the HKMA dated January 28, 2022; and the Secretary of the Financial Services and the Treasury Bureau’s (“FSTB”) letter of March 17, 2022, or those assets whose structures may share characteristics and functions that are

³ <https://media.anz.com/posts/2022/03/anz-completes-landmark-stablecoin-payment?>

⁴ Bank of England Financial Policy Committee, “Financial Stability in Focus: Cryptoassets and decentralised finance” March 2022, page 9

comparable to regulated structures such as collective investment schemes, structured products etc.; and

- (ii) cryptoassets that are unregulated, but do not and are not anticipated to, in fact, pose material risks to the monetary and/or financial stability of Hong Kong at this stage (save for any concerns around money-laundering or terrorist financing activities).

These assets can broadly be categorised as:

- utility tokens;
- security tokens;
- means of exchange non-stablecoins;
- algorithmic stablecoins (whether or not collateralised);
- multi asset-linked tokens.

Further, specifically, in relation to those *payment-related stablecoins* that are pegged to a single fiat currency (i.e., e-money tokens), we propose that in designing its initial framework for regulatory oversight, the HKMA have regard to the following:

(a) Is the backing asset sufficient, i.e., fit for purpose?

Given that some of these forms of collateralisation may be new to the HKMA, an assessment must be done to ensure the safety and sufficiency of these. We would encourage the HKMA to develop mechanisms analogous to those currently in place for the management of the SVF float.

(b) Whether the primary function is as a means of exchange⁵

Limiting the definition in this manner will exclude tokens that function for investment purposes (which fall within scope of other regulatory regimes governed by the SFC) or utility purposes (which may fall out of regulatory scope). We also note that these tokens fall within scope of other regulatory regimes governed by the SFC. We reiterate our proposal that the HKMA consider a “*substance over form*” regulatory approach to avoid creation of an unintended regulatory arbitrage structure, e.g., through introduction of an incidental utility function.

(c) Is there an intention to maintain a fixed or stable value?

We are of the view that a reference to a fixed value will provide greater legal certainty on the status of any stablecoin and may also assist in minimizing/ avoiding any regulatory overlap with other Hong Kong regulatory institutions.

(d) Is its value referenced against a single fiat currency?

As a starting point for regulation of stablecoins, we believe that focusing on those stablecoins that are backed by a single fiat currency will avoid the risk of regulatory overlap as multi-asset linked stablecoins may possess characteristics or functionality that make them subject to other forms of regulatory oversight. We note that stablecoins whose value is referenced against a basket of currencies may be construed as structured products under the Securities and Futures Ordinance (Cap.

⁵ Consideration of this factor may be regarded as optional, given that adoption of the other factors will, de facto, reflect the “means of exchange” nature of the stablecoin in consideration.

571) (“SFO”), and also that these types of stablecoins may have a higher degree of inherent risk vis-à-vis single fiat currency backed stablecoins.

(e) *The risks associated with the denominated currency*

In line with our recommendation of adopting a “*substance over form approach*”, we recommend that the proposed regulation capture in scope payment-related stablecoins, irrespective of their denomination in Hong Kong Dollars, as identification of a pre-defined list of fiat currencies deemed acceptable for stablecoin purposes could promote the use of regulatory arbitrage structures (and also given that there is a risk to the monetary and financial stability of Hong Kong, irrespective of the denomination of the stablecoin).

(f) *excluding digital representations of fiat currencies issued by central banks.*

C.2 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:

- (i) Issuing, creating or destroying stablecoins;
- (ii) Managing reserve assets to ensure stabilisation of the stablecoin value;
- (iii) Validating transactions and records;
- (iv) Storing the private keys providing access to stablecoins;
- (v) Facilitating the redemption of stablecoins;
- (vi) Transmission of funds (for the purpose of ensuring finality of settlement of transactions); and
- (vii) Executing transactions in stablecoins.

This broad list is based on a list of activities of stablecoin arrangements and associated vulnerabilities as identified by the FSB, and as such may be regarded as keeping in line with international standards. We note that the industry views items (i) – (ii) as primary activities relating to payment-related stablecoins and items (iii) – (vii) as secondary activities relating to stablecoins.

As stated in our response to Q1 above, prior to deciding what types of stablecoin-related activities are to be regulated, the HKMA should determine, *ab initio*, the use-cases for stablecoins, and then determine whether the existing regulatory regime already serves (or may, with appropriate modification serve) to capture such activity. As an example, if a stablecoin is in substance determined to be an SVF, then we are of the view that it would be appropriate for the activities specified in (i) – (vii) to be captured in the Guideline on the Supervision of Stored Value Facility Licensees⁶ and the Explanatory Note on Licensing for SVF⁷ (with appropriate modification, as required) as shown in the table below:

⁶ https://www.hkma.gov.hk/media/eng/doc/key-functions/financial-infrastructure/Guidelines-on-supervision-of-SVF-licensees_Eng.pdf

⁷ https://www.hkma.gov.hk/media/eng/doc/key-functions/financial-infrastructure/infrastructure/retail-payment-initiatives/Explanatory_note_on_licensing_for_SVF.pdf

	Item	Reference in Existing Regulation
	<p>Issuing, creating, or destroying stablecoins</p> <ul style="list-style-type: none"> ➤ the activity of the issuer minting and burning of stablecoins. 	<p>See definition of “facilitator” as set out in Section 2B of the PSSVFO and the role of “issuer” as used within the legislation.</p>
(ii)	<p>Managing reserve assets to ensure stabilisation of the stablecoin value</p> <ul style="list-style-type: none"> ➤ the activity of managing the reserve assets that are backing the value of the stablecoins and providing custody/ trust for these assets. 	<p>See section 6.4 of the Guideline on the Supervision of Stored Value Facility Licensees, “<i>Management of float and SVF deposit</i>”.</p>
(iii)	<p>Validating transactions and records</p> <ul style="list-style-type: none"> ➤ the activity of authorising or verifying the validity of transactions and records. 	<p>See section 5.3 of the Guideline on the Supervision of Stored Value Facility Licensees, “<i>Record keeping</i>”.</p>
(iv)	<p>Storing the private keys providing access to stablecoins</p> <ul style="list-style-type: none"> ➤ the activity of safe-keeping of keys used to digitally sign transaction instructions on behalf of stablecoin holders. 	<p>See section 7.2 of the Guideline on the Supervision of Stored Value Facility Licensees, “<i>Technology risk management</i>”.</p>
(v)	<p>Facilitating the redemption of stablecoins</p> <ul style="list-style-type: none"> ➤ the activity of facilitating the stablecoin holders to redeem stablecoins for fiat currencies or other assets. 	<p>See Chapter 3, paragraph 24 - 27 of the Explanatory Note on Licensing for SVF.</p>
(vi)	<p>Transmission of funds</p> <ul style="list-style-type: none"> ➤ the activity of ensuring the correct and final settlement of transactions to minimise the default risk of counterparties. 	<p>See Chapter 3, paragraph 24 - 27 of the Explanatory Note on Licensing for SVF.</p>
(vii)	<p>Executing transactions in stablecoins</p> <ul style="list-style-type: none"> ➤ the activity of conducting transactions on behalf of others. 	<p>See our response to Q1, where these activities may be captured under the licensing requirements to be a Money Service Operator, or potentially a Money Broker.</p>

Whilst we are cognisant of the fact that some amendment to the existing frameworks may be required to account for the differences in technology involved, we are of the view that the responsibilities of the regulated entity would remain the same, irrespective of whether such responsibilities are undertaken (a) directly; (b) reliant in some part on others (where any reliance would then need to undergo a separate risk assessment to determine fitness for purpose); or (c) outsourced (where the material outsourcing responsibilities have previously been defined). We also note that where a stablecoin creator is a separate entity from that managing the issuing of the SVF for payment purposes, the concepts and language of the SVF regime already capture the role of a “facilitator”.

Regulation of Primary Activities:

Taking a broader view, as a matter of course, we are of the view that primary activities (i.e., items (i) and (ii) above) relating to payment-related stablecoins should be subject to the prudential regulation/ supervision of the HKMA.

We recommend that prior to any introduction of new regulation (or amendment of existing regulation), the HKMA consider limiting the scope of any such regulation to capture those legitimate risks to customers and financial stability that are posed by stablecoin issuers or those tasked with managing stablecoin reserve assets, including but not limited to, (a) counterparty risk, i.e., the risk that the stablecoin issuer or the holder of the reserve becomes insolvent or otherwise impaired; or (b) run risk, i.e., where the underlying asset pool loses value, or is perceived to be at risk of losing value⁸, as this type of regulation would be in line with established global frameworks for regulation of financial intermediaries, as well as those frameworks that are currently in development for stablecoin regulation (e.g., the US President’s Working Group on Financial Markets or the Markets in crypto assets regulation within the European Union).

In addition, it would be helpful for the HKMA to clarify its intended approach for (i) multi-entity stablecoin arrangements, (ii) stablecoins that are initiated by decentralised autonomous organisations (“**DAOs**”); and (iii) responsibility for any outsourced activity. In particular:

- (a) with respect to multi-entity stablecoin arrangements, is the expectation that each entity would be required to seek individual authorisation from the HKMA, notwithstanding that they are a part of the same group; or will the HKMA seek to identify the person that is responsible for the overall operation of the stablecoin (or the person that a stablecoin holder may claim against), and apply the licensing/ regulatory requirements upon such person?
- (b) with respect to DAOs, we query whether it is feasible to identify the person responsible for the overall operation of a stablecoin (i.e., the initiating person, or that person gaining substantial economic benefit such that they could be considered as carrying out a business in this regard), and as such believe that stablecoins issued by such entities should fall outside the scope of any proposed new or amended regulation. However, in the event that the HKMA is minded to regulate payment-related stablecoins that are initiated by DAOs, we propose that each DAO be independently assessed to determine whether there is a legal entity

⁸ We note that the HKMA should also be cognisant of risks relating to technology failures and cyber breaches, but these are a matter of course for the virtual asset sector generally, and not limited solely to activities relating to stablecoins.

that is able to be regulated, or whether the person responsible is caught by the provisions of the PSSVFO or other application regulation/ legislation⁹.

- (c) with respect to those activities that are outsourced, as noted above, we are of the view that the relevant persons to remain responsible over material activities that are outsourced.

Regulation of Secondary Activities:

In relation to those activities we consider secondary or incidental activities, we are of the view that many regulations already exist that sufficiently manage these (or are subject to separate proposed new legislation), and requiring the licensing/ registration of other downstream participants (e.g., custody providers, or technology and software service providers) may prove to be duplicative. Specifically, to this point, we would like to highlight the following to the HKMA:

- (a) the act of validating transactions and records: it is worth noting that whilst a failure in validating transactions may present a settlement risk for those stablecoins considered “global stablecoins”, this action is not presently captured by other licensing regimes. Should the HKMA be minded to oversee these activities, we propose that regulation be of the responsible party authorising any such validation.
- (b) storing the private keys providing access to stablecoins: this in effect covers the role that is currently played by custodians, and we note here that (i) many custodians of digital assets have already adopted regulated models; and (ii) technology and software service providers, i.e., those who store access of keys, will view the risks associated with securing a stablecoin as no different from the risks associated with securing any other digital system (e.g., current payment systems that rely upon cryptographic protections). In addition, we do not see the basis for drawing a distinction between custodians holding stablecoins as compared to custodians who hold other virtual assets. As such, we believe there to be no need to require the registration of such service providers who would ordinarily be exempt from direct regulation, whether in Hong Kong, or in any other financial market (to date). In the alternative, we propose that it would be more appropriate for such activities to be captured within legislation such as the Trust Company Service Provider Licensing regime under the AMLO, as appropriately amended.
- (c) facilitating the redemption of stablecoins: we believe it would be more appropriate to limit regulation in this regard to the actual redemption of the stablecoins, and that any regulation would then be limited to the responsible person (see our comments on “Primary Activities” above), rather than the broader scope that is currently proposed. In this regard, we consider there to be three forms of redemption activities: (i) redemption with a stablecoin issuer, which issuer should be regulated by the HKMA; (ii) redemption through a VASP which should be regulated under the proposed VASP regime; and (iii) redemption through OTC activities, which should be regulated under existing regulations.
- (d) transmission of funds: it is unclear from the Discussion Paper whether the HKMA intends to cover activities that are equivalent to money remittance activities that are currently captured under the licensing rules as dictated by the Hong Kong

⁹ See, for example, Sections 8B and 8C, limiting the issuance etc., and promotion of stored value facilities.

Customs & Excise Department under the AMLO, or if another means of regulation is under consideration.

- (e) executing transactions in stablecoins: it is unclear from the Discussion Paper as to the breadth of scope of regulatory oversight of this activity, i.e., does the HKMA intend to regulate every transaction involving a stablecoin? We propose that a reduced regulatory scope, where regulatory oversight is limited to the act of executing transactions involving conversions between payment-related stablecoins and fiat currency may be more appropriate (such as crypto-wallets), and also in line with the position of other financial regulators. Further, we suggest that regulatory oversight for this activity fall within the proposed licensing regime for VASPs.

Further to the above, we have also prepared a flowchart (please see Appendix A) setting out one manner of determining when a payment-related stablecoin could be considered to fall within the ambit of the HKMA's direct regulation of payment-related stablecoins in the narrow sense. For the avoidance of doubt, Appendix A does not apply to the broad substance over form approach as outlined in response to Q1 above (which proposes a means by which the HKMA may deem the activities that are to fall within its regulatory remit).

Finally, as will be discussed further in our answer to Q5 below, the breadth of scope and the potential regulation of secondary activities relating to stablecoins raises concerns on regulatory overlap. We are of the view that any regulation of these secondary activities should bear in mind their materiality to the monetary and/or financial stability of Hong Kong, and also runs the risk of being duplicative of existing regulatory frameworks between the various Hong Kong regulators, including the VASP regime that is administered by the SFC, as well as the proposed revisions to the AMLO. Such overlap is likely to result in an increase in regulatory friction for companies wishing to operate in the region, potentially stymieing innovation and growth of the ecosystem and Hong Kong's competitiveness. There is a risk that an overly broad approach to regulation to secondary activities may result in certain service providers either exiting the Hong Kong market, or continuing to operate in Hong Kong, but with a limited service offering. This will have the practical impact of depriving stablecoin customers of secure technological solutions but will also likely reduce the attractiveness of Hong Kong as a hub for fintech and innovation.

C.3 QUESTION 3

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

It is our view that the authorisation and regulatory requirements for the entities subject to the new licensing regime should be in proportion to the activities undertaken. In respect of those entities that undertake primary activities and are determined to be fall under the purview of the HKMA, we propose the following approach:

- (i) if the payment-related stablecoin is analogous to an "e-money" stored value facility, fully collateralized with cash or safe highly liquid equivalents, then a licensing regime similar to SVF might be considered appropriate;

- (ii) if the payment-related stablecoin is analogous to fractional reserve banking, undercollateralized and with more risky backing assets, then a licensing regime similar to a full banking license might be considered appropriate.
- (iii) if the payment-related stablecoin gains widespread traction as a medium of exchange, underpinning payment, clearing, and settlement processes, then a licensing regime similar to a designated and/or systemically important financial market infrastructure, including the full gamut of CPMI-IOSCO PFMI, might be considered appropriate.

In respect of those entities that undertake secondary activities, we are of the view that the authorisation and regulatory requirements as proposed in the Discussion Paper are, or should be, covered by other licensing and regulatory regimes.

We believe that there is a risk of over-regulating and increasing regulatory friction to stablecoin operators and therefore encourage the HKMA – when considering adoption of a new licensing regime (or amending the current regime) – to bear in mind regulatory proportionality against the activities undertaken, as there is a risk that the requirements against virtual asset operators (in this case payment-related stablecoins) will result in such entities facing more stringent requirements and more regulatory oversight than the equivalent authorised activities within the traditional finance sector. The risks of this include potential stifling of innovation and potentially harming Hong Kong's competitiveness by incentivising these entities to move offshore, lessening Hong Kong's attractiveness as a place to innovate and do business and retain its leading status as a global financial centre. We therefore stress that HKMA should consider the concepts of proportionality and equivalence when drafting its licensing regime for primary activities.

C.4 QUESTION 4

What is the intended coverage as to who needs a license under the intended regulatory regime?

We note the HKMA's view that any person who carries out payment-related stablecoin activities in Hong Kong, or any business that actively markets stablecoin activities to the Hong Kong public should be an Hong Kong-incorporated entity and appropriately licensed by the HKMA.

Whilst we acknowledge the practical benefits that the HKMA derives from licensing and exercising supervisory powers over a locally incorporated entity with respect to day-to-day supervision, investigations, and enforcement, and we note that this is the structure that currently exists for licensees under the PSSVFO, we urge the HKMA to consider alternative arrangements when formulating its approach to regulating stablecoins.

As referenced in Q2 and Q3 above, adopting the stance that all activities relating to stablecoins (be there primary or secondary) require regulation is, arguably, a tougher stance than that adopted in other financial markets. We encourage the HKMA to consider a more flexible and pragmatic approach in relation to the strict requirement for local entity incorporation in Hong Kong, taking into account whether an entity is undertaking a primary or secondary activity. We are concerned that imposition of a

requirement for a local presence could create additional friction that may dissuade responsible operators from providing regulated stablecoin related services to Hong Kong customers. Allowing room for greater dialogue to explore alternative business structures that are still able to reasonably mitigate the corresponding risks would be welcomed and enable pragmatic evolution of the regulatory framework.

As an example, the HKMA could consider the appropriateness of adopting regulatory equivalence standards that would allow it to recognise the adequacy of an overseas entity's regulatory status in another jurisdiction. This may then be coupled with cooperation arrangements between the applicable regulatory authorities (consistent with the HKMA's current relationships with overseas banking regulators through memoranda of understanding arrangements) to cover matters like information-sharing and supervisory access.

As an alternative to the above, the HKMA could also consider permitting a registered Hong Kong branch of an overseas company to be eligible for licensing by the HKMA. This option would be consistent with the proposed regulatory requirements for virtual asset exchanges under the expected amendments to the AMLO¹⁰.

Whilst we trust that the scope of any activities covered would be explicitly defined (please see our comments in Q1 and Q2 above on this), it would also be helpful for the HKMA to produce guidance on what would constitute "*actively market to the public of Hong Kong*", and the corresponding thresholds and triggers, so as to enable offshore operators to understand what is, and is not, permitted. Such guidance would be necessary if the "active marketing" concept is introduced for stablecoin activities due to the increasingly digital (and often online-only) nature of businesses, as well as the global and open footprint of many social media and other communication platforms. We also refer the HKMA to our answer to Q8 below where we set out additional considerations that we believe would be useful to ready the industry, prior to the introduction of any new or amended regulatory regime.

Given the announced intention of the US President's Working Group on Financial Markets to regulate stablecoin issuers as though they are banks, we urge the HKMA to consider the timing and final announcement of its' proposed stablecoin regime, so as to limit any risk of regulatory arbitrage, as well as limiting potential impact to the Hong Kong Dollar, given the linked exchange system between the Hong Kong Dollar and US Dollar.

Lastly, we reiterate that there is also the risk that this suggested requirement from the HKMA may not be conducive to attracting quality companies to Hong Kong, and potentially limiting the future potential of Hong Kong to benefit from adjacent fintech innovations.

C.5 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,

¹⁰ We note that the original proposal by the Financial Services and Treasury Bureau was to require virtual asset exchanges to operate from Hong Kong-incorporated companies, but that in response to consultation feedback, this proposal has been amended to allow Hong Kong branches of overseas companies to be eligible for licensing.

including but not limited to the SFC's VASP regime, and the SVF licensing regime of the PSSVFO?

The HKMA has provided 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”. We believe this to be the right approach and encourage the HKMA to work with its regulatory counterparts to ensure minimal overlap with other financial regulatory regimes, so as to minimise any confusion as to regulatory obligations on the part of market participants, as well as avoiding any unnecessary and undesirable regulatory inefficiencies.

However, we wish to highlight that the breadth of the HKMA oversight, as proposed in the Discussion Paper, is likely to create situations in which there is regulatory overlap. As we have highlighted in Q2 above, service providers for those activities we believe should be regarded as secondary activities are already subject to various regulatory oversight. We reiterate our position that the HKMA limit its regulatory scope/ prudential supervision to activities related to (i) issuing, creating, or destroying payment-related stablecoins; and (ii) managing reserve assets to ensure stabilisation of such stablecoin value, i.e., if a payment-related stablecoin operator can substantively be seen to be acting as a bank, only then should be regulated as a bank.

As an example of possible regulatory overlap, a virtual asset exchange that is undertaking transactions in (a) non-stablecoin cryptoassets; and (b) stablecoins would be regulated by the SFC under the new proposed VASP regime in relation to the former; and the HKMA and the SFC under the proposed stablecoin regime, in relation to the latter. In this respect, we note that the definition of “virtual asset” under the new proposed VASP regime, “... applies equally to virtual coins that are stable (i.e., the so-called “stablecoins”) or not and irrespective of the purported form of underlying assets.”¹¹.

Whilst the HKMA and the 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 responsibility is in respect of a distinctly different type of activity from that currently under consideration. From the perspective of a VASP, the act of executing transactions that involve stablecoins is analogous to that of executing transactions in non-stablecoin cryptoassets. As such, extending the scope of regulation to secondary activities relating to stablecoins (such that VASPs are captured) may lead to unnecessary and undesirable regulatory inefficiencies and complexity.

C.6 QUESTION 6

Stablecoins could be subject to run and become potential substitutes for 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?

As referenced in our answers to Q1 and Q2 above, there are fundamental differences in the activities of payment-related stablecoins that are primary in nature (i.e., issuing,

¹¹ Public Consultation on Legislative Proposals to Enhance Anti-Money Laundering and Counter-Terrorist Financing Regulation in Hong Kong: Consultation Conclusions (May 2021)
https://www.fstb.gov.hk/fsb/en/publication/consult/doc/consult_conclu_amlo_e.pdf

creating, or destroying payment-related stablecoins; or managing reserve assets to ensure stabilisation of such stablecoin value, versus all other actions that can be considered secondary/ ancillary stablecoin activities. Where an issuer is an entity primarily intending for the stablecoin to be an alternative to deposits as a form of providing funds to support a fractional lending business, regulation under the full banking licensing regime may be more appropriate.

It is our view that the HKMA should work together with international regulators and standard-setting bodies to adopt an approach that is consistent with global standards in terms of minimum requirements for stablecoin issuers and encourage coordination at an international level to determine the appropriate designation of “systemic stablecoins”, and the concomitant prudential requirements (in terms of capital liquidity requirements) to ensure protection of users.

We recommend the HKMA to adopt a risk-based approach and apply higher prudential requirements (e.g., capital and liquidity requirements) to systemic payment-related stablecoin arrangements, similar in the current approach taken by the HKMA in relation to banks.

C.7 QUESTION 7

Would the HKMA also have a plan to regulate unbacked cryptoassets given their growing linkage with the mainstream financial system and risk to financial stability?

Whilst the HKMA has not expressly ruled out regulating unbacked cryptoassets, we would recommend that the HKMA not look to regulate these virtual assets at this juncture. We further query whether there is a need for two regulators to review these types of assets, as we believe that the forthcoming revisions to the AMLO are likely to fall under the purview of the SFC. Should this be the case, any regulation by the HKMA of such assets could be duplicative, or potentially be in conflict with, the approach taken by the SFC and raises the possibility of causing uncertainty to entities seeking to be regulated.

We note that since the publication of the Discussion Paper by the HKMA, the FSB has published a report assessing the risks posed to financial stability from cryptoassets, including a review of unbacked cryptoassets and stablecoins¹². We recommend that the HKMA continue to work with other regulators to determine an appropriate regulatory framework for unbacked cryptoassets to ensure that any approach adopted is consistent with that of other regulators.

C.8 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?

We would recommend that the HKMA provide parties with sufficient notice of the expected requirements of any proposed regulatory regime to allow entities that offer stablecoin related activities the opportunity to review their operations and either engage in any necessary remediation to meet the regulatory requirements or exit the market in an orderly

¹² <https://www.fsb.org/wp-content/uploads/P160222.pdf>

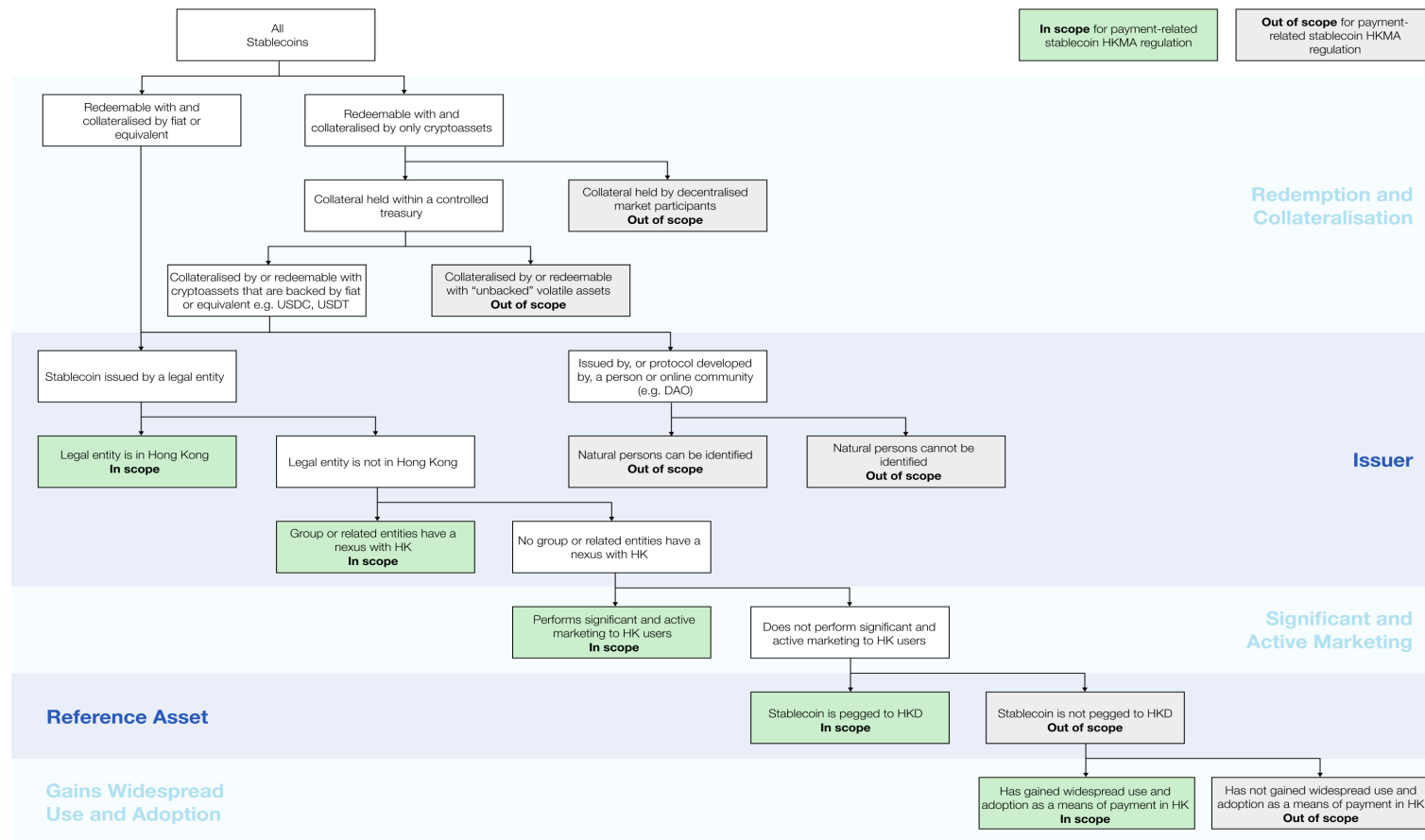
manner. To this end, we would recommend the HKMA consider developing frameworks and standards that focus on the key functions of typical stablecoin arrangements, such as issuance and redemption of tokens and execution of transactions. These standards should include plans to manage risks related to money laundering and terrorist financing, know-your-customer and know-your-transactions. In addition, any such standards should also state clearly the expected systems, contingency planning, internal controls, general risk management of the issuing company, as well as the requirement for stablecoin reserves. In this regard, we encourage the HKMA to adopt a sufficient moratorium period to allow those issuers who have not been previously regulated to comply with the requirements and new licensing regime.

In connection with this, we seek additional clarity from the HKMA and the other regulators and supervisors on prudential, tax and accounting treatment. For example, to support the development of Hong Kong's virtual asset ecosystem, tax certainty is needed on how virtual currencies and other digital assets/ cryptoassets fit within the existing tax framework and how are they classified and treated for tax purposes.

Further, we welcome the HKMA to continue to engage directly with the FTAHK and its' members to gather feedback on the practicalities and challenges of any expected regulations. This feedback can also be obtained through a series of forums or soft-consultations to which industry participants (i.e., those providing both primary and secondary stablecoin activities) are invited.

APPENDIX A

Payment-related stablecoin Primary Activity Scoping Decision Tree



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