

GIBSON DUNN

Financial Regulatory Update

September 10, 2024

Hong Kong's Regulators Publish Consultation Conclusions on Legal Framework for Stablecoin Issuers

This update examines the Consultation Conclusion, particularly the clarifications and guidance provided in further depth.

On July 17, 2024, the Hong Kong Monetary Authority (**HKMA**) and the Financial Services and the Treasury Bureau (**FSTB**) published the conclusions (**Consultation Conclusion**) to the consultation paper setting out a proposed regulatory regime for the issuance of fiat-referenced stablecoins (**FRS**) in Hong Kong (**Consultation Paper**). The two regulators noted that there is overall support for the policy objectives and the key regulatory proposals put forth in the Consultation Paper. By way of context, the Consultation Paper was jointly issued by the HKMA and the FSTB on December 27, 2023. We previously published an alert on this topic^[1] as well as two alerts on the preceding Discussion Paper on Crypto-assets and Stablecoins issued by the HKMA in January 2022^[2] and the related consultation conclusion in January 2023.^[3]

I. Legislative Scope and Approach

A. Definition of stablecoin

As a starting point, the FSTB and HKMA stated in the Consultation Conclusion that they will refine the definition of a “stablecoin”. It was initially proposed that “stablecoin” be defined to mean “a cryptographically secured digital representation of value that, among other things – (a) is expressed as a unit of account or a store of economic value; (b) is used, or is intended to be

used, as a medium of exchange accepted by the public, for the purpose of payment for goods or services; discharge of a debt; and/or investment; (c) can be transferred, stored or traded electronically; (d) uses a *distributed ledger or similar technology that is not controlled solely by the issuer*; and (e) purports to maintain a stable value with reference to a specified asset, or a pool or basket of assets.”

In the Consultation Conclusion, the regulators indicated that they will amend limb (d) of the proposed definition to specify that the stablecoins subject to the proposed regulatory regime are those “operated on a decentralised distributed ledger or similar technology”. In this context, “decentralised distributed ledger” refers to a distributed ledger in which no person has the unilateral authority to control or materially alter its functionality or operation. This slight modification was mainly to address queries as to whether the definition would cover stablecoins issued on distributed ledgers that are controlled by multiple parties acting in a concerted manner (e.g., consortium blockchain) as well as stablecoins operating on digital ledger(s) that are controlled by a single party (e.g., private blockchain run by a single party).

B. Applicability of the licensing regime

In the Consultation Conclusion, the FSTB and HKMA confirmed that they will implement a licensing regime which will be applicable only to issuers of FRS — that is, stablecoins which have as their specified asset one or more fiat currencies, as opposed to other types of stablecoins as initially proposed in the Consultation Paper. In particular, there is no intention of prescribing the reference currencies of FRS under the regime. In relation to multi-currency-referenced stablecoins, it was noted that the requirements proportionate to the complexity of FRS issuers’ operations will be implemented to ensure that the associated risks are adequately addressed.

Nonetheless, given the nascent nature of virtual assets and the fast-evolving landscape, the FSTB and HKMA have left the door open to extend the regulatory regime to other stablecoins in the future.

C. Scope of regulated activity

The FSTB and HKMA also clarified that what constitutes FRS issuance activity is generally a matter to be decided based on specific facts and circumstances. Further guidelines on this point will be forthcoming upon the implementation of the licensing regime.

In response to feedback received, it was noted that there is presently no need to introduce a separate licensing regime for the management and custody of reserve assets, which will be considered as part of the FRS license application assessment process. Furthermore, it was acknowledged that the storage of private keys and the provision of wallet services are important issues as a matter of risk management and user protection—accordingly, the regulators indicated that there will be further engagements with the public and stakeholders on the regulatory approach for such activities.

As regards the legislative approach, it was confirmed that a new piece of legislation will be introduced to specifically implement the regime for FRS issuers and potentially cover the regulatory regime for other virtual asset activities as appropriate in the future.

II. Implementation Timeline and Transitional Arrangements

As stated in the Consultation Paper, the regulatory regime is proposed to commence one month upon gazettal of the proposed new ordinance. The new bill is expected to be introduced into the Legislative Council later this year. The licensing and supervisory guidelines will be published by the HKMA in due course.

Under the proposed transitional regime, pre-existing FRS issuers conducting FRS issuance with a meaningful and substantial presence in Hong Kong prior to the commencement of the regime can continue to operate under a non-contravention period of six months, subject to submitting a licence application to the HKMA within the first three months of the commencement of the regime. The HKMA considers this transitional period to be reasonable and sufficient, and this arrangement will be implemented as proposed.

III. Regulatory Framework for FRS Issuers

A. Licensing Regime for FRS issuers

As stated in the Consultation Paper, an FRS issuer will have to be licensed with the HKMA before it can:

- Issue, or hold itself out as issuing, an FRS in Hong Kong;
- Issue, or hold itself out as, issuing a stablecoin that purports to maintain a stable value with reference to the value of the Hong Kong dollar; or
- Actively market its issuance of FRS to the Hong Kong public.

It was noted that whether an FRS is issued in Hong Kong will be a fact-sensitive question. The HKMA will consider factors such as the FRS issuer's place of incorporation, the location of its operations, provision of subsequent customer service to FRS users, and whether a Hong Kong bank account is used to process issuance and redemption requests. Further guidelines are expected to be published on this requirement. The Consultation Conclusion also clarified that since FRS issuers of HKD-referenced stablecoins would likely target members of the Hong Kong public, and such FRS issuance could have financial and monetary stability implications for Hong Kong, such activity would be in scope even if carried on outside of Hong Kong.

Similarly, whether a person is "actively market its issuance of FRS to the public of Hong Kong" would also be a multi-factorial inquiry. In its assessment, the HKMA will consider non-exhaustive factors such as the language used in the marketing messages, whether the message is targeted at a group of people that resides in Hong Kong and whether a Hong Kong domain name is used for its website. Notably, the Consultation Conclusion stated that agents or intermediaries actively

marketing a licensed entity's FRS issuance will generally not be considered as issuing FRS themselves and thus do not require a licence under the proposed regime.

B. Licensing Criteria and Conditions

We summarise the key licensing requirements as proposed and the responses in the Consultation Conclusion below:

Licensing Requirements		Proposed regulatory regime as described in Consultation Paper	Comments from Consultation Conclusion
Management of reserves and stabilisation mechanism	Full backing	<p>The value of the reserve assets backing an FRS must be at least equal to the par value of the FRS at all times.</p> <p>Issuers of FRS which derive value from arbitrage or algorithms will not be granted a license, given the inherent difficulties of maintaining a stabilisation mechanism in the absence of any backing assets.</p>	<p>To be implemented as proposed.</p> <p>FRS issued must always be fully backed by reserve assets at any given point in time.</p> <p>Licensed FRS issuer will be required to demonstrate to the HKMA's satisfaction that it has put in place measures (e.g., over-collateralisation) to comply with such requirement.</p>
	Investment limitations	<p>The reserve assets must be of high quality and high liquidity with minimal market, credit and concentration risk.</p> <p>Reserve assets must be held in the referenced currency, although flexibility may be allowed on a case-by-case basis subject to the HKMA's approval.</p> <p>The composition of the reserved assets should be determined with reference to the FRS's liquidity requirements, including how liquidity requirements will be met through the management and investment of reserve assets.</p> <p>The HKMA will need to be satisfied of the</p>	<p>In response to calls for detailed guidance on the composition of reserve assets, the HKMA noted that different FRS issuers may have different liquidity needs and thus require different approaches to the management of their reserve assets.</p> <p>Accordingly, the HKMA will adopt a risk-based regulatory approach. FRS issuers will need to demonstrate how their investment policies for their reserve assets, as well as their liquidity management policies, are commensurate with their businesses.</p> <p>For the scope of reserve assets, the HKMA will consider factors including the</p>

		<p>appropriateness of the types of assets held by the FRS issuer and expects that each issuer will have a regularly reviewed investment policy regarding assets that are suitable for holding as reserve assets.</p>	<p>need for managing liquidity and market risks, operational needs of FRS issuers, and the classification of high-quality liquid assets in banking regulations, as well as other applicable international standards.</p> <p>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 high credit quality, (d) overnight reverse repurchase agreements with minimal counterparty risk backed by these securities and (e) tokenised versions of the above assets.</p> <p>It was also noted that issuers should discuss their investment policies with the HKMA, and the proposal of other investment instruments will be considered on a case-by-case basis having regard to factors such as the availability and liquidity of such assets and the ability to liquidate them within a short timeframe.</p> <p>Reserve assets should be held in the same currency as that referenced by the FRS and issuers need to obtain prior approval of the HKMA for currency mismatch between the FRS's referenced currency and its reserve assets.</p>
	<p>Segregation and safekeeping</p>	<p>FRS issuers will be expected to have effective trust arrangements to ensure that</p>	<p>Safekeeping reserve assets with licensed banks in Hong Kong provide greater user</p>

	<p>of reserve assets</p>	<p>reserve assets are appropriately segregated and available to satisfy FRS holders' redemption, as well as their legal right and priority claim in the event of insolvency.</p> <p>Reserve assets must be stored in segregated accounts with licensed banks or with other asset custodians (subject to the HKMA's approval of the proposed arrangements).</p> <p>FRS issuers must maintain effective internal controls to protect the reserve assets from operational risks, including risks of theft, fraud and misappropriation.</p>	<p>protection in case of business disruptions or failures. However, the HKMA indicated that it is open to proposals from licensed FRS issuers on placing the reserve assets in other jurisdictions on a case-by-case basis, provided that they could demonstrate the need for having this alternative arrangement, that additional risks are duly addressed, and that the FRS users' interests are not compromised.</p> <p>As regards what constitutes an effective trust arrangement for segregation, the appointment of independent trustee or a declaration of trust over the reserve assets would be acceptable. Prior to any implementation, the HKMA expects an FRS issuer to submit a draft of the relevant trust deed together with a draft of an independent legal opinion for review.</p>
	<p>Risk management and controls</p>	<p>FRS issuers must put in place adequate policies, guidelines and controls for the proper management of all investment activities associated with the management of the reserve assets.</p> <p>This includes having comprehensive liquidity risk management practices which address the approach to large scale redemptions—i.e., run scenarios or other scenarios of liquidity stress. FRS issuers must also conduct periodic stress tests to monitor the adequacy and the liquidity of the reserve assets.</p>	<p>To be implemented as proposed.</p>
	<p>Disclosure and reporting</p>	<p>FRS issuers must regularly publish the total amount of FRS in circulation, the mark-</p>	<p>The HKMA stated that it is inclined to reduce the frequency of public disclosure</p>

	<p>to-market value of reserve assets and the composition of reserve assets.</p> <p>FRS issuers will also be expected to (in consultation with the HKMA) engage a qualified and independent auditor to perform regular attestations in relation to their FRS, including the (i) composition and market value of the reserve assets; (ii) the par value of FRS in circulation; (iii) whether the reserve assets are adequate to fully back the value of FRS in circulation and are sufficient liquid (as of the last business day of the period covered by the attestation); and (iv) whether the conditions on the reserves management as imposed by the HKMA have all been fulfilled.</p> <p>The proposal recommends that the total amount of FRS in circulation and the value of reserve assets be disclosed at least daily, the composition of reserve assets be disclosed at least weekly, and attestation by the independent auditor be performed at least monthly.</p>	<p>regarding FRS in circulation as well as the market value and composition of reserve assets. This is to strike a balance between the operational burden on FRS issuers and the need for transparency and having regard to international developments.</p> <p>Subject to further discussion with relevant stakeholders (such as market participants and service providers) in the course of finalising the detailed guidelines, the HKMA intends to proceed with the proposed requirement of monthly attestation on reserve assets conducted by a qualified and independent auditor, to instil public confidence.</p>
Prohibition on paying interest	<p>FRS issuers must not pay interest to FRS users.</p> <p>Any income or loss from the reserve assets, including but not limited to interest payments, dividends or capital gains or losses are attributable to the FRS issuer.</p>	<p>To be implemented as proposed.</p> <p>It was clarified that the offering of marketing incentives would not be prohibited. However, FRS issuers would not be allowed to make arrangements with third parties to provide interest to FRS users.</p>
Effective stabilisation	<p>The FRS issuer is ultimately responsible for ensuring the effective functioning of the stabilisation mechanism of its FRS, notwithstanding any</p>	<p>No comments – to be implemented as proposed.</p>

		engagement of third parties to carry out the stabilisation activity.	
Redemption requirements	<p>The HKMA expects for FRS users to have the right to redeem their FRS at par value with the FRS issuer to have a claim on the reserve assets (or the issuer if the issuer is not able to meet redemption obligations).</p> <p>An FRS issuer is expected to process redemption requests without undue costs and on a timely basis. The issuer must not impose unreasonable conditions on redemption, such as a very high minimum threshold amount.</p> <p>If fees for redemption are charged, such fees must be clearly communicated to FRS users and must be proportionate, at a level that do not deter redemption.</p> <p>The FRS issuer must meet the redemption request at par value by paying in the fiat currency underlying the relevant FRS.</p> <p>Where channels for FRS users to exchange their FRS into fiat currency become unavailable (e.g., due to disruption to infrastructure), the FRS issuer must nevertheless still be able to ensure direct redemption for all FRS users at par in a reasonably timely manner.</p> <p>The FRS issuer is expected to draw up and maintain a contingency plan to enable orderly redemption of FRS by users if the issuer is unable to meet redemption requests (including in the case of</p>	<p>In response to queries as to what is considered “timely” for processing redemption requests, the HKMA stated that it will require FRS issuers to fulfil redemption requests within one business day in normal circumstances after the day on which a redemption request is received.</p> <p>It was added that FRS issuers should seek the HKMA’s prior approval if they foresee any difficulty in fulfilling redemption requests within one business day.</p>	

	suspension or revocation of the issuer's licence).	
Restrictions on business activities [4]	<p>The HKMA's approval must be sought before an FRS issuer can commence any new lines of business. To this end, the FRS issuer must conduct a risk assessment and demonstrate to the HKMA that adequate resources are allocated to the issuance and maintenance of the FRS, that the new business will not introduce significant risks, and that proper risk controls are in place to ensure that the new line of business will not impair its functions as an FRS issuer.</p> <p>However, provided that the FRS issuer have adequate systems for the segregation and safekeep of FRS and handling of deposit and withdrawal requests for FRS, the FRS issuer will be allowed to conduct activities ancillary or incidental to its issuance of FRS, such as providing wallet services for the FRS it issues.</p> <p>The FRS issuer is prohibited from carrying on lending and financial intermediation or other regulated activities (e.g., regulated activities under the SFO).</p>	<p>As noted in the Consultation Paper, the provision of lending or financial intermediation activities should not be undertaken by FRS issuers.</p> <p>The HKMA stated it would assess other proposed business activities on a case-by-case basis, having regard to the associated risks and effectiveness of mitigating measures.</p>
Physical presence in Hong Kong [5]	<p>The FRS issuer must be a company incorporated in Hong Kong with a registered office in Hong Kong.</p> <p>Its key personnel and senior management must be based in Hong Kong, and must be empowered with effective management and control of FRS issuance and related activities.</p>	To be implemented as proposed.

<p>Financial resources requirements[6]</p>	<p>The FRS issuer is expected to maintain a minimum paid-up share capital to be HKD 25,000,000 or 2% of the par value of FRS in circulation, whichever is higher.</p>	<p>In response to the feedback, the HKMA will impose a minimum paid-up share capital requirement of HKD 25,000,000 or 1% of the par value of FRS in circulation, whichever is higher.</p> <p>The HKMA nonetheless retains flexibility and power to impose additional paid-up share capital requirements as licensing conditions where necessary.</p>
<p>Disclosure requirements</p>	<p>The FRS issuer is expected to disclose general information about the issuer itself, the rights and obligations of its FRS users, the FRS stabilisation mechanism, reserves management arrangements, the underlying technology and the risks through a published white paper.</p> <p>The FRS issuer must also disclose their redemption policies, including the timeframe for the redemption process, the applicable fees and the right of FRS users to redemption.</p>	<p>The white paper for a prospective FRS should be ready when the licence application is submitted to the HKMA. FRS issuers will be required to notify the HKMA before publication.</p> <p>The white paper should be published on the issuer's website for easy access to the public.</p>
<p>Governance, knowledge and experience</p>	<p>Controllers, chief executives and directors of an FRS issuer must be fit and proper. Their appointment and any changes to the ownership and management of the FRS issuer are subject to HKMA approval.</p> <p>The FRS issuer is expected to have an adequate system of control for the appointment of the senior management team and suitable staff under a robust corporate governance structure.</p>	<p>In its assessment of fit and proper criteria of senior management, the HKMA will consider the applicant's experience of overseeing other financial activities in a similar capacity, the applicant's financial status and solvency, and the applicant's educational qualifications.</p>

<p>Risk management requirements</p>	<p>An FRS issuer is expected to implement appropriate risk management processes and measures, such as adequate security and internal controls, effective fraud monitoring and detection measures; technological risk management measures; and contingency arrangements to address operational disruptions.</p> <p>The FRS issuer must also perform risk assessments on a sufficiently frequent basis and at a minimum, on an annual basis, to ensure adequacy of its internal controls.</p>	<p>In response to queries regarding the frequency of the risk assessment, the HKMA stated that issuers should do so at least on an annual basis, regardless of the size of business or risk level of FRS operations.</p>
<p>Audit requirements</p>	<p>The FRS issuer is required to submit audited financial statements to the HKMA annually.</p> <p>Where required by the HKMA, the FRS issuer must submit reports prepared by external independent auditors and assessors to validate the management and operational soundness of the FRS issuance, such as whether the FRS issuer has adequate systems of control for the management of reserve assets, cybersecurity and the integrity of smart contracts.</p>	<p>To be implemented as proposed—further guidance on the scope of audit will be published in guidelines.</p>
<p>Anti-money laundering and counter-financing of terrorism requirements</p>	<p>The FRS issuer must ensure that the design and implementation of its issuance business has adequate and appropriate systems of control for preventing or combating possible money laundering and terrorism financing, and for ensuring compliance with the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (“AMLO”) and any other</p>	<p>FRS issuers should adopt a risk-based approach to mitigate and manage money laundering and terrorist financing risks that arise from the operation of FRS issuance, including any interaction with intermediaries within the ecosystem.</p> <p>Separate guidelines will be issued setting out the regulatory AML/CFT</p>

	<p>related rules or regulations issued by the HKMA. This includes ensuring that the FRS issuer has adequate customer due diligence measures in relation to FRS issuance, redemption, transaction monitoring and travel rule requirements.</p>	<p>requirements which will be consistent with international standards set by the Financial Action Task Force, including as relate to transaction monitoring and compliance with the travel rule.</p>
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Apart from the above, the HKMA also noted that viable and proper use cases are crucial to the sustainability of operations of FRS issuers. Therefore, they will take into account the use cases and business plans of prospective FRS issuers when reviewing their licence applications.

IV. Custody and offering of FRS

The Consultation Conclusion noted that there was broad agreement among respondents on allowing only licensed FRS issuers, accredited investors, licensed corporations and licensed virtual asset trading platforms (collectively, “**specified licensed entities**”) to offer FRS.

- Notably, it was clarified that “offer”, in relation to an FRS, means communication to the public in any form, or by any means, presenting sufficient information on the term of the offer and channels through which the FRS is to be offered so as to enable a person to decide whether to acquire the FRS.
- While specified licensed entities would not be required to obtain a licence for the purpose of offering FRS, these entities are expected to comply with the regulatory requirements applicable under their respective regimes. They should also seek necessary approvals from the relevant regulatory authorities before engaging in such activity.

In response to feedback regarding the offering of *foreign* FRS, the HKMA indicated that many FRS currently operate outside the purview of any regulatory regimes and this raises concerns about the stability mechanisms of these FRS and the potential risks they pose. In this regard, the HKMA stated that it would consider formal regulatory cooperation mechanisms with other jurisdictions as and when equivalent regimes are established, such as mutual recognition or “passporting” arrangements, subject to the progress of international regulatory developments.

V. Supervisory Powers of the HKMA

In respect of both the HKMA’s powers over the management of the licensee and other supervisory powers (e.g., powers to gather information, give directions and make regulations), there was broad support from respondents and this will be implemented as proposed.

VI. Disciplinary Framework

As regards the criminal offences and sanctions proposed, it was noted that these are formulated with reference to the AMLO and other financial regulations. In response to comments regarding the effectiveness of the offences and sanctions, the HKMA stated it would further discuss the

proposed scope and level of criminal offences and sanctions with the Department of Justice to ensure that they are sufficient and appropriate to bring about a deterrent effect.

As regards the civil and supervisory sanctions (e.g., the issuance of cautions, warnings, reprimands and temporary suspension of license), these will be implemented as proposed.

The appeal tribunal mechanism will also be implemented as proposed.

[1] “Hong Kong’s Regulators Refresh Guidance on Virtual Assets and Propose Legal Framework for Stablecoin Issuers”, published by Gibson, Dunn & Crutcher (February 2, 2024), available at <https://www.gibsondunn.com/hong-kong-regulators-refresh-guidance-on-virtual-asset-and-propose-legal-framework-for-stablecoin-issuers/>.

[2] “Another Step Towards the Regulation of Cryptocurrency in Hong Kong: HKMA Releases Discussion Paper on Stablecoins”, published by Gibson, Dunn & Crutcher (January 18, 2022), available at <https://www.gibsondunn.com/another-step-towards-the-regulation-of-cryptocurrency-in-hong-kong-hkma-releases-discussion-paper-on-stablecoins/>.

[3] “Hong Kong Monetary Authority Introduces Plans To Regulate Stablecoins”, published by Gibson, Dunn & Crutcher (February 7, 2023), available at <https://www.gibsondunn.com/hong-kong-monetary-authority-introduces-plans-to-regulate-stablecoins/>.

[4] This licensing requirement will not apply to FRS issuers which are authorized institutions, considering that these authorized institutions are already subject to relevant requirements under banking regulation.

[5] This licensing requirement will not apply to FRS issuers which are authorized institutions, considering that these authorized institutions are already subject to relevant requirements under banking regulation.

[6] This licensing requirement will not apply to FRS issuers which are authorized institutions, considering that these authorized institutions are already subject to relevant requirements under banking regulation.

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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

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