

# Regulatory Regime for Stablecoin Issuers in Hong Kong

by Monetary Management Department

## Background

In the past decade, significant efforts have been made to harness distributed ledger technology (DLT), such as blockchain, to enhance cost-efficiency, transparency and inclusiveness of financial services. As with the development of other technologies, the adoption of DLT has not been without challenges. Notably, the crypto-asset industry, being a strong proponent of blockchain adoption, experienced “DeFi (decentralised finance) Summer” in 2020, which saw a wave of experiments providing financial services on blockchain. It later entered into the so-called “Crypto Winter” in 2022 following a series of market incidents, including the de-pegging of algorithmic stablecoins (e.g. TerraUSD), as well as the subsequent collapse of various crypto hedge funds, lenders and exchanges (e.g. FTX).

Although these incidents have a limited impact on the traditional financial sector, financial regulators worldwide recognise the potential risks posed by crypto-assets and related players to the financial system, and have been collaborating with international bodies to address these risks. Drawing on the lessons learnt, the Financial Stability Board (FSB) finalised its global regulatory framework for crypto-asset activities in July 2023, comprising recommendations for the regulation, supervision and oversight of crypto-asset activities and markets, as well as “global stablecoin” arrangements<sup>1</sup>. Other standard-setting bodies have also published recommendations and standards to mitigate the various risks associated with crypto-assets.

Having well-defined regulations not only help to address the risks associated with these activities, but also create regulatory certainty and an enabling environment for innovations to thrive. Furthermore, appropriate regulations will provide soil for nurturing use cases that can tackle pain points in economic activities, as well as create value and new opportunities for Hong Kong’s economy and financial services sector.

Despite the Crypto Winter in 2022, the adoption of DLT in financial services has shown no signs of slowing down. Driven in part by technological advancement and global regulatory and supervisory development since 2022, traditional financial institutions have been actively adopting DLT and bridging the gap between the on-chain and off-chain worlds. This is evident in the launch of spot crypto exchange-traded products and tokenised funds by global asset managers. Global banks are exploring the provision of digital asset services, particularly in the area of asset tokenisation. Some overseas institutions have also issued stablecoins, or partnered with stablecoin issuers to complement their services.

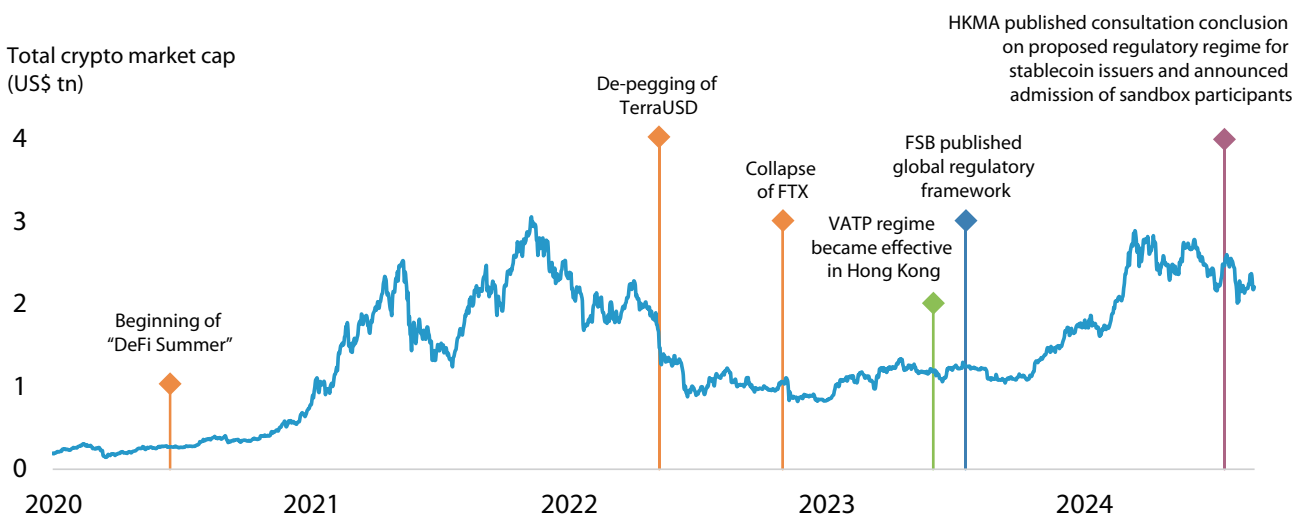
<sup>1</sup> See FSB Global Regulatory Framework for Crypto-asset Activities, FSB (July 2023) (<https://www.fsb.org/2023/07/fsb-global-regulatory-framework-for-crypto-asset-activities/>).

In Hong Kong, the Government issued a policy statement on the development of virtual assets in October 2022<sup>2</sup> to embrace financial innovations and technology development while also putting in place timely and necessary guardrails. Since then, the Government and financial regulators have been working to promote the sustainable and responsible development of the digital assets sector in Hong Kong. Notably, Hong Kong has introduced a new licensing regime for virtual asset trading platforms (VATPs), with licensed VATPs now operating in Hong Kong, and has approved the launch of several Bitcoin and Ether spot exchange-traded funds.

Concurrently, the public and private sectors in Hong Kong have been exploring various forms of tokenised money to complement the traditional forms of money. In addition to the exploration of central bank digital currencies (CBDCs), the HKMA has been working towards establishing a regulatory regime for stablecoin issuers, as a form of private tokenised money. The HKMA also launched a sandbox in July 2024 to facilitate communication of its supervisory expectations with potential stablecoin issuers in Hong Kong, and to allow participants to test out their proposed use cases within a limited scope and a risk-controlled environment.

### Exhibit 1

#### Key events in the crypto-asset market



<sup>2</sup> See Policy Statement on Development of Virtual Assets in Hong Kong, HKSAR Government (October 2022) ([https://gia.info.gov.hk/general/202210/31/P2022103000454\\_404805\\_1\\_1667173469522.pdf](https://gia.info.gov.hk/general/202210/31/P2022103000454_404805_1_1667173469522.pdf)).

## Digital assets and stablecoins

Digital assets, often referred to as crypto-assets, are digital representations of value that are cryptographically secured, typically through the use of DLT, such as blockchain. Bitcoin and Ether are two of the better-known examples of crypto-assets that are native to their respective blockchain networks, which have attracted and grown a sizeable community of users over time. Since Bitcoin's introduction in 2009, a wide spectrum of crypto-assets has been issued on different blockchains, some of which have attempted to solve real-world problems and create value for stakeholders; many others may lack intrinsic value.

Crypto-assets are often associated with price volatility, a characteristic not uncommon in less mature markets. This price volatility of crypto-assets has in turn led to market friction and fragmentation, prompting the introduction of stablecoins as a settlement asset for facilitating efficient transactions on the blockchain. In essence, stablecoin is a type of digital asset designed to maintain a stable value with reference to certain asset(s), typically fiat currencies. Users can exchange fiat currency with a stablecoin issuer in return for stablecoins of equivalent value, or redeem the stablecoins for a corresponding amount of fiat currency.

Over time, there have been explorations into the potential use of stablecoins as a medium of exchange in the real economy, for instance, in payments. With the use of DLT, payment and settlement via stablecoins could potentially become more efficient and transparent with enhanced certainty brought by the immutability of transactional data. When used in conjunction with smart contracts, i.e. self-executable programmes that are stored on blockchain, stablecoins could also function as "programmable money" and be used to execute complex transactions.

The inclusiveness of stablecoins — being a programmable means of payment or settlement that can move across different blockchain networks and be accessed by different players — may have the potential to incentivise collaboration and drive innovation, giving rise to a greater network effect in both the digital and real economies.

## Potential risks of stablecoins

The crypto-asset market remains far from maturity and is likely to continue to evolve, despite the multiple cycles it has been through in the past few years. Nevertheless, there are increasing indications that the traditional financial and digital asset sectors are becoming more integrated. In the case of stablecoins, some overseas institutions have already issued or adopted stablecoins to enhance their cross-border payment services. Should stablecoins become one of the preferred payment options by the general public, the question of whether stablecoin is indeed "stable" would then become increasingly crucial. In the absence of regulation, users may not be adequately protected, and the stability of the financial system could also be adversely affected.

From the standpoint of users, their confidence in using stablecoins stems from stablecoins' ability to maintain their value against the referenced fiat currencies, and the ease of redeeming stablecoins for the underlying fiat currencies. It is therefore essential for stablecoin issuers to maintain adequate reserve assets with proper disclosures to uphold the stable value of the stablecoin, and to enable redemption of the stablecoin at par value within a reasonable time frame. Failure to do so could cause financial losses to the users and lead to undue disturbance to economic and financial activities.

More broadly, the reserve assets of stablecoins often comprise not only cash but also other financial assets, which should normally be of high quality and highly liquid. Consequently, stablecoin issuers have become a natural point of linkage between the digital asset and traditional financial sectors. In the event of large-scale redemption of stablecoins, issuers may need to liquidate the reserve assets on an extensive scale in order to meet redemption requests, potentially leading to spillover to the traditional financial market.

## Formulation of a regulatory regime for stablecoin issuers

In response to the potential risks of stablecoins, international bodies, including the FSB under the G20, have already set out clear recommendations requiring member jurisdictions to formulate and implement a regulatory regime for crypto-asset activities, including stablecoin issuance. Other global financial centres are also expediting legislative work in relation to regulatory regime for stablecoin issuance. In line with international standards and practices, Hong Kong should put in place a regulatory regime, taking into account local circumstances, so as to provide appropriate safeguards to address the risks posed by stablecoins, protect users, foster a conducive environment for the development of digital asset ecosystem in Hong Kong, and further consolidate Hong Kong's status as an international financial centre.

In January 2022, the HKMA issued a discussion paper on crypto-assets and stablecoins, setting out its thinking on the regulatory approach for crypto-assets, particularly stablecoins. The conclusion to the discussion paper was issued in January 2023, summarising the feedback received and proposing to bring certain activities relating to stablecoins into the regulatory perimeter. In December 2023, the Financial Services and the Treasury Bureau (FSTB) and the HKMA jointly issued a public consultation paper on the

legislative proposal for implementing a regulatory regime for stablecoin issuers. The consultation conclusion was published in July 2024, addressing the feedback received regarding the scope of the proposed regulatory regime and licensing criteria.

Under this proposed regime, an issuer would be required to obtain a licence from the HKMA if it issues a stablecoin that references the value of one or more fiat currencies (a "fiat-referenced stablecoin") in Hong Kong. A licensee has to be locally incorporated with management presence in Hong Kong, and ensure its officers who are responsible for day-to-day management of the business have the necessary knowledge and experience. It would be required to maintain an effective stabilisation mechanism, such as maintaining a pool of high-quality and highly liquid reserve assets with proper custody arrangement, with a view to ensuring that users would be able to redeem the stablecoins for fiat currency at par should they wish to. The licensee would also need to put in place robust governance, risk management, and anti-money laundering and counter-financing of terrorism (AML/CFT) measures. The HKMA also intends to impose restrictions on the offering of stablecoins to ensure protection to users. In particular, only stablecoins issued by licensed issuers could be offered to retail investors.

### Exhibit 2

#### Proposed regulatory requirements for stablecoin issuers



## Stablecoin issuer sandbox

In an ever-changing market, it is important for the regulator to keep abreast of the latest developments, as well as to establish a regulatory regime that strikes a good balance between safeguarding financial stability and embracing innovation. With this in mind, the HKMA has rolled out its stablecoin issuer sandbox to better understand the business models of, and to communicate supervisory expectations and guidance to, institutions that plan to issue fiat-referenced stablecoins in Hong Kong. The sandbox also provides a means for the HKMA to obtain feedback from sandbox participants on the proposed regulatory requirements, so that the design of the regime will be fit for purpose and commensurate with the risk. For the sandbox participants, they can test out the feasibility of their intended business models and communicate with the HKMA directly to understand how to comply with the future regulatory requirements.

In view of the nature of stablecoins and the proposed regulatory requirements, the HKMA has set the admission bar of the sandbox at a reasonably high level, and developed specific requirements for acceptance into the sandbox. In particular, applicants need to demonstrate that they have (i) a genuine interest in and a reasonable plan on issuing fiat-referenced stablecoins in Hong Kong; (ii) a concrete plan for participation in the sandbox; and (iii) a reasonable prospect of complying with the proposed regulatory requirements. When assessing an application, the HKMA maintains communication with the applicants and takes into account a range of factors such as the proposed use case, stabilisation mechanism, management of reserve assets, and user protection.

Whether an individual institution, including existing stablecoin issuers, will apply for sandbox participation depends on a number of factors, such as its business plans when the legislation is implemented, and its need to test out stablecoin issuance process within a limited scope at the current stage. It should, however, be emphasised that sandbox participation is not a prerequisite for the application for a stablecoin issuer licence in the future. Sandbox participants that intend to apply for a licence later on will still need to submit a formal application when the regulatory regime comes into effect.

## Proposed use cases of stablecoins in the sandbox

In Hong Kong, there are multiple mediums of exchange that have been used extensively and proven effective, such as traditional bank deposits and stored value facilities. The HKMA and the banking industry have also been actively exploring the potential use cases of CBDC and tokenised deposits. With all these options, it will be the end users who ultimately decide which options work best for them. The inclusive nature of stablecoins presents a unique opportunity to develop innovative use cases that address existing, real-world pain points. The stablecoin sandbox will provide a controlled environment for applicants with a reasonably concrete plan to refine and bring their intended use cases to fruition.

The first batch of three participants was admitted to the sandbox in July 2024. Their primary proposed use cases include payments, supply chain management and applications in capital markets. The use cases are designed to target pain points in the movement of funds across financial institutions, payment service companies, settlement systems, etc. in different time zones. Currently, these intermediaries or financial market infrastructures do not operate on a 24/7 basis, and the transactional costs are relatively high with low efficiency. Stablecoins, as a possible medium for payments, will not only lower costs and reduce transaction time, but also provide various innovative solutions by leveraging their programmability feature. They will generate more automated and “smarter” financial services, thereby facilitating fund flows and enabling better management of risks associated with the transactions. The sandbox participants have also proposed application of their stablecoins in other areas such as Web3, gaming and digital asset trading.

### Testing in the sandbox

All operations and testing under the sandbox arrangement will be conducted within a limited scope and risk-controlled environment. For example, there will be restrictions on the number of users and the size of stablecoin issuance, and the testing will not involve the handling of customers’ or the general public’s funds at the initial stage. Depending on the participants’ proposals and the progress of testing, the HKMA may fine-tune the operation parameters and testing scope as appropriate. The HKMA will make separate announcement in case sandbox participants are allowed to handle the general public’s funds to a limited extent as a result of adjustments to the testing scope.

Through the sandbox process, the HKMA expects participants to demonstrate, among others, the feasibility of their stablecoin issuance and redemption processes, robustness of their wallet and private key management measures, and adequacy of measures for protecting stablecoin holders and combating money laundering/terrorist financing. Based on the experiences and feedback gathered from the testing process, the HKMA will develop good practices for various operational aspects to enhance supervisory efficiency and effectiveness.

Apart from complying with the requirements of the sandbox and the laws of Hong Kong, participants must ensure that they and their overseas partners strictly comply with the applicable laws and regulations of relevant jurisdictions if the use case involves cross-border elements. In case of any non-compliance, the HKMA may terminate their participation.

### Stay on guard against scams under sandbox-related claims

Meanwhile, there has been an increasing trend of scams involving digital assets in recent years. Some scams have involved entities falsely claiming to be licensed stablecoins in Hong Kong to attract investments, or misrepresenting themselves as participants in the sandbox or offering related products. It is therefore crucial to equip the public with the knowledge to identify and avoid scams.

To keep the public informed, the HKMA has published a list of sandbox participants on its website with timely updates<sup>3</sup>. When in doubt, members of the public are encouraged to contact the HKMA to enquire about and confirm information about the sandbox participants. In case of any suspected false or misleading announcements, the HKMA may refer these to law enforcement agencies for follow-up and will keep the public informed through various channels.

## Conclusion

The Government and financial regulators encourage financial innovation by providing a robust and transparent regulatory environment. Following the implementation of the licensing regime for VATPs, the FSTB and the HKMA are working full steam ahead on the draft legislation for implementing a regulatory regime for stablecoin issuers in Hong Kong and will strive to introduce the bill into the Legislative Council by the end of 2024. The HKMA believes early implementation of the regulatory regime can lay a solid foundation to foster innovations and help promote the healthy, responsible and sustainable development of stablecoin and the broader digital asset ecosystem in Hong Kong.

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<sup>3</sup> See HKMA's website for the list of sandbox participants (<https://www.hkma.gov.hk/eng/key-functions/international-financial-centre/stablecoin-issuers/>).