Hong Kong Monetary Authority grants first round of Stored Value Facilities licences

30 August 2016

On 25 August 2016, the Hong Kong Monetary Authority (the "**HKMA**") announced a first round of five successful Stored Value Facilities ("**SVF**") licensees under the Payment Systems and Stored Value Facilities Ordinance (the "**Ordinance**"). The successful applicants are Alipay, HKT, Tencent, TNG and Octopus.

The Ordinance commenced operation on 13 November 2015 with a one year transition period allowing existing SVF issuers to apply for licences. Upon the expiry of this one year period, i.e. from 13 November 2016 onwards, it will be unlawful for any person to issue or operate a SVF in Hong Kong without a licence (or the benefit of an exemption). The SVF licences awarded to Alipay, HKT, Tencent and TNG have immediate effect. Octopus's SVF licence will take effect from 13 November 2016. The announcement comes at a time when Hong Kong is making a considered push to be a fintech leader in the Asia-Pacific region. In the wake of Financial Secretary John Tsang's encouraging allocations towards fintech in the 2016-17 budget (including $2 billion earmarked for an Innovation and Technology co-investment fund), it is clear that this emerging sector has the government's attention. The HKMA has moved to establish a Fintech Facilitation Office and the Securities and Futures Commission has established a Fintech Contact Point. Both initiatives are squarely directed at creating space for engagement by regulators with start-ups and others in the fintech ecosystem.

The new SVF regime represents the most significant regulatory development in relation to Hong Kong fintech to date, bringing regulatory oversight to all businesses that enable payments to merchants and amongst peers through any manner of stored value facility. The previous regime applied only to card-based SVF and had Octopus as its sole active licensee. The new SVF regime represents an important updating of the regulation to reflect the advances in payments products made possible by new technologies. We understand that there are more than a dozen other applicants currently seeking SVF licences in time for the expiry of the grace period in November, and others preparing to make applications with a view to launching new businesses in the coming months.

How to obtain an SVF licence?

The HKMA has issued an Explanatory Note on Licensing for Stored Value Facilities (the "**SVF Guidance Note**"), which sets out the scope of the licensing regime as well as licensing criteria and particulars of the licensing process. The SVF Guidance Note may be found by **clicking here**.

Apart from the general and high level supervisory principles and approach summarised by the HKMA under the SVF Guidance Note (for analysis on the general licensing criteria and application procedure, please **click here**), applicants are expected to satisfy certain specific practical regulatory expectations of the HKMA in the course of the application process.

The Principal Business Requirement

The Ordinance requires that the principal business of an SVF licensee must be the issue or the facilitation of the issue of a SVF, and the licensee is not allowed to carry on any money lending services, financial intermediation activities or any other regulated activities. The practical consideration here is that applicants may need to restructure in order to prepare themselves for the application process, which may prolong and complicate the application process, in addition to adding cost.

A frequent question raised by applicants is whether an SVF licensee may also operate a business regulated under the Money Service Operator ("**MSO**") licensing regime provided for under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance, given that cross-border remittance and foreign exchange services are often bundled with SVFs in order to enable cross-border payments and redemptions in foreign currency.

In order to avoid regulatory overlap between the SVF regime and MSO regime (which is overseen by the Hong Kong Customs and Excise Department), the HKMA has indicated that SVF licensees are not required to separately obtain an MSO licence, as the relevant anti-money laundering and counter-terrorist financing requirements, being the major regulatory concern under the MSO regime, will be addressed by the SVF regime. While the specific nature of the MSO business needs to be looked at in each case, it is clear that SVF licensees will be able to carry on MSO business without offending the "principal business" rule.

The HK$25 Million Paid Up Capital Requirement

The Ordinance requires that an SVF licensee must either have paid-up capital of no less than HK$25 million (or an equivalent amount in any other currency) or other financial resources that are equivalent to or exceed this amount.

The HKMA has indicated that the HK$25 million is only a minimum requirement, and the regulatory expectation for each SVF issuer varies depending on its size, operations, number of users, business model and products to be launched in the market.

It is clear that the HK$25 million requirement has generated some concerns amongst start-ups seeking to obtain SVF licensees. As there is no general exemption for SVFs having a float below a threshold amount (such as the S$30 million minimum float threshold for SVF licensing in Singapore), smaller businesses wishing to carry on SVF business in Hong Kong are left to try to find an exemption from the licensing regime (for analysis on the exemptions, please **click here**) or find a collaborative partnership with an SVF licensee or financial institution.

Corporate Governance and a Hong Kong Base

SVF licensees are required to have a clear organisational structure with well-defined, transparent and consistent lines of responsibility. The governance structure is required to be properly documented and implemented in relation to all relevant decision making procedures, reporting lines and communication processes.

Whilst the ultimate responsibility for the overall sound and prudent management of an SVF issuer's business is with its Board of Directors, the day-to-day management and operation of an SVF issuer may be delegated to the senior management team, who remains accountable to the Board of Directors.

One of the challenges faced by SVF licence applicants headquartered elsewhere than Hong Kong is the Ordinance's requirement that: (1) the Chief Executive (including the Alternative Chief Executive) shall be and remain ordinarily resident in Hong Kong; and (2) other senior management team members and key personnel shall be based in Hong Kong. The strict requirement on the Chief Executive means that SVF applicants with overseas backgrounds must locate and assign a competent, proper and trustworthy candidate to be based in Hong Kong on a long-term basis. Nevertheless, the requirement that senior management members be "based in Hong Kong" falls short of a residency requirement, and so there is a degree of flexibility in this regard. The regulatory concern of the HKMA is that senior management of an SVF licensee must be reachable, responsive and contactable by the HKMA in case of any urgent SVF-related matters.

The other challenging aspect under corporate governance requirement is that members of the board have an adequate number and appropriate composition of members to ensure sufficient checks and balances and collective expertise for effective, objective decision-making. The HKMA's expectations have tended to be that one third of a licensee's board members be independent, non-executive directors ("**INED**"). In practice, some applicants may find it difficult to meet this requirement, either due to financial constraints or an inability to locate appropriately qualified candidates to act as INEDs. The HKMA has demonstrated some degree of flexibility on this point where alternative arrangements enable sufficient checks and balances and ensure adequate collective expertise within, for example, a wider group of companies of which the SVF licensee is part.

Anti-money Laundering and Counter-Terrorist Financing ("AML-CTF") Requirements

One of the major concerns of the HKMA in the regulation of SVF businesses is compliance with AML-CTF requirements. On the one hand, money laundering and terrorist financing has been a growing global concern and most jurisdiction have adopted tighter measures in this area; on the other hand, the specific nature of SVF business, being a business mainly structured on virtual and internet-based payments platforms, requires SVF issuers to adopt user-friendly mobile user interfaces in order to offer a good user experience and succeed in the market. A proper balance is required to be struck between the two competing concerns.

In the press conference held by the HKMA on 25 August 2016 announcing the grant of first batch of SVF licences, the HKMA stated that (1) for device-based reloadable SVFs with maximum stored value not exceeding HK$3,000; and (2) for non-reloadable network-based SVFs with maximum stored value of less than HK$8,000, there is no requirement to conduct any customer due diligence as a condition of taking the customer on (suspicious transaction reporting requirements will of course remain in place). Above these thresholds the requirements become more complex. SVF licence applicants will have had sight of draft AML-CTF guidelines as part of their engagement with the HKMA. These draft guidelines follow a "risk-based" structure similar to that applied by the HKMA to financial institutions regulated under the Banking Ordinance in prescribing criteria for carrying out "simplified" and "enhanced" due diligence. The HKMA indicated that it will publish its formal AML-CTF guidelines for SVF licensees in September 2016.

Based on the draft guidelines made available to applicants to date, it is expected that the HKMA will maintain a flexible, risk-based approach to customer due diligence, drawing distinctions on the basis of a number of characteristics of the specific SVF product and the nature of the issuer's interaction with the customer, in particular in terms of: (1) reloadability; (2) cross-border fund transfer functionality; and (3) cash withdrawal functionality.

As part of the application process for an SVF licence, the HKMA has been applying very close scrutiny to AML-CTF considerations. The business, technology, risk management, legal, compliance and product teams of an SVF licensee are required to work closely to take into account AML-CTF standards, particularly customer due diligence requirements, before launching any SVF product into the market. It is also expected that the customer due diligence requirements for reloadable network-based SVF will be transaction amount-based (annually, bi-annually, etc.) for particular SVF users.

Float Protection Requirements

Apart from AML-CTF issues, another key area of HKMA focus during the SVF licence application process has been scrutiny of the measures taken to manage the float of funds representing users' stored value and the corresponding SVF deposit held by the licensee.

SVF licensees are required to have in place an effective and robust system to protect and manage the float and ensure that the funds are: (1) used only in accordance with SVF users' instructions; (2) protected against claims by other creditors of the SVF issuer in all circumstances; and (3) protected against the risk of misappropriation by any means.

When considering practical measures for the implementation of these general principles, reference can usefully be made to similar regulatory frameworks in other jurisdictions. For instance, in the United Kingdom, the electronic money ("**e-money**") regulatory regime overseen by the Financial Conduct Authority ("**FCA**") imposes float safeguarding principles. Electronic money institutions must implement one of two specific float safeguarding measures: (1) a deposit in a segregated bank account with an authorised credit institution or an investment in an approved low risk, liquid asset held by an authorised custodian; or (2) arranging for the funds to be covered by an insurance policy or a comparable guarantee from an authorised insurer or credit institution.

The HKMA has required more comprehensive float protection measures, with the expectation that a trust arrangement supported by a legal opinion will be put in place to ensure priority for SVF users in the event of the insolvency of the SVF licensee. Depending on the specific business model and products of the SVF issuer, the HKMA may also require a bank guarantee or the appointment of a custodian as part of the float security arrangements. The additional safeguards required under the Hong Kong SVF regime above and beyond those required under the UK e-money regime may in part be explained by the fact that the Ordinance does not amend the Hong Kong insolvency rules to provide SVF users with any priority of claims in the event of the insolvency of the SVF licensee. This is a key feature of the regulations underlying the UK e-money regime.

Flexibility: Scope for Outsourcing Arrangements

The HKMA has generally been receptive to applicants' proposals to outsource aspects of their operations to third parties, provided that the applicant can demonstrate the measures will be taken to retain ultimate responsibility for the quality, safety, stability and efficiency of the operations being outsourced.

In line with its material outsourcing guidelines for financial institutions "**Supervisory Policy Manual SA-2**", the HKMA will be requiring that SVF issuers have adequate arrangements in place to facilitate on-site audits and inspections of outsourced service providers by the HKMA, the SVF issuer itself and the SVF issuer's internal and external auditors. The contractual arrangements with outsourced service providers are therefore key and should be carefully drafted in order to ensure adequate oversight.

Conclusions

As mentioned by Mr. Norman Chan, the Chief Executive of the HKMA, in his remarks on 25 August announcing the first round of licensees, the new SVF regime marks the turning of a new page in the development of retail payments in Hong Kong. The opening of the SVF regime is an important milestone in Hong Kong's advance as a fintech hub.

Some debate remains over how conducive the new regime will be towards encouraging fintech start-ups to enter into the SVF market in Hong Kong. Whilst there are a number of licensing exemptions under the SVF regime that allow certain business models to avoid SVF licensing requirements, these are narrowly crafted to be limited to tightly defined user bases and specific types of products. Fintech start-ups seeking to scale up in Hong Kong's already limited retail market may struggle to find a business logic that works within these constraints. It is clear that the SVF regime places a priority on the security of consumers' money and on maintaining Hong Kong's reputation as a well-run financial services hub, but it is also clear that the regime introduces trade-offs that will limit growth in certain parts of the market. Supporters of the new regime will point to the sheer number of applicants for SVF licences (reportedly over two dozen to date) and conclude that this is evidence that the regulations get the balance right.

We can expect that the HKMA will be gathering valuable experience regulating these new licensees and that the lessons learned will lead to adjustments of the regulator's risk-based assessments over time. The good news for now is that Hong Kong has taken a significant step forward in its regulation of financial services and the market demand for the new licences is strong.

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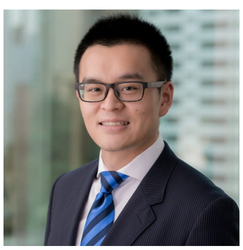

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