Hong Kong Publishes Bill Establishing New Regime for Stored Value Facilities and Retail Payment Systems

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On 23 January, the Hong Kong government published the Clearing and Settlement Systems (Amendment) Bill 2015 (the “Bill”), which will introduce a new regulatory framework for stored value facilities (“SVF”) and retail payment systems (“RPS”). The framework will be introduced under the Clearing and Settlement Systems Ordinance (“CSSO”), which will be renamed by the Bill as “Payment Systems and Stored Value Facilities Ordinance”, the “PSSVFO”. The CSSO currently legislates for oversight of interbank clearing house transfer systems and some other key market settlements systems in Hong Kong.

Currently, only device-based SVFs are regulated in Hong Kong, the ubiquitous “Octopus” card used in the city’s public transit system and at retail terminals being the only active licensee. A key consequence of the Bill will be to bring all multi-purpose SVFs, including non-device based ones, within the scope of regulation. It will be a criminal offence to operate a multi-purpose SVF in Hong Kong without a licence.

RPS will be regulated in a different manner, with the new regime under the PSSVFO applying only to designated RPSs that are so substantial that disruption of their operations would have wider adverse impacts on Hong Kong’s monetary or financial stability, public confidence in its financial systems or its day-to-day commercial activities. The Bill does not set out detailed designation criteria for RPSs, but does list a number of factors for consideration as part of the designation process, as discussed below.

First reading of the Bill took place on 4th February and the expectation is that the Bill will pass in this legislative session. The Executive Council proposes that the Bill be implemented in two phases: (i) an implementation phase that would begin immediately to establish the licensing regime and allow time for licence applications to be made and processed; and (ii) a second phase that would follow a year later, at which point the offences provisions and other measures would come into force.

Background

The publication of the Bill brings to a close a lengthy period of consultation on how Hong Kong will bring its regulatory framework for SVF and RPS up to date, a consultation which concluded with the publication by the Financial Services and Treasury Bureau (the “FSTB”) and the Hong Kong Monetary Authority (the “HKMA”) of their “Consultation Conclusions” in October 2014 (the “FSTB/HKMA Consultation Conclusions”). (Please click here to see our earlier briefing.)

The reforms are timely given the rapidly evolving market for payment services, in Hong Kong and elsewhere, and the increasing importance of electronic and mobile payment systems to retail markets for a wide range of goods and services. The explicit aim of the Bill is to enhance public confidence in payment services and introduce reforms that will maintain Hong Kong’s status as a leading international financial centre.

The payments services sector is in a state of considerable flux, with many rival technologies and business models competing in a market that can only be expected to grow significantly in the coming years. In many ways then, scrutiny of the Bill will come to focus on how different participants in the “payments ecosystem” (actual or prospective) will come to be regulated, from banks and credit card schemes through to payments service providers, telecommunications services providers and emerging technology businesses.

**SVF issuers**

SVFs are broadly defined in the Bill as facilities which may be used for storing value of a pre-paid amount of money or making payments for goods or services. The regime would cover both:

1. device-based multi-purpose stored value products such as the Octopus Card; and
2. non-device-based multi-purpose stored value facilities, which store value on mobile network accounts or computer network-based accounts.

The primary regulatory concern in relation to SVFs is the need to protect users’ stored value and, more broadly, regulate the float maintained by SVF issuers in order to meet payment demands.

Under the proposed framework, all SVFs of whatever size will be subject to mandatory licensing requirements unless they are exempted by the PSSVFO as a class or by the HKMA on a case-by-case basis. Schedule 8 to the Bill sets out a series of class exemptions:

1. **Single purpose SVFs**, such as prepaid cards, loyalty reward schemes and gift vouchers issued by retailers solely for the purpose of funding purchases of goods and services from that issuing retailer;
2. **Department store SVFs**, which involve a department store or similar retailer issuing an SVF that may only be used as a means of purchasing goods or services from the issuer or other persons carrying on business within the premises of the issuer, provided that the total float of the SVF does not exceed HK$1 million;

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3. **Specified premises SVFs**, in which an SVF can only be used at specified premises, such as recreational clubs or university campuses, provided that the total float of the SVF does not exceed HK$1 million;

4. **Bonus and loyalty point schemes**, where points or units that are "money's worth" are used to purchase goods or services and those points or units are not redeemable for cash; and

5. **SVFs used to purchase digital products**, where goods or services are paid for through, delivered to and intended to be used through an electronic device and the relevant operator of the payment facility does not act only as an intermediary between the purchaser and the provider of the goods or services. This exemption is meant to cover online platforms offering third party digital music, books, video, games and apps where these platforms have similar attributes to single-purpose SVFs.

The HKMA may issue further exemptions on a case-by-case basis, provided that the HKMA is of the view that the risks posed by the SVF to its users and the financial system of Hong Kong are immaterial. Likewise, the HKMA may declare an otherwise exempt SVF to be subject to a licensing requirement if it determines that the SVF poses material risks to users or the financial system of Hong Kong.

Operating an SVF without an appropriate licence will be punishable on indictment by a fine of HK$1 million and 5 years' imprisonment or on summary conviction to a fine of HK$100,000 and 6 months' imprisonment.

**SVF Facilitators**

The new regime will also require the licensing of "facilitators" of SVFs, defined as persons other than the issuers of SVFs who provide issuers with valuable consideration that contribute to the funding of the SVF scheme. The example given in the FSTB/HKMA Consultation Conclusions is that of Mondex, which at one time operated a scheme in Hong Kong under which it maintained a pool of funds accessed by cards issued by Hong Kong banks. By these comments, and by the definition set out in the Bill, "facilitator" is intended to cover contributors of value, not providers of ancillary services to a SVF scheme, such as payment collections, telecommunications and operational support services providers.

The FSTB/HKMA Consultation Conclusions state that an SVF facilitator which is also an issuer would not necessarily be required to obtain a separate facilitator's licence, provided that the issuer licence incorporates float safeguarding measures that are appropriate to both the issued and facilitated SVFs.

**Licensed banks as SVF Issuers or Facilitators**

Banks are regulated in a somewhat different fashion to other SVF licensees due to existing prudential regulation under the BO. In particular (see section headed "SVF Licensing Criteria" below):

- they need not issue or facilitate SVFs as their principal business;
- they are exempted from the paid-up capital requirements; and
- they are exempted from the "fit and proper" requirements.

**SVF Licensing Criteria**

SVF licence applicants will be assessed against a number of criteria, including the following requirements:

- the applicant has adequate financial resources for operating the SVF scheme;
- the applicant has paid-up share capital of not less than HK$25,000,000 or equivalent financial resources;
- the chief executive and each director or controller is "fit and proper" to hold his or her position and the applicant has in place adequate systems of control to ensure that each manager is "fit and proper" to hold the position concerned (the HKMA will be issuing supervisory guidelines on the "fit and proper" requirements in due course);
- the officers of the applicant responsible for implementing the SVF scheme or the day-to-day management of the scheme have appropriate knowledge and experience to discharge their duties responsibly;
- the applicant has appropriate risk management policies and procedures that are commensurate with the scale and complexity of the SVF scheme;
- the applicant has adequate and appropriate systems of control for preventing or combating possible money laundering or terrorist financing, including the requirements of the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance and any rules, regulations or guidelines issued by the HKMA on these topics;
- the applicant has adequate risk management policies and procedures for managing and protecting the SVF scheme float and ensuring that float is kept separate from other funds;
- the applicant will redeem in full a user's stored value as soon as practicable following a request to do so and its terms of service shall clearly and prominently state any fees to be charged for redemption and any deadline for using or redeeming stored value;
the applicant has prudent and sound operating rules for
the SVF scheme, having regard to the purposes of the
SVF scheme and how the scheme is to be operated and
governed; and

the SVF scheme itself must be prudent and sound, having
regard to the purpose, business model and operational
arrangement of the scheme.

SVF Licence Conditions

The regime will allow the HKMA to issue licences with
conditions, including in relation to maximum stored value and
float.

If the HKMA intends to attach conditions to a new SVF
licence, it must give a written notice to the licence applicant
setting out the proposed conditions and the grounds for
imposing them. The HKMA must then allow the applicant no
less than 14 days to make written or oral representations as
to why the grounds for attaching conditions have not been
made out.

Designated RPS operators

Under the PSSVFO, RPS will broadly encompass any
"system or arrangement for the transfer, clearing or settlement
of payment obligations relating to retail activities, principally
by individuals, that involve purchases or payments."

The Bill proposes to bring designated RPS into close
oversight and monitoring similar to the monitoring applicable
to the clearing and settlement systems currently regulated
under the CSSO. The scope of "system operators"
designated and licensed under the PSSVFO is potentially
very broad, encompassing persons responsible for the
transfer, clearing or settlement functions of the system or
"other related functions."

RPS will be designated for regulation under the PSSVFO in
cases where they are so substantial that disruption of their
operations would have wider adverse impacts on Hong
Kong's monetary or financial stability, the public's confidence
in its financial systems or its day-to-day commercial activities.

Factors to be taken into account by the HKMA in designating
an RPS will include:

- the estimated aggregate value of amounts transferred,
cleared or settled through the RPS in a normal business
day;
- the estimated average value of amounts transferred,
cleared or settled through the RPS in a normal business
day;
- the estimated number of transactions processed through
the RPS in a normal business day;
- the estimated number of participants in the RPS; and
- whether the system is linked to any other system
designated under the PSSVFO or any clearing and
settlement system operated by a clearing house under the
Securities and Futures Ordinance.

The HKMA is obliged to publish its intention to designate an
RPS in the Gazette, stating its grounds for designation and
providing a notice of a period of not less than 14 days to allow
oral or written representations to be made against the
designation.

According to the FSTB/HKMA Consultation Conclusions, the
stated intention is not to separately regulate licensed banks'
internet and mobile banking payment services, electronic fund
transfer services, ATM networks or other payments systems
under the PSSVFO as RPSs. The FSTB/HKMA Consultation
Conclusions also refer to (but do not endorse) public
submissions to the effect that the materiality threshold for
designation of an RPS should be established by reference to
specific transaction volumes (for example, 10,000 per day) or
aggregate transaction values (for example, HK$5 million per
day). The Bill does not propose any specific threshold
amounts and it is not clear at this stage whether or not the
HKMA will issue guidance to this effect in future.

Regulation of Designated RPSs

Under the proposed framework, designated RPSs will be
overseen by the HKMA. They will be required to have in
place operating rules to provide for the system to be operated
in accordance with requirements, including relevant default
arrangements which are appropriate and adequate for the
system.

Designated RPS will also be subject to safety requirements
which include risk management and control procedures
relating to the operation of the system, safety and integrity of
information held within the system, soundness of the system
including financial soundness and efficiency requirements
including cost of participation and reasonableness of criteria
for admission as a participant in the system.

Certain RPSs may be exempted from some of these
obligations if they are established outside of Hong Kong and
are already subject to sufficient regulatory supervision.

Conclusions

The introduction of SVF and RPS regulation to Hong Kong
under the Bill will bring much needed certainty to a number of
areas of payments processing which are currently operating in
a "grey area."

Improving public confidence in SVFs through transparent
regulation is no doubt a positive development, but it is clear
that there will be some fine distinctions to be drawn, in
particular, around the exemptions to SVF licensing. We are
seeing an enormous amount of innovation around stored
value coming forward, as businesses experiment with new
models of encouraging brand affinity and customer loyalty,
and new m-commerce retail models and as consumers'
appetite to transact quickly and flexibly by electronic means
continues to grow at a rapid pace.
It can readily be seen that smaller start-ups in the stored value space will struggle with HK$25 million capitalisation requirements and broader prudential regulation, leading some to question Hong Kong’s commitment to internet entrepreneurship by not establishing a de minimums float value below which the SVF regime will not apply (as is the case in Singapore).

More broadly, while the distinction between bank and non-bank SVFs has been narrowed since the initial legislative proposals were put forward, there are those who feel that banks have an implicit advantage by being deemed licensed to carry out SVF schemes, which at the very least will give them a head start in planning their businesses under the new regime.

The regulation of RPSs tracks the existing regime under the PSSVFO but leaves significant uncertainty as to how material a system must be in order that it face the full weight of regulation. From the official comments in the FSTB/HKMA Consultation Conclusions it appears likely that the major credit card schemes will become subject to the regime. Whether this means any material change in practice from the outlines of the voluntary regime currently in place in Hong Kong remains to be seen. The specific nature of regulation under the new regime has generally been left to be determined on the specific facts, so there remains significant uncertainty on the RPS front until the HKMA issues clearer directions on the scope for designation of RPSs and the specific regulatory requirements that would follow from designation.

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