

How can listed companies in Hong Kong engage in the virtual asset sector?

Key things to know

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The recent wave of virtual asset sector institutionalisation has seen a special class of regulation become especially relevant – stock exchange listing rules. Many listed companies are interested in gaining exposure to virtual assets through directly holding virtual assets or through blockchain sector investments.

What are the rules governing listed companies in Hong Kong (“**HK Listed Companies**”) when making investments into virtual assets or venturing into virtual asset-related business activities? Further, what are the listing requirements for new listing applicants whose principal line of business involves virtual assets?

In this alert, we will examine some of the key things to know about Hong Kong’s requirements for HK Listed Companies and potential listing applicants, focussing on the following key areas:



Is the activity within the “ordinary and usual course of business”?



Disclosure rules



Investment policies and governance



HKIPO (new listings)

1. Is the activity within the HK Listed Company’s existing “ordinary and usual course of business”?

The key regulatory framework relevant to the activities of listed companies is set out in the rules and guidance of the Stock Exchange of Hong Kong Limited (“**HKEx**”). Overall, HK Listed Companies have a strong degree of latitude in relation to their investment and business activities in the “ordinary and usual course of business”, subject to applicable disclosure rules (refer to section 2 of this alert), governance standards (refer to section 3 of this alert) and the general compliance with the requirements of the HKEx and the laws of the Hong Kong SAR (“**Hong Kong**”).

The concept of the “ordinary and usual course of business” is especially relevant because any transactions of HK Listed Companies outside such ambit will need to comply with the requirements under Chapter 14 (“**Notifiable Transactions**”) of the Rules Governing the Listing of Securities on HKEx (“**Listing Rules**”). For more details, please refer to section 2 of this alert.

Proprietary securities and/or investment activities (“**Proprietary Trading and Investment**”) conducted by HK Listed Companies will normally **not** be regarded as business carried out in the ordinary and usual course of business *unless* they are carried out by a banking company, an insurance company or a securities house that is mainly engaged in regulated activities. Of course, it is not uncommon for HK Listed Companies to make Proprietary Trading and Investment outside their ordinary and usual course of business, but they must comply with the Listing Rules.

Are there any special rules for Proprietary Trading and Investment in virtual assets?

Not at this time. Proprietary Trading and Investment in virtual assets does not carry any special requirements under the Listing Rules. This means that there is a strong degree of latitude for compliance with the Listing Rules, although a degree of market practice is emerging and HK Listed Companies should consider what unique considerations apply (see more on this below).

Examples of virtual asset sector engagement by HK Listed Companies

- From app operation to blockchain

A HK Listed Company which operated online advertising and premium subscription services and in-app purchase business, announced that its board had purchased virtual assets with an aggregate consideration at the time of around US\$40million, comprising Ether and Bitcoin. The same company later made another public announcement pursuant to Chapter 14 of the Listing Rules regarding its further acquisitions of virtual assets with an aggregate consideration of approximately US\$90 million, which triggered the Listing Rules disclosure requirement (refer to section 2).

- Building a new virtual asset business segment

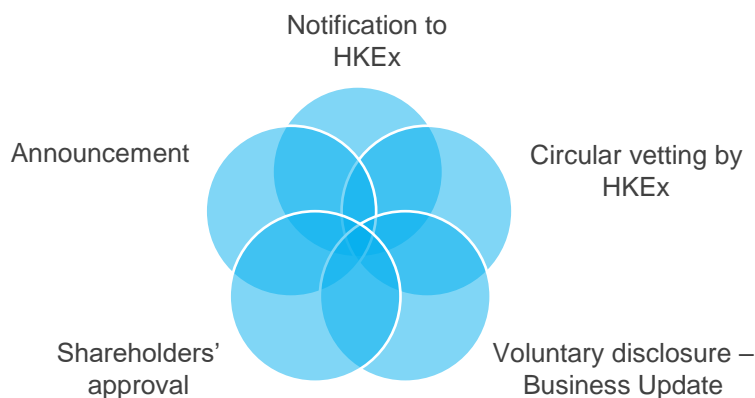
A HK Listed Company which operated a traditional advertising and business park area management business expanded its group activities to include blockchain sector businesses including a Hong Kong-regulated exchange, custody services and software-as-a-service solutions. A joint venture involving the group and the venture arm of a leading bank was also recently announced with the aim of establishing a virtual asset platform for institutional and corporate clients in the United Kingdom and Europe.

- Managing funds to investing in virtual assets

A HK Listed Company which sells power-related and electrical/electronic products and provides technology solution services announced that it had launched four virtual asset-related funds, after obtaining its virtual asset manager licences from the Securities and Futures Commission of Hong Kong (the “SFC”). The virtual asset-related funds included two virtual asset tracker funds and a multi-strategy virtual asset fund, all of which were solely invested in virtual assets.

2. Disclosure requirement under Listing Rules framework

Pursuant to Chapter 14 of the Listing Rules, HK Listed Companies, may be required to satisfy the following key requirements, depending on the size, nature and counterparties involved in the transaction.



Under Chapter 14 of the Listing Rules, “transaction” includes, *inter alia*, the acquisition or disposal of assets; the definition of “assets” encapsulate both tangible and intangible assets and include businesses, companies and securities, whether listed or not (unless otherwise stated in the Listing Rules). Thus, by definition, as virtual assets would be considered intangible assets, their acquisition or disposal would be a transaction that would fall into the ambit of Chapter 14 of the Listing Rules.

As noted above, the specific rules that apply will depend on whether certain thresholds are met. For example, as disclosed in the announcement of one HK Listed Company, the aggregate consideration of both its acquisitions of virtual assets reached the threshold of an announcement, but did not reach the threshold of the shareholder approval requirement, therefore, no shareholders' approval was needed, nor was there a requirement to have the circular vetted by HKEx.

Are virtual assets unique from a HKEx standpoint?

Given the relatively short history of investment in virtual assets, HKEx has yet to publish any specific guidelines or impose additional disclosure requirements for HK Listed Companies on this area. As at the date of this alert, no HK Listed Company has reached the shareholders' approval threshold to issue circular which required to obtain clearance from the vetting team of the HKEx prior issuance. Therefore, it is still uncertain on the regulator's vetting attitude towards investment in virtual assets.

That said, virtual assets do carry a unique set of opportunities and risks, emphasising the need for robust disclosure to the retail market. By way of example, the virtual asset sector experiences periodic volatility, and two key outcomes can emerge:

- 1. Direct exposure** – If the HK Listed Company directly holds virtual assets, and the market value of those virtual assets drops significantly, the HK Listed Company could be undermined financially. The size of the investment, as well as the accounting treatment evaluating such loss, will be relevant to evaluate the risk exposure to shareholders.
- 2. Indirect exposure** – If the HK Listed Company makes an investment into a company that has material virtual asset exposure and the market drops significantly and the investee company is forced to liquidate at a net loss, HK Listed Company shareholders would also be exposed to loss indirectly.

Arguably, the virtual asset sector is not wholly unique and the same principles apply to other types of investments – for example, even traditional sector stocks can be volatile and regular “bricks and mortar” businesses can fail through exposure to volatile *tangible* commodities. However, just as those risks must be assessed and properly disclosed, it is important to take into account that smart contract and distributed ledger technologies are still relatively new in the virtual asset sector and that many virtual assets and blockchain protocols are still in an experimental phase. On top of this, governance and regulatory frameworks are also in a phase of rapid development globally.

What this means for HK Listed Companies is that due diligence and expert support are essential to be able to make the right choices in any Proprietary Trading and Investment – including in relation to selecting virtual assets, acquisition, trading and liquidation strategies, custodial arrangements and third party trading venues. In addition, retail (and other) investors are likely to rely on HK Listed Companies for information about virtual assets and on the quality of HK Listed Companies' diligence. This heightens the risk of disputes for HK Listed Companies that do not take a robust approach.

If virtual assets become a more common target of Proprietary Trading and Investment among HK Listed Companies, it would be especially useful for retail investors if HKEx issues additional guidance to standardise the approach to disclosure and scrutiny of these assets akin to the approach on ESG (refer to our [Legal Guide to ESG](#) and [April 2021 alert](#) on these issues). The SFC has also made significant strides in setting standards for its regulated entities, with more on the way (refer to our virtual asset alert [here](#)). Further afield, the Australian Securities and Investment Commission is also consulting on listed products that have virtual asset underlying (see [here](#)).

3. Investment policies and governance

Apart from complying with the disclosure requirements mentioned above, the directors of HK Listed Companies are required to fulfil their fiduciary duties and the duty of skill, care and diligence to a standard at least commensurate with the standard established by the laws of Hong Kong, which includes acting within the ambit and scope of the authorities granted to them pursuant to the HK Listed Companies' articles of associations.

Technically speaking, it is subject to interpretation whether a director is allowed to make investments in certain areas when no restrictions are imposed or specified in the articles of associations or terms of references for subordinate board committees ("**Constitutional Rules**"). Nevertheless, in order to enhance the standard of corporate governance, amending and explicitly stipulating the directors' authority in the Constitutional Rules to invest in virtual assets may be a more viable step to justify the board's decision to make such Proprietary Trading and Investment in the future, and may enable investment strategies for the Proprietary Trading and Investment to be seamlessly implemented.

For instance, one HK Listed Company approved and adopted a virtual asset investment plan for making acquisitions of virtual assets by cash reserves other than proceeds from its initial public offering.

From a corporate governance perspective, having considered the unique characteristics virtual assets marked with a relatively short trading history, HK Listed Companies may consider explicitly endorsing and approving any Proprietary Trading and Investment in virtual assets in their amended Constitutional Rules, which in turn would have to be considered by the shareholders and approved to grant explicit authority to the directors to make such investments. As foreshadowed in section 2, we would strongly recommend proper due diligence and expert involvement in defining the approach, as well as creating appropriate policies and procedures governing which assets are invested and how.

A similar approach could be taken for other blockchain sector investments and business expansions.

4. New listings

HKEx adopts a disclosure-based approach and looks at a basket of requirements embedded in the Listing Rules when deciding whether to approve the listings of new applicants. HKEx also retains an absolute discretion in its decision¹ despite all such requirements having been met. Apart from the general listing requirements which all new listing applicants would need to meet, *inter alia*, financial requirements, suitability requirements and management and ownership continuity requirements, there are also other requirements which warrant new listing applicants' attention prior to the preparation of their IPO applications on the HKEx.

Special HKEx guidance for internet-based business models

In July 2018, HKEx published a guidance letter to provide guidance on HKEX's approach to new listing applicants in the internet-based business models to facilitate their listing within the existing regulatory framework². The special requirements for internet-based new listing applicants are summarised below. In particular, HKEx has highlighted how the lack of an established regulatory environment is an important element that would warrant higher level of disclosure. If the laws and regulators applicable to the new listing applicants are still developing and are not expected to be promulgated in the near future – HKEx would expect such applicants to ensure that the disclosure of associated risks in the prospectus is sufficient. However, if it is clear in the circumstances of the case that draft regulations affecting the new listing applicant's business will be promulgated in the near future, HKEx will impose additional requirements and expect the new listing applicant to demonstrate, with the support of a local legal opinion, that it is able to comply with the requirements of the draft regulations in the event such are actually promulgated.

What does this mean for virtual assets?

The HKEx guidance letter noted above is not specifically targeted at blockchain or virtual assets, but it does signal a regulatory attitude and expectations that are relevant to them. In particular, virtual asset regulations are rapidly unfolding in Hong Kong (with both strong SFC guidance and Hong Kong Government proposals for a new regime underway), as well as in other major markets. An applicant (as well as established HK Listed Company) will therefore be expected to:

¹ Listing Rule 8.01.

² Guidance Letter 97-18.

- understand the regulatory environment for their business and their investments – not just generically, but with specific reference to its specific objectives, strategies and activities; and
- consider the viability and sustainability of its business model. This may be especially relevant, for example, to applicants that are focussed on a particular type of technology (say, virtual asset mining equipment) if market trends and technological advancements suggest that this will be obsolete because of competitor technologies or because the sector is moving in a different direction (say, proof of stake blockchain protocols that require a different approach).

5. To sum up....

Virtual assets and related companies are likely to be a continuing trend, particularly as institutional-grade platforms and new regulatory frameworks support greater confidence to the market. Despite the lack of specific regulations for HK Listed Companies to engage in the sector, there are multiple existing principles that support Proprietary Trading and Investment and new listings related to the sector. Ultimately, due diligence, disclosure and governance are the key pillars for complying with HKEx expectations and avoiding unintended downside risk to shareholders.

The evolving regulatory environment in Hong Kong and other jurisdictions, coupled with the growth and maturing of blockchain infrastructure, is likely to have an especially large role to play in how HKEx, HK Listed Companies and investors assess the relative risks and opportunities.

If there are any questions regarding the topic of this alert, you are welcome to come and speak to us.

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