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[online version](http://www.charltonslaw.com/sfc-publishes-consultation-paper-on-the-professional-investor-regime/)

# SFC Publishes Consultation Paper On The Professional Investor Regime

The Securities and Futures Commission (**SFC**) has published [a consultation paper](http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=13CP1) [[archived copy](CP.pdf)] on proposed amendments to the professional investor regime and to the client agreement requirements in relation to offering investment products to professional investors (**PI**s). This newsletter will briefly summarise the current regime and the proposed amendments to it. The consultation questions raised by the SFC can be viewed [below](#Questions). The public can submit written comments in relation to the matters discussed in the consultation no later than 14 August 2013.

## Key issues

* Whether corporate and individual PIs should continue to be allowed to participate in private placement activities;
* Whether the monetary thresholds for classifying PIs should be increased;
* A requirement that intermediaries must comply with all requirements of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code**) when dealing with PIs who are individuals (including their wholly owned investment vehicles and investment vehicles that are wholly owned by family trusts); and
* For corporate PIs, whether intermediaries should continue to be exempt from the suitability requirement and other current Code exemptions after conducting a principles-based knowledge and experience assessment.

## Background

During the financial crisis in 2009, there were complaints that individual investors in Lehman Brothers-related products were classified as PIs and therefore subject to less investor protections. It was complained that certain investors who had purchased Lehman Brothers-related products from banks did not know that the declaration they had signed was a confirmation that they wished to be treated as a PI, and the risks and consequences of being so treated. At a Legislative Council (**LegCo**) meeting, legislators questioned whether the qualifying criteria and procedural requirements for ascertaining PIs under the current regime were clear and appropriate. As a result, the SFC conducted a comprehensive review of the current PI regime governing the sale of investment products to PIs.

## The Professional Investor Regime

“PI” is defined under Schedule 1 to the Securities and Futures Ordinance (**SFO**), collectively known as Institutional PIs. They are mainly financial institutions which are highly sophisticated in the financial markets. The following individuals, trusts and corporations are also defined as “PI” under the Securities and Futures (Professional Investor) Rules:

* Any individual who (either alone or with his/her spouse or child on a joint account) has a portfolio of not less than $8 million; (**Individual PI**s)
* Any trust corporation having been entrusted with total assets of not less than $40 million;
* Any corporation or partnership having: (i) a portfolio of not less than $8 million; or (ii) total assets of not less than $40 million; and
* Any corporation the sole business of which is to hold investments and is wholly owned by any one or more of (a), (b) or (c) above.

The entities in (b) to (d) are collectively known as “**Corporate PI**s”.

Under the current regime, intermediaries [[1]](#footnote-28) offering investment products to PIs are exempted from complying with some or all of the requirements contained in the Code, depending on the type of the PIs. These requirements include, inter alia:

* the Suitability Requirement;
* the need to establish a client’s financial situation, investment experience and investment objectives;
* the need to characterize a client based on his knowledge of derivatives;
* the need to disclose certain sales related information;
* the need to enter into a written agreement and provide relevant risk disclosure statements; and
* for discretionary accounts, the need to obtain the client’s prior written authority to effect transactions for the client without his specific authority and the need to confirm it on an annual basis.

## Suitability Requirement

The Suitability Requirement is the requirement set out in paragraph 5.2 of the Code that having regard to the information about a client which an intermediary is or should be aware, the intermediary is required to ensure the suitability of its recommendation or solicitation for a client is reasonable in all the circumstances. In short, intermediaries should “know their clients”, conduct product due diligence, provide reasonably suitable recommendations by matching the risk return profile of each investment product with the personal circumstance of the clients and retain the reasons for each product recommendation made to each client and provide it with a copy.

## Application of the exemption to Corporate and Individual PIs

An intermediary can be exempted from complying with the Code requirements only if the Corporate or Individual PI is sufficiently knowledgeable and experienced in the relevant products and markets. Under the current regime, an intermediary is required to conduct the Knowledge and Experience Assessment for each Corporate and Individual PI to see whether it can be exempted from the Code requirements. The Knowledge and Experience Assessment is a bright-line test, requiring intermediaries to consider the following factors:

* The type of products in which the person has traded;
* The frequency and size of trades (not less than 40 transactions per annum);
* The person’s dealing experience (active in the relevant market for at least 2 years);
* The person’s knowledge and expertise in the relevant products; and
* His awareness of the risks involved in trading in the relevant products and/or markets

However, the SFC notes that the Knowledge and Experience Assessment is not used frequently in practice.

Corporate and Individual PIs can decide on the level of investor protection they require when dealing with intermediaries. Their consents are required before treating them as PIs and the consents can be revoked at any time.

Intermediaries dealing with Institutional PIs are automatically exempt from complying with all the Code requirements.

## Compensation to aggrieved clients

Under the current regime, the SFC cannot compel intermediaries who are in breach of the Code requirements to pay compensation to aggrieved clients. Nor can the aggrieved clients seek compensation or bring other claims against the intermediaries as the Code requirements are not usually incorporated into the agreement between them.

In practice, some intermediaries include clauses in client agreements to restrict clients’ ability to seek compensation. This is done by incorporating clauses which mis-describe the actual services to be provided.

## The proposed amendments

### Private placements

The SFC notes that the primary purpose of the PI Regime is to enable issuers to raise funds through private placements. The marketing documentation for a private placement does not require SFC authorization giving rise to a concern that information disclosure requirements which are lower than for public offerings render PIs vulnerable. Other overseas jurisdictions such as the United States allow investors to access private placements solely by reference to wealth criteria. The SFC also recognizes the benefit the industry derives from continuous access to the PI market for fund raising purposes. However, there is a concern that PIs who qualify solely by meeting the prescribed monetary thresholds under the current regime may not in practice be financially sophisticated, knowledgeable and experienced and they could be vulnerable.

Therefore, the SFC seeks views on whether any changes should be made to the private placement regulations.

### Qualification of PIs

The SFC does not support the LegCo’s proposal to strengthen investor protection by codifying the Knowledge and Experience Assessment as a statutory obligation so that individuals and corporations will not be treated as PIs solely by virtue of their reaching the monetary thresholds. The SFC comments that the proposal, if adopted, would not be an effective way to classify PIs and limit the flexibility of intermediaries in using different methods to identify PIs. [[2]](#footnote-35)

Alternatively, some LegCo members proposed to increase the current minimum monetary thresholds for qualifying as PIs. The SFC notes that the $8 million minimum portfolio threshold for Individual PIs is higher than that in the United Kingdom, but lower than that in Australia and Singapore.

The SFC seeks views on whether the current monetary thresholds for Corporate and Individual PIs should be increased.

### Conduct regulation – Individual PIs

As the vast majority of selling misconduct cases dealt with by the SFC involve individual investors, the SFC considers that Individual PIs generally merit greater protection than Corporate PIs. In the United Kingdom and the United States, intermediaries cannot be exempted from the relevant suitability requirements when dealing with individuals, no matter how wealthy they may be.

The SFC proposes that all Code requirements should be followed by intermediaries without exemption when they deal with Individual PIs, their wholly owned investment vehicles and investment vehicles wholly owned by family trusts.

### Conduct regulation – Corporate PIs

The SFC proposes to revise the Knowledge and Experience Assessment for determining whether a Corporate PI is knowledgeable and experienced in the relevant products and/or markets. The SFC comments that the current bright-line test is too rigid and is not a reliable indicator of a corporation’s knowledge and experience.

It is proposed that when performing the Knowledge and Experience Assessment, intermediaries should follow a principles-based approach by considering the following factors:

* The corporate structure and investment process and controls, i.e. how investment decisions are made, including whether the corporation has a specialised treasury or other function responsible for making investment decisions; and
* The background of the persons(s) responsible for making investment decisions on behalf of the corporation including the investment experience, work experience, training and qualifications, and whether they have sufficient investment experience in relevant products and/or markets.

It is proposed that intermediaries dealing with institutional PIs should continue to be automatically entitled to all current Code exemptions.

### Suitability Requirement

The SFC proposes that intermediaries serving Individual PIs must comply with the Code’s Suitability Requirement without exception. The SFC also invites any other views on the Suitability Requirement, including the scope and substance of the requirement.

### Client agreement requirements

To address the issue that aggrieved clients may not be able to seek compensation from intermediaries in case of breaches of the Code requirements, the SFC proposes that:

* The Suitability Requirement should be incorporated into all client agreements as a contractual term, regardless of the type of the PIs;
* An intermediary should not incorporate any clause, provision or term in the client agreement which is inconsistent with its obligations under the Code; and
* No clause, provision, term or statement should be included in any client agreement which mis-describes the actual services to be provided to the client.

## Consultation questions

The Consultation Paper requests responses to the following questions:

1. Should Corporate and Individual Professional Investors continue to be allowed to participate in private placement activities?
2. Do you think the minimum monetary thresholds for Corporate and Individual Professional Investors should be increased?
3. Do you agree that intermediaries should observe the Code without exception when they deal with individuals?
4. Do you agree that investment vehicles wholly owned by individuals and by family trusts should be treated on the same basis as individuals under the Code?
5. Do you agree that a principles-based Knowledge and Experience Assessment should dispense with bright line tests concerning dealing experience?
6. Do you have any views on the Suitability Requirement?
7. Do you agree with the proposals in relation to the client agreement?

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1. Defined as a licensed corporation or a registered institution under the SFO [↑](#footnote-ref-28)
2. The SFC refers to the experience in Australia where a principles-based assessment for classifying PIs is a legal obligation. Given that intermediaries are vulnerable to legal liability if they have incorrectly classified a client as a PI, the assessment is rarely conducted and most clients are not treated as PIs. [↑](#footnote-ref-35)