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SFC Publishes Consultation Conclusions on Amendments to the Professional Investor Regime and Further Consultation on Client Agreement Requirements

The Securities and Futures Commission (**SFC**) has published its consultation conclusions[1] (**Consultation Conclusions)** on proposed amendments to intermediaries' obligations in relation to professional investors as set out in the Code of Conduct for Persons Licensed by or Registered with the SFC (the **Code**). The original proposals were included in the SFC's May 2013 Consultation Paper on the Proposed Amendments to the Professional Investor Regime and the Client Agreement Requirements (**Consultation Paper**). The amendments to the Code, which have been revised following the consultation process, will be implemented on **25 March 2016**.

The SFC has also included in the Consultation Conclusions a further consultation on amendments to the Code's requirements for client agreements with professional investors (**PIs**). Responses to the further consultation on client agreements should be submitted no later than **24 December 2014** and all amendments to the requirements for client agreements will take effect on a date to be specified in the consultation conclusions on the further consultation.

The key features of the revised professional investor regime include the following:

1. individual and corporate PIs will continue to be allowed to participate in private placement activities;
2. there will be no change to the minimum monetary thresholds for qualifying as individual PIs and corporate PIs;
3. intermediaries must comply with all requirements of the Code when dealing with individual PIs. They will not be allowed an exemption from the Suitability Requirement or reliance on other Code exemptions inherently linked to the Suitability Requirement, or necessary for investor protection, when serving individual PIs;
4. investment vehicles wholly owned by individual PIs and by family trusts will be assessed in the same way as other corporate PIs;
5. in the case of corporate PIs, intermediaries will be exempt from the Suitability Requirement and other current Code exemptions after conducting a principles-based assessment (**CPI Assessment**);
6. the SFC will conduct a detailed internal study of the Suitability Requirement; and
7. a new clause, instead of the Suitability Requirement, will be required in client agreements and the public are invited to comments on the proposed wording of the new clause.

1 http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=13CP1

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 reduced investor protections. In particular, it was alleged that some investors who purchased Lehman Brothers-related products from banks did not know that the declaration they signed was a confirmation that they wished to be treated as a PI, and understood 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 are clear and appropriate.

The SFC received a total of 51 written submissions from various market participants and professional bodies and approximately 300 signed template submissions during the three-month consultation period.

Private Placement Activities

The Current Regime

Under the current regime, certain categories of offers of investments are exempt both from the prospectus requirements under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) and the prohibition on public offers of securities without SFC authorisation under the Securities and Futures Ordinance (Cap. 571) (the **SFO**). These include offers of investments made to professional investors which include:

a) certain categories of institutional investors as set out in paragraphs (a) to (i) of the definition of "professional investor" in Schedule 1 to the SFO, such as banks, entities licensed or registered under the SFO, insurance companies, etc.;

b) individual professional investors and corporate professional investors who are classified as professional investors based on the value of their assets or investment portfolio as set out in the Securities and Futures (Professional Investor) Rules (**PI Rules**).

The SFC cites the following reasons why certain types of professional investor may not be able to make appropriately informed investment decisions:

- in practice, individual and corporate PIs may not be financially sophisticated; and
- marketing documentation for private placements is not subject to the mandatory content requirements that apply to documentation marketing public offers which also requires approval or authorisation by the SFC.

Under the PI Rules, professional investors include:

a) any individual who (either alone or with his/her spouse or child on a joint account) has a portfolio of not less than HK$8 million (**Individual PIs**);

b) any trust corporation having been entrusted with total assets of not less than HK$40 million;

c) any corporation or partnership having: (i) a portfolio of not less than HK$8 million; or (ii) total assets of not less than HK$40 million; and

d) 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.

Entities in (b) to (d) above are collectively referred to as "Corporate PIs".

Consultation Paper Proposals

The Consultation Paper sought views on whether:

a) Individual and Corporate PIs should continue to be allowed to participate in offers where the marketing documentation does not require authorisation by the SFC (**private placements**); and

b) whether the minimum portfolio thresholds for qualifying as Individual and Corporate PIs should be increased.

Consultation Response

The majority of respondents and the SFC agreed that the private placement regime is well established in Hong Kong and is comparable to other overseas jurisdictions such as the United States, Australia and Singapore. Changes to the existing private placement regime might adversely affect the private placement market to the detriment of issuers, distributors and investors. Moreover, the minimum monetary thresholds to qualify as a PI under the PI Rules in Hong Kong are comparable to other jurisdictions. Hong Kong's minimum threshold for individual PIs is higher than that in the United Kingdom, while lower than that in Singapore and Australia.

Consultation Conclusions

The SFC concluded that:

- Individual and Corporate PIs will be allowed to continue to participate in private placement activities; and
- the monetary thresholds for classifying PIs should remain unchanged (i.e. $8 million minimum portfolio threshold for Individual PIs and a portfolio of not less than $8 million and/or total assets of not less than $40 million for Corporate PIs).

Intermediaries' Conduct Regulation – Individual PIs

The Current Regime

Under the current regime, intermediaries[2] offering investment products to PIs who have been assessed to have sufficient knowledge, expertise and investment experience in relevant products and markets (assuming compliance with all other procedural requirements, e.g., obtaining informed consent, are complied with), are exempt from complying with some or all of the Code's requirements. The Code requirements to which the exemption applies are:

a) the requirement under paragraph 5.2 of the Code that intermediaries should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for the client is reasonable in all the circumstances (the **Suitability Requirement**);

b) the need to establish a client's financial situation, investment experience and investment objectives;

c) the need to assess a client's knowledge of derivatives and characterise the client based on his knowledge of derivatives;

d) the need to disclose certain sales-related information;

e) the need to enter into a written agreement and provide relevant risk disclosure statements;

f) 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;

g) the need to inform the client about itself (e.g. information about its business including contact details and services available to clients) and the identity and status of its employees and others acting on its behalf;

h) the need to confirm with the client promptly the essential features of a transaction after effecting a transaction; and

i) the need to provide the client with the documentation on the Nasdaq-Amex Pilot Program.[3]

The Code requirements referred to in paragraphs a) to i) above are together referred as the **Exempted Requirements**.

Consultation Paper Proposals

Most mis-selling cases dealt with by the SFC have involved individual investors. The SFC concludes from this that Individual PIs require greater protection than Corporate PIs. It therefore proposed in the Consultation Paper that when dealing with Individual PIs, intermediaries must comply with all Code requirements (including the Suitability Requirement) and should not be able to rely on any exemptions that are inherently linked to the Suitability Requirement and/or have significant bearing on investor protection (e.g. the need to enter into a written client agreement).

Consultation Response

The majority of respondents opposed the proposed requirement that Individual PIs should be treated as retail investors. Arguments were made that Individual PIs with substantial financial resources have sufficient sophistication, knowledge and investment experience to make their own investment decisions, and should therefore be given the option of opting out of some of the Code's protections. Others commented that Individual PIs are already sufficiently protected under the Code which requires intermediaries dealing with them to assess their knowledge, expertise and investment experience and provide a written explanation of the consequences of being treated as a PI.

2 Defined as a licensed corporation or a registered institution under the SFO.

3 Selected overseas securities listed on the National Association of Securities Dealers Automatic Quotations (**NASDAQ**) or the American Stock Exchange (**AMEX**) Securities are admitted to trading but not listed on the Stock Exchange of Hong Kong. For details please refer to paragraph 1 of Schedule 3 to the Code.

Consultation Conclusion

The SFC has decided to distinguish Code requirements that are fundamental to investor protection which cannot be waived for Individual PIs (and Corporate PIs who fail to meet the criteria in the CPI Assessment which is dealt with below), from those that are more administrative in nature and can be waived. The SFC views the Suitability Requirement as the cornerstone of investor protection, particularly for individual investors, and will not therefore allow intermediaries an exemption from the requirement when dealing with individuals, whether or not they meet the qualifying criteria for an Individual PI.

The SFC also considers that some of the other existing exemptions available to intermediaries dealing with PIs, are inherently linked with the Suitability Requirement and/or have significant bearing on investor protection (i.e. those listed under paragraphs (b) to (f)) above). It therefore considers that these exemptions should not be available to intermediaries when dealing with individual PIs. Intermediaries will however be able to rely on the Code exemptions referred to in paragraphs (g) to (i) above when dealing with Individual PIs provided that they explain the risks and consequences of these Code exemptions and obtain written client consent.

Intermediaries' Conduct Regulation – Investment Vehicles

Consultation Paper Proposals

The SFC proposed in the consultation paper that intermediaries should not be able to rely on the Code exemptions which apply to professional investors when dealing with Corporate PIs that are investment vehicles wholly owned by Individual PIs and by their family trusts. Instead Corporate PIs that are investment vehicles of Individual PIs or their family trusts should be treated in the same manner as retail individual investors.

Consultation Response

The majority of respondents to the Consultation Paper were against the proposal. The point was made that many investment vehicles, particularly those owned by large family trusts or offices, appoint investment professionals or other third party experts to manage their investments. The investment decisions of such investment vehicles are made by persons who are sophisticated in terms of knowledge and investment experience and such vehicles should therefore be treated in the same way as other Corporate PIs.

Consultation Conclusion

The SFC has concluded that intermediaries may apply the Code exemptions referred to in paragraphs (b) to (f) above, when dealing with Corporate PIs which are investment vehicles wholly owned by Individual PIs or their family trusts which satisfy the proposed CPI Assessment (which is discussed in detail under "Intermediaries' Conduct Regulation – Corporate PIs", below).

Accordingly, investment vehicles wholly owned by Individual PIs and their family trusts will be assessed in the same manner as other Corporate PIs.

Intermediaries' Conduct Regulation – Corporate PIs

Consultation Paper Proposals

Currently, an intermediary can rely on exemptions from certain Code requirements (i.e. those referred to in paragraphs (a) to (i) of the Exempted Requirements) when dealing with professional investors, only if the intermediary has formed the view that the investor is sufficiently knowledgeable and experienced in relevant products and/or markets from conducting an assessment of the investor's investment knowledge and experience. The Code sets out the following factors (**Relevant Factors**) which intermediaries must consider:

a) the type of products in which the person has traded;

b) the frequency and size of trades (not less than 40 transactions per annum);

c) the person's dealing experience (active in the relevant market for at least 2 years);

d) the person's knowledge and expertise in the relevant products; and

e) his awareness of the risks involved in trading in the relevant products and/or markets.

The SFC acknowledged that the above bright-line tests are not used frequently and, in practice, many clients are unable to satisfy the Relevant Factors. Another consideration is that the listed bright-line tests, such as the number of transactions per annum and years of activities in relevant markets, when taken in isolation, are not necessarily indicative of sophisticated knowledge and investment experience. The Consultation Paper therefore proposed introducing a principles-based

assessment to replace the bright-line tests in determining whether an intermediary should be able to dis-apply the Code requirements in the case of a Corporate PI.

Consultation Response

The proposed principles-based assessment received support from a majority of respondents to the consultation as it provides greater flexibility. Those objecting to it raised the practical difficulties in obtaining information on a client's corporate structure, its investment process and background information on its staff. Concerns were also raised that a principles-based test lacked certainty and risked being applied inconsistently. Some favoured the bright-line tests on the basis that they are clearer, objective and capable of consistent application.

Consultation Conclusion

The SFC concluded that a principles-based assessment free of bright-line tests is best suited to assessing whether the Code exemptions within paragraphs (a) to (f) of the Exempted Requirements should apply to different types of corporate investors. Accordingly, the SFC will adopt a new corporate professional investor assessment (**CPI Assessment**) with the following three criteria:

a) the Corporate PI must have an appropriate corporate structure and investment process and controls;

b) the person(s) responsible for making investment decisions must have sufficient investment background ; and

c) the Corporate PI must be aware of the risks involved.

The Suitability Requirement

Consultation Paper Proposals

The Consultation Paper sought views on the Code's key investor protection provision: the obligation on intermediaries to ensure, that when making a recommendation or solicitation to a client, the recommendation or solicitation is reasonably suitable for the particular client, having regard to the information about the client of which the intermediary is or should be aware (paragraph 5.2 of the Code).

Consultation Response

The majority of respondents were from small and medium-sized agency brokers and they requested more guidance from the SFC on the Suitability Requirement. Key concerns were the lack of clarity in relation to:

a) the circumstances in which the Suitability Requirement is triggered and what constitutes a "solicitation" or a "recommendation"; and

b) the steps an intermediary is required to take to satisfy the Suitability Requirement obligations; for example, how the documentation standards should be applied given the different operational types or services provided to clients, and whether these standards can be more principles-based and less document intensive.

Consultation Conclusion

The SFC reiterated that the Suitability Requirement is fundamental to the regulation of intermediaries' conduct. The SFC will conduct a detailed internal study of the Suitability Requirement which will involve obtaining views from the industry. The proposed study of the Suitability Requirement is however completely separate from the introduction of a new contractual obligation in client agreements as detailed below.

Client Agreement Requirements

The Current Regime

The Suitability Requirement is currently only an obligation under the Code which means that in the case of breach, the SFC is entitled to take disciplinary action against the intermediary concerned. The SFC cannot however require an intermediary to compensate an investor for any loss suffered as a result of the intermediary's breach of the obligation. Likewise, an intermediary's breach of the Suitability Requirement does not entitle a client to claim compensation or bring any other claims against the intermediary.

The SFC noted that some intermediaries include clauses in client agreements which are designed to restrict their potential contractual liability to clients. This is done by mis-describing the actual services to be provided or requiring clients to sign a declaration allowing the intermediary to disclaim potential liability.

Consultation Paper Proposals

The SFC proposed amending the client agreement requirements to:

a) incorporate the Suitability Requirement into client agreements as a contractual term;

b) require client agreements to contain a clear description of the actual services to be provided to the client; and

c) prohibit client agreements from: (i) containing terms which are inconsistent with the Code obligations; and (ii) mis-describing the actual services to be provided to the client.

Consultation Response

The majority of respondents were against the proposals primarily because of concerns about increased compliance costs. Other arguments included that:

a) it would be inappropriate to include the Suitability Requirement in client agreements as a contractual term since the requirement is principles-based and there is a lack of certainty as to how it should be interpreted;

b) the courts may not be the appropriate forum for making determinations on suitability;

c) the proposal is at odds with the legal principle of freedom of contract;

d) given the magnitude of the change, it should be implemented by legislation not a Code amendment; and

e) the proposal could open the floodgates to vexatious and frivolous litigation.

With regard to the proposal that client agreements must include a clear description of the actual services to be provided, respondents argued that:

a) it may present practical differences as a wide range of services may be provided;

b) a client's needs may change over time. Since it is impossible to foresee all the services that may be provided at the time of signing the client agreement, the agreement would need to be amended if additional services are to be provided;

c) the proposal would prevent intermediaries providing *ad hoc* or ancillary services; and

d) the existing requirement under paragraph 6.2(d) of the Code for intermediaries to set out the nature of services to be provided to or available to the client is appropriate and provides the right balance between operational flexibility and clear disclosure to clients.

Consultation Conclusion

Importing the Suitability Requirement into Client Agreements

The SFC states in the Consultation Conclusions that while it acknowledges that the proposals will increase compliance costs, this is outweighed by the benefits of enhanced investor protection.

The SFC denies that a requirement to include a suitability requirement as a term in the client agreement is contrary to the principle of freedom of contract. The SFC therefore now proposes that instead of requiring client agreements to cross-refer to the Suitability Requirement, it will require that a new self-contained clause that is more amenable to interpretation by the courts should be included in client agreements. The Consultation Conclusions invite views on the proposed wording of the new clause (**New Clause**) to be included in client agreements as a new paragraph 6.2(i) of the Code. The SFC invites written comments to be submitted no later than **24 December 2014** on the wording which is:

If we [the intermediary] solicit the sale of or recommend any financial product to you [the client], the financial product must be reasonably suitable for you having regard to your financial situation, investment experience and investment objectives. No other provision of this agreement or any other document we may ask you to sign and no statement we may ask you to make derogates from this clause."

The Consultation Conclusions also note that:

a) the clause will only be triggered when an intermediary solicits the sale of, or recommends, a specific financial product to the client where the solicitation or recommendation is not reasonably suitable for the client. The SFC considers that this should be a question of fact which the court will be easily able to adjudicate;

b) the requirement that a financial product must be "reasonably" suitable introduces an objective standard;

c) the factors about a client to which an intermediary must have regard are clearly stipulated, being his financial situation, investment experience and investment objectives;

d) the New Clause incorporates a non-derogation provision so that its purpose cannot be defeated by provisions elsewhere in the client agreement or separate documents; and

e) the proposal is intended only to make client agreements fairer and it should not result in an increase in frivolous litigation.

Including a Clear Description of Services to be Provided in Client Agreements

The SFC acknowledged the practical difficulties in describing the actual services to be provided in client agreements. It has therefore decided not to amend the relevant paragraph (paragraph 6.2(d) of the Code) and will provide guidance on the application of that paragraph.

Prohibition of Provisions Defeating Code Obligations or Mis-describing Actual Services

The SFC has decided to refine paragraph 6.5 of the Code given that investor protection may also be reduced or eliminated by:

a) non-reliance provisions in client agreements which require clients to acknowledge that they do not rely on any advice given or recommendation made by the intermediary in making investment decisions; and

b) verbal statements containing contrary clauses and disclaimer clauses etc.

The proposed wording for revised paragraph 6.5 is set out in Appendix B to the Consultation Conclusions and provides as follows:

> "**6.5 No inclusion of clauses which are inconsistent with the Code or which mis-describe the actual services provided to clients**
>
> A licensed or registered person should not incorporate any clause, provision or term in the Client Agreement or in any other document signed or statement made by the client at the request of the licensed or registered person which is inconsistent with its obligations under the Code.
>
> *Note: This paragraph precludes the incorporation in the client agreement (or in any other document signed or statement made by the client) of any clause, provision or term by which a client purports to acknowledge that no reliance is placed on any recommendation made or advice given by the licensed or registered person.*
>
> No clause, provision, term or statement should be included in any Client Agreement (or any other document signed or statement made by the client at the request of a licensed or registered person) which mis-describes the actual services to be provided to the client."

The proposed amendments to the client agreement will only take effect on a date to be stipulated in the conclusions paper on the proposed new clause.

Effective Date for Amendments to Client Agreements

The proposed amendments to Client Agreements will only come into effect once the wording has been settled for the new Suitability Requirement to be incorporated in Client Agreements as a stand-alone clause.

The Way Forward

The Consultation Conclusions state that:

a) The amendments to paragraph 15 of the Code (the revised version of which is set out in Appendix A to the Consultation Conclusions) will take effect on **25 March 2016**;

b) The SFC will conduct a separate study and seek industry views on the Suitability Requirement;

c) The SFC is consulting on the wording of the proposed New Clause (set out above) and comments are requested before **24 December 2014**; and

d) Following the consultation on the New Clause, the SFC will publish consultation conclusions which will specify the date on which the revised requirements for Client Agreements will take effect.

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