



Hong Kong

March 2016

AMENDMENTS TO THE HONG KONG PROFESSIONAL INVESTOR REGIME TAKE EFFECT ON 25 MARCH 2016

Amendments to intermediaries' obligations in relation to certain categories of professional investors under the Code of Conduct for Persons Licensed by or Registered with the SFC (the **Code**) take effect on 25 March 2016. The amendments were first proposed in the SFC's May 2013 Consultation Paper on the Proposed Amendments to the Professional Investor Regime and the Client Agreement Requirements, and were revised in the Consultation Conclusions¹ published in September 2014. The amendments to the Code are set out at the end of this newsletter.

The key changes to the professional investor regime which take effect on 25 March 2016 are as follows.

1. Intermediaries must comply with all requirements of the Code when dealing with individual professional investors. They will no longer be allowed an exemption from the requirement to ensure the suitability of recommendations and solicitations to clients under paragraph 5.2 of the Code (the **Suitability Requirement**) or reliance on other Code exemptions inherently linked to the Suitability Requirement, or necessary for investor protection, when serving individual professional investors;
2. Investment vehicles wholly owned by individual professional investors and by family trusts must be treated in the same way as other corporate professional investors; and

3. In order to rely on the exemption from the Suitability Requirement and other Code exemptions in relation to corporate professional investors (including those under paragraph (2) above), intermediaries will have to conduct a principles-based assessment (**CPI Assessment**) which will replace the existing bright line tests.

The May 2013 Consultation Paper also proposed amending the Code to require client agreements to incorporate the Suitability Requirement as a contractual term. A further consultation was conducted and the Consultation Conclusions on the Client Agreement Requirements were published in December 2015. As a result, all client agreements, including those with existing clients, must include the following suitability clause, on or before 9 June 2017:

"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."

Note: "Financial product" means any securities, futures contracts or leveraged foreign exchange contracts as defined under the SFO. Regarding "leveraged foreign exchange contracts", it is only applicable to those traded by persons licensed for Type 3 regulated activity.

¹ "Consultation Conclusions on the Proposed Amendments to the Professional Investor Regime and Further Consultation on the Client Agreement Requirements". September 2014. Available at <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=13CP1>

For further details of the Code amendments which will take effect in June 2017, please see our December 2015 Newsletter.²

Background

During the financial crisis in 2008, there were complaints that individual investors in Lehman Brothers-related products were classified as professional investors 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 professional investor, and understood the risks and consequences of being so treated. The amendments to the Code's conduct requirements for entities that are licensed by or registered with the SFC under Part V of the Securities and Futures Ordinance (the **SFO**)(**intermediaries**) when dealing with individual professional investors and corporate professional investors are intended to improve investor protection.

Categories of Professional Investors

For the purposes of the Code, professional investors (**Professional Investors**) are divided into three categories:

1. **Institutional Professional Investors** – i.e. those falling within paragraphs (a) to (i) of Part 1 of Schedule 1 to the SFO, e.g. authorised banks, licensed intermediaries.
2. **Individual Professional Investors** – i.e. individuals who, either alone or with their spouse or children on a joint account, have a portfolio³ of at least HK\$8 million or its foreign currency equivalent.⁴
3. **Corporate Professional Investors** being:
 - a) Trust corporations with trust assets of at least HK\$40 million;

b) Corporations or partnerships which have a portfolio of at least HK\$8 million or total assets of at least HK\$40 million;

c) Corporations whose sole business is to hold investments and which are wholly owned by one or more of the following: (i) a trust corporation within (a) above; (ii) an Individual Professional Investor; (iii) a corporation or partnership within (b) above.⁵

The New Regime

Under the new regime, the exemptions which an intermediary can rely on depend on the category of professional investor.

Individual Professional Investors

Intermediaries dealing with Individual Professional Investors will no longer be able to rely on exemptions from the following Code requirements:

- a) the need to ensure the suitability of a recommendation or solicitation for the client (the **Suitability Requirement**) (paragraph 5.2 and paragraph 49 of Schedule 6 to the Code);
- b) the need to establish a client's financial situation, investment experience and investment objectives (paragraph 5.1 of the Code and paragraphs 2(d) and 2(e) of Schedule 6 to the Code);
- c) the need to assess a client's knowledge of derivatives and characterise the client based on his knowledge of derivatives (paragraph 5.1A of the Code);
- d) the need to disclose certain sales-related information (paragraph 8.3A of the Code);
- e) the need to enter into a written client agreement and provide relevant risk disclosure statements (paragraph 6.1, paragraph 2 of Schedule 3, paragraph 2 of Schedule 4 and paragraph 1 of Schedule 6 to the Code); and
- 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 (paragraphs 7.1(a)(ii) and 7.1(b) of the Code).

² "Suitability Requirement to Become Mandatory Provision of Client Agreements under SFC Code Amendments". December 2015. Available at <http://www.charltonslaw.com/suitability-requirement-to-become-mandatory-provision-of-client-agreements-under-sfc-code-amendments/>.

³ The term "portfolio" is defined as a portfolio of securities, money held by a custodian or a certificate of deposit issued by a Hong Kong authorised financial institution or a bank which is regulated in any other jurisdiction.

⁴ Securities and Futures (Professional Investor) Rules, section 3(b).

⁵ Ibid. sections 3(a), (c) and (d).

Intermediaries dealing with Individual Professional Investors will only be allowed exemptions from the more administrative matters listed under paragraph 15.5 of the Code (the **Paragraph 15.5 Exemptions**):

- a) the need to inform the client about the licensed or registered person (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 (paragraph 8.1 of the Code);
- b) the need to promptly confirm with the client the essential features of a transaction after effecting a transaction (paragraph 8.2, paragraph 4 of Schedule 3 and paragraph 18 of Schedule 6 to the Code); and
- c) the need to provide the client with the documentation on the Nasdaq-Amex Pilot Program (paragraph 1 of Schedule 3 to the Code).⁶

Individual Professional Investors: Conditions for Reliance on Paragraph 15.5 Exemptions

In order to rely on the Paragraph 15.5 Exemptions in relation to an Individual Professional Investor, the intermediary must first carry out the following procedures which are set out in paragraph 15.3B of the Code:

- a) obtain a written and signed declaration from the client that the client has given consent;
- b) fully explain to the client the consequences (i.e., all relevant regulatory exemptions that the intermediary is entitled to) of being treated as a Professional Investor and that the client has the right to withdraw from being treated as such at any time; and
- c) specify that the client is treated as a Professional Investor in a particular product and market and inform the client that he has the right to withdraw from being treated as a Professional Investor whether in respect of all products or markets or some only.

Intermediaries must additionally carry out an annual confirmation exercise to ensure that the client continues to qualify as a Professional Investor under the Securities and

⁶ 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.

Futures (Professional Investor) Rules (the **Professional Investor Rules**). As part of the annual confirmation exercise, the intermediary is required to remind the client in writing of:

- a) the risks and consequences (i.e., all relevant regulatory exemptions that the intermediary is entitled to) of being treated as a Professional Investor; and
- b) the client's right to withdraw from being treated as a Professional Investor in respect of all or any products or markets.

Corporate Professional Investors

As noted above, Corporate Professional Investors include investment vehicles that are wholly owned by Individual Professional Investors and family trusts.

Intermediaries may rely on exemptions from the provisions of the Code referred to in paragraph 15.4 of the Code (**Paragraph 15.4 Exemptions**) when dealing with Corporate Professional Investors which meet the criteria of the CPI Assessment (discussed below).

Paragraph 15.4 provides exemptions from the following Code requirements:

- a) the need to ensure the suitability of a recommendation or solicitation for the client (the **Suitability Requirement**) (paragraph 5.2 and paragraph 49 of Schedule 6 to the Code);
- b) the need to establish a client's financial situation, investment experience and investment objectives (paragraph 5.1 of the Code and paragraphs 2(d) and 2(e) of Schedule 6 to the Code), except where the licensed or registered person is providing advice on corporate finance work;
- c) the need to assess a client's knowledge of derivatives and characterise the client based on his knowledge of derivatives (paragraph 5.1A of the Code);
- d) the need to disclose certain sales-related information (paragraph 8.3A of the Code);
- e) the need to enter into a written client agreement and provide relevant risk disclosure statements (paragraph 6.1, paragraph 2 of Schedule 3, paragraph 2 of Schedule 4 and paragraph 1 of Schedule 6 to the Code); and

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 explain that authority and confirm it on an annual basis (paragraphs 7.1(a)(ii) and 7.1(b) of the Code). The intermediary is still required to obtain an authorization from the client to effect transactions on his behalf, although the procedures for obtaining such authorization are relaxed.

Corporate Professional Investors: Conditions for Reliance on Paragraph 15.4 Exemptions

In order for an intermediary to rely on the Paragraph 15.4 Exemptions in relation to a Corporate Professional Investor it must first:

- a) perform the new corporate professional investor assessment (**CPI Assessment**) which is set out in new paragraph 15.3A of the Code; and
- b) perform the procedures set out in new paragraph 15.3B of the Code.

Intermediaries dealing with Corporate Professional Investors may also rely on the Paragraph 15.5 Exemptions, which are discussed in relation to Individual Professional Investors above, subject to performing the procedures set out in new paragraph 15.3B of the Code.

The CPI Assessment

The CPI Assessment is a principles-based assessment and it replaces the bright line tests currently set out at paragraph 15.3 of the Code. The CPI assessment requires intermediaries to be reasonably satisfied that Corporate Professional Investors meet the following three criteria:

- a) the Corporate Professional Investor has an appropriate 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);
- b) the person(s) responsible for making investment decisions has(have) sufficient investment background (including the investment experience of such person(s)); and
- c) the Corporate Professional Investor is aware of the risks involved; this is considered in terms of the person(s) responsible for making investment decisions.

CPI Assessments must be in writing and records of all relevant information and documents obtained in the assessment should be kept by the licensed or registered person so as to demonstrate the basis of the assessment.

A separate assessment should be undertaken for different product types or markets. In addition, intermediaries should conduct a new assessment where a Corporate Professional Investor has ceased to trade in the relevant product or market for 2 years.

Procedures for Dis-applying Provisions under Paragraphs 15.4 and 15.5

In order to rely on the Paragraph 15.4 and 15.5 Exemptions, the intermediary must first:

- a) obtain a written and signed declaration from the client that the client has given consent;
- b) fully explain to the client the consequences (i.e., all relevant regulatory exemptions that the intermediary is entitled to) of being treated as a Professional Investor and that the client has the right to withdraw from being treated as such at any time; and
- c) specify that the client is treated as a Professional Investor in a particular product and market and inform the client that he has the right to withdraw from being treated as a Professional Investor whether in respect of all products or markets or some only.

Intermediaries must additionally carry out an annual confirmation exercise to ensure that the client continues to qualify as a Professional Investor under the Securities and Futures (Professional Investor) Rules (the **Professional Investor Rules**). As part of the annual confirmation exercise, the intermediary is required to remind the client in writing of:

- a) the risks and consequences (i.e., all relevant regulatory exemptions that the intermediary is entitled to) of being treated as a Professional Investor; and
- b) the client's right to withdraw from being treated as a Professional Investor in respect of all or any products or markets.

Institutional Professional Investors

Intermediaries dealing with Institutional Professional Investors are entitled to rely on the exemptions under Paragraphs 15.4 and 15.5 without taking any further steps. No assessment of the Institutional Professional Investors' experience is required.

The Code Amendments (as set out at Appendix B to the Consultation Conclusions on the Proposed Amendments to the Professional Investor Regime and Further Consultation on the Client Agreement Requirements of 25 September 2014)

Paragraph 15 of the Code

(The following will replace the current Paragraph 15 in full)

Paragraph 15

Professional Investors

15.1 Professional Investors: in general

- a) "Professional Investor" is defined in section 1 of Part 1 of Schedule 1 to the SFO. It includes specified entities set out in paragraphs (a) to (i) of the definition (e.g., banks and insurance companies) and persons belonging to a class which is prescribed under the Securities and Futures (Professional Investor) Rules ("Professional Investor Rules") (paragraph (j) of the definition).
- b) Notwithstanding that some legal restrictions imposed by the SFO (e.g. the issuance of advertisements, the making of unsolicited calls and the communication of an offer in relation to securities) do not apply to licensed or registered persons in dealing with Professional Investors, all the requirements in the Code (including the general principles such as acting honestly and fairly in the best interests of clients and the requirements to ensure the suitability of a recommendation or solicitation for a client is reasonable in all the circumstances) must still be strictly observed subject to exemptions.
- c) For the purposes of setting out exemptions and for ease of reference under the Code, Professional Investors are referred to in the Code in specific terms as set out in paragraph 15.2.

15.2 Overview and terminology

Professional Investors are referred to in the Code in the following terms:

Institutional Professional Investors – persons falling under paragraphs (a) to (i) of the definition of "professional investor" in section 1 of Part 1 of Schedule 1 to the SFO.

Licensed or registered persons dealing with Institutional Professional Investors are automatically exempt from the provisions set out in paragraphs 15.4 and 15.5 hereunder.

Corporate Professional Investors – trust corporations, corporations or partnerships falling under sections 3(a), (c) and (d) of the Professional Investor Rules.

Should licensed or registered persons wish to be exempt from the provisions set out in paragraph 15.4, they should observe the assessment requirements set out in paragraph 15.3A and comply with paragraph 15.3B. Should licensed or registered persons wish to be exempt from the provisions set out in paragraph 15.5 only, they should just comply with paragraph 15.3B.

Where a Corporate Professional Investor cannot meet the requirements under paragraph 15.3A in any aspect, the licensed or registered person cannot be exempt from the provisions set out in paragraph 15.4 when dealing with this Corporate Professional Investor. If paragraph 15.3B is not complied with in any aspect, all regulatory obligations should be observed by the licensed or registered persons without any exemption unless stated otherwise.

Individual Professional Investors – investors falling under section 3(b) of the Professional Investor Rules.

Should licensed or registered persons wish to be exempt from the provisions set out in paragraph 15.5, they should comply with paragraph 15.3B.

If paragraph 15.3B is not complied with in any aspect, all regulatory obligations should be observed by the licensed or registered persons without any exemption unless stated otherwise.

15.3A Assessment requirements for Corporate Professional Investors

- a) If a licensed or registered person has complied with paragraph 15.3B, it is exempt from the provisions set out in paragraph 15.5 and may also be exempt from the provisions set out in paragraph 15.4 if it is reasonably satisfied that the Corporate Professional Investor meets the three criteria set out in paragraph 15.3A(b) in relation to the relevant products and markets.
- b) In making the assessment on a Corporate Professional Investor in relation to the relevant product and/or markets, the licensed or registered person should assess whether or not the Corporate Professional Investor satisfies all of the following three criteria:
 - i) the Corporate Professional Investor has the appropriate 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 decisions);
 - ii) the person(s) responsible for making investment decisions on behalf of the Corporate Professional Investor has(have) sufficient investment background (including the investment experience of such person(s)); and
 - iii) the Corporate Professional Investor is aware of the risks involved which is considered in terms of the person(s) responsible for making investment decisions.
- c) The above assessment should be in writing. Records of all relevant information and documents obtained in the assessment should be kept by the licensed or registered person so as demonstrate the basis of the assessment.
- d) A licensed or registered person should undertake a separate assessment for different product types or markets.

- e) A licensed or registered person should undertake a new assessment where a Corporate Professional Investor has ceased to trade in the relevant product or market for more than 2 years.

15.3B Procedures for dis-applying provisions under paragraphs 15.4 and 15.5

- a) Prior to dis-applying the provisions set out in paragraph 15.4 (when dealing with Corporate Professional Investors only) and/or the provisions set out in paragraph 15.5 (when dealing with Corporate Professional Investors and Individual Professional Investors), a licensed or registered person should also:
 - i) obtain a written and signed declaration from the client that the client has given consent;
 - ii) fully explain to the client the consequences (i.e., all relevant regulatory exemptions that the licensed or registered person is entitled to) of being treated as a Professional Investor and that the client has the right to withdraw from being treated as such at any time; and
 - iii) specify that the client is treated as a Professional Investor in a particular product and market and inform the client that he has a right to withdraw from being treated as a Professional Investor whether in respect of all products or markets or any part thereof.
- b) A licensed or registered person should carry out a confirmation exercise annually to ensure that the client continues to fulfil the requisite requirements under the Professional Investor Rules. In carrying out the annual confirmation exercise, a licensed or registered person should remind the client in writing of:
 - i) the risks and consequences (i.e., all relevant regulatory exemptions that the licensed or registered person is entitled to) of being treated as a Professional Investor, in particular, the licensed or registered person is not required to comply with the regulatory requirements set out in paragraphs 15.4 and/or 15.5 of the Code (as the case may be); and

- ii) the right for the client to withdraw from being treated as a Professional Investor whether in respect of all products or markets or any part thereof.

15.4 Exempt provisions for Corporate Professional Investors where licensed or registered persons have complied with paragraphs 15.3A and 15.3B and Institutional Professional Investors

- a) Information about clients
 - i) the need to establish a client's financial situation, investment experience and investment objectives (paragraph 5.1 and paragraphs 2(d) and 2(e) of Schedule 6 to the Code), except where the licensed or registered person is providing advice on corporate finance work;
 - ii) the need to ensure the suitability of a recommendation or solicitation (paragraph 5.2 and paragraph 49 of Schedule 6 of the Code); and
 - iii) the need to assess the client's knowledge of derivatives and characterize the client based on his knowledge of derivatives (paragraphs 5.1A of the Code);
- b) Client agreement
 - i) the need to enter into a written agreement and the provision of relevant risk disclosure statements (paragraph 6.1, paragraph 2 of Schedule 3, paragraph 2 of Schedule 4 and paragraph 1 of Schedule 6 to the Code);
- c) Information for clients
 - i) the need to disclose transaction related information (paragraph 8.3A of the Code);
- d) Discretionary accounts
 - i) the need for a licensed or registered person to obtain from the client an authority in a written form prior to effecting transactions for the client without his specific authority (paragraph 7.1(a)(ii) of the Code); and

- ii) the need to explain the authority described under paragraph 7.1(a)(ii) of the Code and the need to confirm it on an annual basis (paragraph 7.1(b) of the Code).

(For the avoidance of doubt, a licensed or registered person should still obtain an authorization from a client in order to effect transactions on the client's behalf, however where Professional Investors are concerned the procedures for obtaining such authorizations as described in (i) and (ii) above are relaxed.)

15.5 Exempt provisions for Corporate Professional Investors and Individual Professional Investors where licensed or registered persons have complied with paragraph 15.3B and Institutional Professional Investors

- a) Information for clients
 - i) the need to inform the client about the licensed or registered person and the identity and status of its employees and others acting on its behalf (paragraph 8.1 of the Code);
 - ii) the need to confirm promptly with the client the essential features of a transaction after effecting a transaction for a client (paragraph 8.2, paragraph 4 of Schedule 3 and paragraph 18 of Schedule 6 to the Code); and
 - iii) the need to provide the client with documentation on the Nasdaq-Amex Pilot Program (paragraph 1 of Schedule 3 to the Code).

Consequential amendments to the Code

Paragraph 5

Information about clients

5.1A Know your client: investor characterization

- a) A licensed or registered person should, as part of the know your client procedures, assess the client's knowledge of derivatives and characterize the client based on his knowledge of derivatives.

Paragraph 8

Information for clients

8.3A Disclosure of transaction related information

- a) Where a licensed or registered person distributes an investment product to a client (including where it sells an investment product to or buys such product from the client), the licensed or registered person should deliver the following information to the client prior to or at the point of entering into the transaction:
- i) The capacity (principal or agent) in which a licensed or registered person is acting;
 - ii) Affiliation of the licensed or registered person with the product issuer;
 - iii) Disclosure of monetary and non-monetary benefits (*Please refer to paragraph 8.3 of the Code*); and
 - iv) Terms and conditions in generic terms under which client may receive a discount of fees and charges from a licensed or registered person.

CHARLTONS

Best Boutique Firm 2015

Asian Legal Business Awards

This newsletter is for information purposes only.

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at unsubscribe@charltonslaw.com

Hong Kong Office

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

Tel: + (852) 2905 7888

Fax: + (852) 2854 9596

www.charltonslaw.com