



Hong Kong

March 2017

SFC PUBLISHES CONSULTATION ON AMENDMENTS TO THE PROFESSIONAL INVESTOR RULES

Introduction

The Securities and Futures Commission (**SFC**) published a **Consultation Paper on the Proposed Amendments to the Securities and Futures (Professional Investor) Rules (Consultation Paper)**¹ on 1 March 2017. The SFC is proposing to amend the Securities and Futures (Professional Investor) Rules (Cap 571D) (the **Professional Investor Rules**) to incorporate modifications to those rules which it has granted pursuant to section 134 of the Securities and Futures Ordinance (Cap 571) (**SFO**). The proposed amendments would:

- i) allow individuals to aggregate portfolios held in joint account(s) with non-associates and by individuals' investment vehicles with individuals' portfolios in determining whether they meet the HK\$8 million threshold to qualify as a professional investor;
- ii) expand the definition of Corporate Professional Investors to include investment holding companies; and
- iii) allow alternative forms of evidence to demonstrate whether a person qualifies as a professional investor.

The new proposals follow the reform of the professional investor regime which took effect on 25 March 2016 which revised intermediaries' obligations according to the categorisation

1 SFC Consultation Paper on the Proposed Amendments to the Securities and Futures (Professional Investor) Rules, 1 March 2017 <<http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=17CP1>>.

of professionals as Institutional, Corporate or Individual professional investors. For further information on that regime, please see our **March 2016 newsletter**.²

The Consultation Paper includes an indicative draft of the proposed revised Professional Investor Rules.

Responses to the Consultation Paper are required to be submitted by 3 April 2017.

Background

Categories of Professional Investors

The SFO provides for two types of professional investors, namely:

1. entities specified in paragraphs (a) to (i) of the definition of "professional investor" in Part 1 of Schedule 1 to the SFO (e.g. banks and insurance companies). These are Institutional Professional Investors under the Code of Conduct for Persons Licensed by or Registered with the SFC³ (the **Code of Conduct**); and
2. high net worth professional investors as set out in the Securities and Futures (Professional Investor) Rules (Cap 571D) (the **Professional Investor Rules**).

2 Charltons, Amendments to the Hong Kong Professional Investor Regime Take Effect on 25 March 2016, March 2016 <<https://www.charltonslaw.com/amendments-to-the-hong-kong-professional-investor-regime-take-effect-on-25-march-2016/>>.

3 SFC. Code of Conduct for Persons Licensed by or Registered with the SFC. Paragraph 15.2.

The Consultation Paper is concerned with high net worth professional investors under the Professional Investor Rules.

There are four types of high net worth professional investors, namely:

- a) a trust corporation entrusted with total assets of not less than HK\$40 million (or its foreign currency equivalent);
- b) a corporation or partnership with either a portfolio of not less than HK\$8 million (or its foreign currency equivalent) or total assets of not less than HK\$40 million (or its foreign currency equivalent);
- c) an individual who, either alone or with his/her associate(s) (i.e. spouse and children) in a joint account, has a portfolio of not less than HK\$8 million (or its foreign currency equivalent);⁴ and
- d) a corporation the sole business of which is to hold investments and which is wholly owned by any of the persons falling within paragraphs (a), (b) or (c) above.

Paragraph 15.2 of the Code of Conduct defines professional investors within paragraph (c) above as Individual Professional Investors and those in paragraphs (a), (b) and (d) as Corporate Professional Investors.

Evidential Requirements

Under the Professional Investor Rules, licensed and registered intermediaries can adopt a principles-based approach or a prescriptive approach to determine whether high net worth professional investors satisfy the applicable assets or portfolio thresholds.

Principles-based Approach

The principles-based approach allows intermediaries to adopt methods they consider appropriate to satisfy themselves that an investor meets the applicable assets or portfolio threshold at the relevant date.⁵ The SFC expects intermediaries to keep proper records of their assessment process in order to

demonstrate that they have exercised professional judgement and that their conclusions that clients satisfy the relevant thresholds are reasonable.⁶

Prescriptive Approach

Sections 3(a) to (c) of the Professional Investor Rules set out a prescriptive approach according to which intermediaries are required to obtain specified evidential documents before the relevant date. These are:

Type of Professional Investor	Evidential Documents
Trust corporation	<ul style="list-style-type: none"> i. The most recent audited financial statement prepared in respect of the trust corporation and within 16 months prior to the relevant date; ii. one or more audited financial statements, each being the most recent audited financial statement, prepared in respect of the trust or any of the trusts and within 16 months prior to the relevant date; or iii. one or more custodian statements issued to the trust corporation in respect of the trust or any of the trusts and within 12 months prior to the relevant date.⁷
Corporation or partnership	<ul style="list-style-type: none"> i. The most recent audited financial statement prepared in respect of the corporation or partnership and within 16 months prior to the relevant date; or ii. one or more custodian statements issued to the corporation or partnership within 12 months prior to the relevant date.⁸

⁴ Section 3(b) of the Professional Investor Rules.

⁵ "Relevant date" is defined in section 2 of the Professional Investor Rules.

⁶ See, SFC Consultation Conclusions on the Evidential Requirements under the Securities and Futures (Professional Investor) Rules published on 23 February 2011 <<http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=10CP6>>.

⁷ Professional Investor Rules s3(a)

⁸ Professional Investor Rules s3(c)

Individual	<ul style="list-style-type: none"> i. A certificate issued by an auditor or a certified public accountant within 12 months prior to the relevant date; or ii. one or more custodian statements issued to the individual (either alone or with his/her spouse or children in a joint account) within 12 months prior to the relevant date.⁹
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Intermediaries have sought modifications to the Professional Investor Rules to gain greater practical flexibility for themselves and their clients, as a result of which the SFC has granted modifications under section 134 of the SFO which the SFC considers to facilitate efficiency without compromising investor protection. There are around 40 subsisting modifications which are published on the SFC's website which will terminate if the Consultation Paper's proposals are implemented.

The SFC proposes in the Consultation Paper to amend the Professional Investor Rules by formalising the modifications that it has granted to expand the categories of persons who qualify as professional investors and the evidence that can be relied upon in determining whether the threshold criteria are met. The SFC's principal aim is to incorporate standardised modifications into the Professional Investor Rules to enhance transparency and promote market consistency. The latest consultation is not related to other elements of the investor regime, such as the assets and portfolio thresholds or the regulation of intermediary conduct, which were the subject of a separate SFC consultation which concluded in September 2014.¹⁰

Proposed amendments to the Professional Investor Rules

The SFC proposes to amend the Professional Investor Rules by incorporating a consolidated version of the modifications previously granted under section 134 of the SFO. Where the proposed amendments become effective, the SFC also proposes to revoke all section 134 modifications.

⁹ Professional Investor Rules s3(b)

¹⁰ SFC Consultation Conclusions on the Proposed Amendments to the Professional Investor Regime and Further Consultation on the Client Agreement Requirements published on 25 September 2014 <<http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=14CP7>>.

1. Allowing aggregation of certain assets

The SFC proposes that when assessing whether an individual satisfies the applicable portfolio threshold for qualification as an Individual Professional Investor, the individual will be allowed to aggregate the portfolio or share of the portfolio of any corporation wholly or partially owned by the individual the principal business of which is to hold investments at the relevant date.

This will allow investors who use investment vehicles to hold their assets to aggregate their portfolio or share of a portfolio which is held by an investment vehicle with their individual portfolio.

The SFC further proposes allowing the inclusion of an individual's share of a portfolio held in an account jointly owned by the individual with other persons (including individuals, corporations and partnerships) who are not associates of that individual at the relevant date when determining whether the individual meets the portfolio threshold for an Individual Professional Investor.

Currently, the Professional Investor Rules define "associate" as the spouse or any child of an individual. It is commonplace for individuals to establish joint accounts with other family members (e.g. siblings, parents and grandparents), as well as with business partners (i.e. corporations and partnerships). The proposal would allow individuals to aggregate the share of a portfolio held by an individual in a joint account with non-associates with their individual portfolios.

2. Expanding the definition of corporations which qualify as professional investors

The SFC proposes to expand the categories of persons qualifying as professional investors to include any corporation whose principal business at the relevant date is to hold investments, where the corporation is wholly owned by one or more persons where each of them qualify as a professional investor (under the Professional Investor Rules or Schedule 1 to the SFO). The SFC proposes to also include as professional investors, corporations which wholly own another corporation that qualifies as a professional investor under the Professional Investor Rules by satisfying the assets or portfolio tests.

The SFC accepts the industry view that it is quite common for individuals and corporations to set up corporations for investment purposes, and that an investment vehicle's involvement in other businesses would not materially affect

or detract from its principal business of investment holding. The SFC further considers that it would be sensible for a corporation to qualify as a professional investor where it wholly owns another corporation which qualifies as a professional investor under the assets and portfolio tests.

The SFC is of the opinion that these proposals will promote the participation of corporations in private placement activities, and will not compromise investor protection as intermediaries will still be required to comply with the suitability requirements of the Code of Conduct for Persons Licensed by or Registered with the SFC.

3. Allowing alternative forms of evidence

The SFC proposes to modify the evidential requirements of sections 3(a) to (c) of the Professional Investor Rules by permitting investors to use certain alternative forms of evidence in determining whether a person satisfies the applicable assets or portfolio threshold so as to qualify as a professional investor. Investors will be allowed under the proposals to rely on public filings made pursuant to legal or regulatory requirements in Hong Kong or in a place outside Hong Kong, or certificates issued by custodians, auditors or certified public accountants.

The SFC is seeking comments from the market as to whether these alternative forms of evidence, which are commonly used by intermediaries, should be subject to any conditions.

The SFC predicts that the proposed amendments, if enacted, would result in an increased number of persons qualifying as professional investors. However, the SFC emphasises that intermediaries must continue to comply with the suitability requirements and other fundamental requirements¹¹ when serving Individual Professional Investors. Under the new professional investor regime, which became effective on 25 March 2016, intermediaries are no longer able to rely on an individual professional investor exemption in relation to such requirements.

¹¹ For example, the need to disclose certain transaction related information, the need to enter into a written client agreement and the provision of relevant risk disclosure statements.

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