

Panel on Financial Affairs
Special meeting on 16 July 2013

**Securities and Futures Commission's Consultation on the
Proposed Amendments to the Professional Investor Regime and
the Client Agreement Requirements**

Background

1. The Securities and Futures Commission's ("**SFC**") has conducted a comprehensive review of the current professional investor regime and examined the minimum contents requirements of client agreements under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("**the Code**"). With a view to enhancing investor protection, a consultation paper was issued in May 2013 and the consultation period will end on 14 August 2013.
2. This briefing paper is divided into two parts, namely –
 - A. The current professional investor regime.
 - B. Key proposals in relation to the:-
 - (i) Professional investor regime as regards private placements;
 - (ii) Professional investor regime as regards intermediaries' conduct regulation (including the application of the 'Suitability Requirement¹'); and
 - (iii) Client Agreement requirements.

Part A - The current professional investor regime

3. The term "professional investor" is defined under the Securities and Futures Ordinance ("**the Ordinance**"). It includes *institutional professional investors*² for example, licensed corporations, banks and insurance companies. By virtue of the Securities and Futures (Professional Investor) Rules ("**the Professional Investor Rules**") it also extends to those *corporate professional investors* and *individual professional investors* who have wealth above prescribed monetary thresholds.³

¹ The Suitability Requirement refers to paragraph 5.2 of the Code. In brief, this requirement is to ensure that the suitability of a recommendation or a solicitation made to a client is reasonable in all circumstances.

² Please refer to paragraphs (a)-(i) of the definition of "professional investor" in section 1 of Part 1 of Schedule 1 to the Ordinance.

³ These investors are: - (a) any individual who (either alone or with his/her spouse and child on a joint account) has a portfolio of not less than \$8 million; (b) any trust corporation having been entrusted with total assets of not less than \$40 million; (c) any corporation or partnership having (i) a portfolio of not less than \$8 million; or (ii) total assets of not less than \$40 million; (d) any corporation the sole business of

4. Under the current regime, all professional investors can participate in private placements (i.e. in offerings where the marketing documentation does not require authorization by the SFC). The extent and quality of information disclosure in private placements is not subject to the regulatory standards equivalent to a public offering or authorization by the SFC.
5. Furthermore, under the Code, intermediaries (i.e. licensed corporations and banks that conduct securities business) are automatically entitled to use certain exemptions when dealing with *institutional professional investors*. One of the key exemptions is the disapplication of the Suitability Requirement. Another is the disapplication of the requirement to enter into a written client agreement. In the case of *corporate professional investors* and *individual professional investors*, intermediaries must first assess and be satisfied that these clients are sufficiently knowledgeable and experienced in the relevant financial markets and obtain consent from these clients before they can use the exemptions to disapply the prescribed provisions of the Code. This “knowledge and experience” assessment includes “bright-line” tests such as the minimum number of transactions per annum and years of being active in the relevant market.

Part B: Key proposals

(i) The professional investor regime as regards private placements

6. Given that information disclosure in private placements is not subject to mandatory contents requirements equivalent to a public offering or authorization by the SFC, there may be a concern that investors may not be in a position to make informed investment decisions. *Corporate professional investors* and *individual professional investors* who qualify solely by meeting the prescribed monetary thresholds under the Professional Investor Rules might not in practice be financially sophisticated and could be vulnerable⁴.

which is to hold investments and is wholly owned by any one or more of (a), (b) or (c) above. For the purpose of this briefing paper, professional investors falling under (a) are referred to as *individual professional investors* while professional investors falling under (b), (c) and (d) are collectively referred to as *corporate professional investors*.

⁴ *Institutional professional investors* are regarded to be financially sophisticated given that their day-to-day business involves substantial dealings in the financial markets.

7. Nevertheless, as the private placement regime is well established and other overseas jurisdictions, including the United States, Australia and Singapore, allow investors to access private placements solely by reference to wealth criteria, the SFC does not propose any change to the access to private placements by professional investors. Nevertheless, the SFC wishes to seek views as to –

(a) whether, and what, further measures should be introduced so as to better protect the interest of *corporate professional investors* and *individual professional investors* when participating in private placements; and

(b) whether the minimum monetary thresholds under the Professional Investor Rules should be increased.

(ii) The professional investor regime as regards intermediaries' conduct regulation (including the application of the 'Suitability Requirement')

8. Given that the vast majority of mis-selling cases dealt with by the SFC involve individual investors (i.e. natural persons), the SFC is of the view that in general *individual professional investors* merit greater protection than *corporate professional investors*. The SFC therefore proposes that no Code exemptions will be available for intermediaries to use when serving any individual investors, including *individual professional investors*.

9. The SFC also proposes that Code exemptions will cease to be available for intermediaries to use when dealing with corporations that operate as investment vehicles wholly owned by individuals and/or by family trusts, on the basis that their owners are expected to make investment decisions little differently from individual investors.

10. The sum of the proposals summarised in paragraphs 8 and 9 mean that all Code requirements, including the Suitability Requirement, should be observed by intermediaries without exemption when they deal with individual investors, their wholly owned investment vehicles and investment vehicles wholly owned by family trusts.

11. In contrast, where *corporate professional investors* have dedicated and experienced investment personnel who make investment decisions – often as part of corporate treasury functions, they may in fact be just as financially sophisticated as *institutional professional investors* though they may operate different businesses. In view of the above, the SFC considers that intermediaries should continue to be able to use the existing Code exemptions when dealing with *corporate professional investors* provided that they meet the "knowledge and experience" assessment and have given their consent.

12. It is further proposed that an intermediary should exercise its own judgement in assessing a *corporate professional investor's* knowledge and investment experience by considering its corporate structure and investment process and the background of relevant personnel, including their investment experience and risk awareness. The current "bright-line" tests are proposed to be abandoned as they may not be good indicators of knowledge and investment experience if taken in isolation.

13. The SFC is of the view that –

- (a) the requirement for intermediaries dealing with *individual professional investors* to ensure suitability in all cases will greatly enhance their protection while leaving their choice of, or access to, investments unaffected; and
- (b) the replacement of the "bright-line" tests for assessing the knowledge and investment experience of *corporate professional investors* by a "principles-based" test is more flexible and practical.

(iii) The Client Agreement requirements

14. Intermediaries are required to act "honestly, fairly, and in the best interests of clients and the integrity of the market" under General Principle 1 of the Code. Further, under paragraph 5.2 of the Code, intermediaries are also required to ensure the suitability of the recommendation or solicitation for the client is reasonable in all the circumstances.

15. Some intermediaries however include clauses in client agreements which are designed to restrict the ability of clients to seek compensation by misdescribing the actual services to be provided. Such restrictions may also appear in declarations or acknowledgements signed by clients at the request of intermediaries.
16. Furthermore, whilst the Suitability Requirement is a key investor protection measure, the requirement is regulatory in nature so that, even though a breach may enable the SFC to take disciplinary action against an intermediary, the SFC cannot require the intermediary to pay compensation to aggrieved clients. Nor do such breaches, of themselves, enable clients of an intermediary to claim compensation or bring any other claims.
17. In order to enhance investor protection, the SFC proposes⁵, in summary, that –
- (a) the Suitability Requirement should be incorporated into client agreements as a contractual term; and
 - (b) client agreements should not contain terms which are inconsistent with the Code and should accurately set out in clear terms the actual services to be provided to the client.

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⁵ These proposals will however not affect the client agreement exemption available for *institutional professional investors* and *corporate professional investors* that meet the "knowledge and experience" assessment and have given their consent.