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Paper for the House Committee

**Report of the Subcommittee on Securities and Futures
(Professional Investor) (Amendment) Rules 2018**

Purpose

This paper reports on the deliberations of the Subcommittee on Securities and Futures (Professional Investor) (Amendment) Rules 2018 ("the Subcommittee").

Background

2. "Professional investor" is defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) ("SFO") to include any intermediary, authorized financial institution, insurer, collective investment scheme, registered provident fund, retirement scheme, etc., and any person of a class prescribed by rules under section 397 of SFO (i.e. the Securities and Futures (Professional Investor) Rules (Cap. 571D) ("the PI Rules")). Under the professional investor ("PI") regime, certain requirements of SFO imposed on intermediaries may be dis-applied when intermediaries are serving PIs as such investors are generally regarded as more sophisticated who are generally more capable of protecting their interests. The requirements that may be dis-applied include:

- (a) an offer should not be made unless the issue is authorized by the Securities and Futures Commission ("SFC") (section 103(1) of SFO);
- (b) certain agreements should not be made in an unsolicited call (section 174(1) of SFO); and
- (c) an offer should be accompanied by an offering document containing specified information (section 175(1) of SFO).

Yet, the suitability requirement is still applicable vis-à-vis PIs.

3. The PI Rules prescribe the following persons meeting the monetary thresholds as PIs:

- (a) any trust corporation with total assets of not less than \$40 million;
- (b) any individual, either alone or with any of his/her associates¹ on a joint account, having a portfolio of not less than \$8 million;
- (c) any corporation or partnership having a portfolio of not less than \$8 million or total assets of not less than \$40 million; and
- (d) any corporation whose sole business is to hold investments and which is wholly owned by (a), (b) and/or (c) above.

4. The PI Rules also specify the kinds of documents that can be relied upon as evidence in ascertaining compliance with the relevant monetary threshold, which include:

- (a) the most recent audited financial statement prepared within 16 months before the relevant date for trust corporations, corporations or partnerships;
- (b) certificates issued by auditors or Certified Public Accountants within 12 months before the relevant date for individuals; and
- (c) custodian statements² issued within 12 months before the relevant date for trust corporations, corporations, partnerships or individuals.

The Securities and Futures (Professional Investor) (Amendment) Rules 2018

5. Over the years, SFC, on request by intermediaries and pursuant to section 134 of SFO, has granted around 40 modifications to relax some requirements of the PI Rules with a view to improving the operational efficiency of the intermediaries without compromising investor protection.

¹ The existing Securities and Futures (Professional Investor) Rules (Cap. 571D) ("PI Rules") define the term "associate" as the spouse or any child of an individual.

² "Custodian statement" is defined as a statement of account issued by, among others, a corporation, an authorized financial institution or a licensed corporation whose business includes acting as a custodian of securities or other property for another person, whether on trust or by contract.

SFC considers it timely and appropriate to update the PI Rules by incorporating the modifications granted. SFC conducted a one-month public consultation on the proposed amendments in March 2017 ("2017 public consultation"). According to SFC, the respondents were generally supportive of the proposals.

6. The Securities and Futures (Professional Investor) (Amendment) Rules 2018 ("the Amendment Rules") are made by SFC under section 397(1) of SFO to amend the PI Rules to expand the types of individuals and corporations that are to be regarded as PIs, and the records which may be considered in ascertaining whether an individual or corporation is a PI. The main provisions are summarized paragraphs 7 to 9.

Allowing the aggregation of certain assets by individuals towards meeting the portfolio threshold to qualify as professional investors

7. Under the Amendment Rules, in determining whether an individual qualifies as a PI, an individual's share of a portfolio jointly held with persons other than his/her associate, and the portfolio of an investment holding corporation wholly owned by the individual, may also be taken into account in calculating the individual's portfolio. An individual's share of a portfolio in a joint account with persons other than his/her associate is the individual's share as specified in a written agreement among the account holders or, in the absence of such an agreement, an equal share of the portfolio.

Expanding the definition of corporations as professional investors

8. Under the Amendment Rules, a corporation qualifies as a PI if: (a) its principal business³ is investment holding and it is wholly owned by one or more PIs qualified under either the "professional investor" definition in section 1 of Part 1 of Schedule 1 to SFO, or the PI Rules; or (b) it wholly owns another corporation which has been ascertained to have met the asset or portfolio threshold to qualify as a PI.

Allowing the use of alternative forms of evidence to demonstrate qualification as professional investors

9. Under the Amendment Rules, in ascertaining the size of the portfolio or total assets of individuals, corporations, trust corporations or partnerships, one may refer to the public filings submitted by them or on their behalf, or certificates issued by custodians, in addition to other forms of acceptable evidence (e.g. audited financial statements, custodian statements, and an auditor/accountant's certificates). Under the amended section 2 of the PI Rules,

³ Under the existing PI Rules, the term "sole business" is used.

"public filing" means a document submitted under the legal or regulatory requirements in Hong Kong or elsewhere to a person or body that has a duty to publish the document to, or make it available for inspection by, members of the public.

10. The Amendment Rules were gazetted on 18 May 2018 and tabled at the Legislative Council ("LegCo") meeting of 23 May 2018 for negative vetting. The Amendment Rules will come into operation on 13 July 2018.

The Subcommittee

11. At the House Committee ("HC") meeting on 25 May 2018, Members agreed to form a subcommittee to study the Amendment Rules. The membership list of the Subcommittee is in **Appendix**. Under the chairmanship of Hon Holden CHOW Ho-ding, the Subcommittee has held three meetings with the Administration and SFC to examine the Amendment Rules.

12. To allow sufficient time for the Subcommittee to scrutinize the Amendment Rules, the Chairman moved a proposed resolution at the Council meeting of 20 June 2018 to extend the scrutiny period to the Council meeting of 11 July 2018. The proposed resolution was passed.

Deliberations of the Subcommittee

Expanding the definition of corporation as professional investors

13. The Subcommittee notes that under the Amendment Rules, a corporation qualifies as a PI if it ("the holding company") wholly owns another corporation which has met the portfolio or total asset threshold and qualified as a PI. Mr James TO has expressed concern that as the shareholders of the holding company may be different from those of the wholly owned subsidiary, extending the PI status to the holding company may bring risks to its shareholders, in particular if the company is a small and medium sized one without a formal or proper governance structure. He has reservation that the holding company should be automatically regarded as a PI without adequate measures to protect its shareholders.

14. SFC has explained that, given that a holding company has control over the assets or portfolios held by a wholly-owned subsidiary, a holding company which wholly owns another corporation meeting the relevant monetary threshold should also be regarded as having met the relevant monetary threshold to qualify as a PI. The proposal will facilitate participation of corporations in private placement activities in Hong Kong, while providing flexibilities to the holding

company in allocating investments amongst different entities it wholly owns, without necessarily having to concentrate their investments in one single entity.

15. Mr James TO has enquired how the shareholders of the holding company would be aware that the company becomes qualified as a PI and how they would be informed of the consequences and impacts on them. In this regard, some members, including Mr Christopher CHEUNG Wah-fung and Mr CHAN Chun-ying, have enquired about the requirement on intermediaries in ascertaining whether a corporation qualifies as a PI. For instance, whether the intermediary is required to obtain documents from the corporation concerned confirming its shareholders' acknowledgement of the corporation's PI status, and how the intermediary would determine which parties are to be covered in the suitability assessment and assess the investment experience and investment objectives of the corporation. In order to properly protect the interests of the shareholders of the holding company when it becomes a PI, Mr James TO opines that SFC should consider specifying such requirements on intermediaries in the Amendment Rules or the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct").

16. SFC has advised that a corporation should have an adequate and proper governance structure over its investment decision-making process. The governance structure should determine (a) who is responsible for making the investment decisions for the corporation, (b) under what circumstances its shareholders should be informed of a decision made, and (c) under what circumstances consent from shareholders is necessary. An authorized person (usually a director or owner of the company) should be bound by the governance structure to make investment decisions in accordance with the corporation's investment objective. SFC is mindful that the shareholders of a holding company should be properly informed if and when the company becomes a PI under the Amendment Rules because its wholly-owned subsidiary is a PI. SFC has committed in the consultation conclusions of May 2018 to remind directors and shareholders of a corporation to review the corporate governance structure. SFC will also issue a press release to remind the public of the same when the Amendment Rules become effective in July 2018, and will provide more investor education in this regard. These measures are to ensure that the shareholders of a corporation are properly informed and aware of the implications when the corporation becomes a PI pursuant to the Amendment Rules.

17. In light of Subcommittee members' views, SFC has further reviewed the situation. In addition to the measures mentioned above, SFC will issue a circular requiring intermediaries to obtain confirmation from the authorized person(s) of the holding company of a corporate PI that the shareholders of that holding company have been informed of its corporate PI status, prior to providing services to the holding company. The circular will be issued once the Amendment Rules become effective. Mr James TO has requested SFC to

consider reminding intermediaries that when they conduct suitability assessment on corporate PIs, they should pay particular attention to those PIs whose total assets comprise primarily real property which are for self-occupation. This would ensure that the corporate PIs concerned have sufficient liquidity to bear the potential losses in the trading of investment products.

18. As regards assessment of corporate PIs by the intermediaries, SFC has pointed out that as part of the know-your-client ("KYC") procedures, an intermediary should collect information about its clients (including PIs), including their financial situation, investment experience (e.g. trading history), investment objectives and investment knowledge. For a client which is a corporation, such information should be collected and assessed at the company level. An intermediary may determine how to assess the level of investment experience and knowledge of a corporate client by considering, among other things, who the persons authorized to make and responsible for making investment decisions are (e.g. the directors and/or officers of an investment committee (for large corporations) or the owners (for small private companies)) and the investment experience and knowledge of such authorized persons.

19. SFC has supplemented that when making the assessment, an intermediary should adopt a holistic approach and take into account all the relevant information about a client to ensure that the suitability of the recommendation for a client is reasonable in all the circumstances. For example, when providing services to a corporate client in derivative products, the intermediary should assure itself that the authorized persons of the corporate client understand the nature and risks of the products and that the corporate client itself has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.

Review of the professional investor regime

Monetary thresholds for qualification as professional investors

20. The Subcommittee notes that under the existing PI Rules, an individual having a portfolio ("投資組合" in Chinese) of not less than \$8 million qualifies as a PI, whereas a corporation having a portfolio of not less than \$8 million or total assets ("總資產" in Chinese) of not less than \$40 million qualifies as a PI. A "portfolio" is defined under the PI Rules to basically include securities and cash. Meanwhile, "assets" includes real property. Some members have enquired if investment-linked assurance schemes ("ILAS") are covered under the definition of "portfolio", and why different asset classes are adopted for the monetary thresholds in respect of individual and corporate PIs.

21. SFC has responded that "portfolio" is defined in section 2 of the PI Rules as a portfolio comprising securities, certificates of deposit issued by banks

or money held by custodians for a person. ILAS are excluded from the definition of "securities" under section 1 of Part 1 of Schedule 1 to SFO, and thus are not counted towards the portfolio threshold in determining whether an individual qualifies as a PI.

22. SFC has pointed out that the monetary threshold test is a simple and easy-to-interpret method for evaluating whether an individual or corporation qualifies as a PI. Apart from Hong Kong, there are other jurisdictions (e.g. the United Kingdom ("the UK") and the United States ("the US")) which use different asset classes for the different monetary thresholds for individuals and corporations. SFC has re-iterated that PIs, like other investors, are further subject to the KYC procedures, suitability requirement, etc. before being sold a product.

23. With the escalating real property prices in recent years, some members of the Subcommittee including Mr James TO and Dr CHIANG Lai-wan have questioned the effectiveness of the existing monetary thresholds of \$8 million (for individual PIs) and \$40 million (for corporate PIs) under the PI Rules in providing sufficient protection for investors. Noting that the monetary thresholds have been in place for over 10 years, these members have commented that it is high time for SFC to review the monetary thresholds and consider adjusting the levels upward to ensure that the levels could keep up with market changes and that the protection for investors could be maintained. Mr Christopher CHEUNG Wah-fung considers that the \$8 million portfolio threshold for individual PIs appropriate and should be maintained, while Mr CHAN Chun-ying considers it important to educate investors on the rights (e.g. having access to a wider range of investment products) and risks (e.g. from engaging in private placement activities, which do not have to be authorized by SFC) of becoming PIs.

24. SFC has stressed that it has been keeping in close view the operation of the PI regime and would review, amongst other things, the monetary thresholds for qualification as PIs from time to time. In the review of the monetary thresholds conducted by SFC in 2014, a comparison was made on the monetary thresholds adopted in Hong Kong and other jurisdictions including the UK and the US. The results indicated that the thresholds adopted in Hong Kong were higher than those used in the UK. The Administration and SFC have stressed that any alterations to the existing regime will have considerable impact on the investors and the operation of the industry, and must be considered in a holistic manner (including to study the implementation, and if applicable, transitional details) and after a due consultation process. Otherwise, changes made in haste may cause market confusion, and would compromise the protection for the investors. The Amendment Rules are to standardize the modifications granted by SFC to individual intermediaries under section 134 of SFO over the years. The purpose is to ensure consistency in the application of the PI Rules and provide a level playing field for the market. The preceding consultation was on

the standardization proposal only. The Administration and SFC fully understand members' concern over the PI regime, particularly the monetary thresholds adopted under the regime. They would actively consider members' suggestion to carry out a review on the thresholds.

Suggestions on alternative criteria for qualification as professional investors

25. Some members of the Subcommittee have reservation over merely adopting the monetary thresholds for prescribing PIs. They are concerned that individual investors with in-depth investment knowledge and rich investment experience but cannot meet the monetary threshold of \$8 million would not be regarded as PIs, thus restricting their investment options. Mr Christopher CHEUNG Wah-fung and Mr James TO have suggested that individual investors who can prove that they have met certain experience and/or qualification (e.g. having received relevant training provided by SFC or intermediaries and passed relevant examinations) requirements should qualify as PIs even though they do not have a "portfolio" of \$8 million.

26. SFC has re-iterated that the monetary threshold test under the PI regime is a simple and easy-to-interpret method for evaluating whether an individual or corporation qualifies as a PI. Under section 103(1) of SFO, no person may issue an invitation to the public to invest in any securities unless the issue is authorized by SFC or an exemption under SFO applies. In general, products that could be offered to the public include authorized collective investment schemes (i.e. authorized funds), and listed shares.⁴ Meanwhile, products offered only to PIs are exempted from the authorization requirements. Examples include private placements of unauthorized shares and debentures, which are often offered to groups of non-public investors.

Proposed resolution by Mr James TO to repeal the Securities and Futures (Professional Investor) Amendment Rules

27. Mr James TO and Dr CHIANG Lai-wan have urged the Administration and SFC to conduct a review of the PI regime especially the monetary thresholds as soon as possible. Mr TO has further requested the Administration and SFC to provide an undertaking to complete the said review and report the results to LegCo within a year.

28. The Administration and SFC have responded that the monetary thresholds are an important element of the PI regime. They took note of members' views on the subject and reiterated that they would actively consider

⁴ Other products include listed structured products (e.g. callable bull/bear contracts and derivative warrants), authorized structured products (e.g. equity-linked investments/notes), and authorized debentures (e.g. retail bonds).

the suggestion to carry out a review on the thresholds. Given the complexity of the issues involved and that any changes to the regime would have considerable impact on investors and intermediaries, it would be difficult to commit on a timetable for the review at the present stage.

29. In view of the lack of a clear commitment from the Administration and SFC to conduct a review on the monetary thresholds adopted under the PI regime and provide a timetable, Mr James TO has indicated that he will give notice to move a motion at the Council meeting of 11 July 2018 to repeal the Amendment Rules.

30. The Administration and SFC have re-iterated that, given that the Amendment Rules can ensure consistency and transparency in the application of the PI Rules and provide a level playing field for the market, the proposals therein should be implemented as soon as possible. SFC published the conclusions to the 2017 public consultation in May 2018 which also set out the timetable for implementing the amendments. The market and intermediaries have made preparations for the Amendment Rules. Any delay in the implementation may cause confusion in the market.

Investor protection issues

Investor protection measures adopted after the Lehman Brothers Minibonds Incident

31. Some members of the Subcommittee have pointed out that the Lehman Brothers Minibonds Incident ("the LB Incident") of 2008 had exposed a loophole that some investors were classified as individual PIs without their knowledge, and these investors subsequently encountered difficulties in seeking compensation from banks for mis-selling the minibonds to them. The Subcommittee has examined the investor protection measures adopted by the Administration and SFC after the LB Incident.

32. SFC has advised that it has put in place a series of measures to enhance investor protection after the LB Incident. Examples of key ones include:

- (a) on the business conduct of intermediaries, SFC has imposed requirements relating to the selling of investment products to clients. Under these requirements, intermediaries need to, among others, assess a client's knowledge of derivatives and characterize the client accordingly before selling derivative products to them, and disclose transaction-related information to clients prior to or at the point of sale, e.g. the capacity in which an intermediary is acting, affiliation of the intermediary with the product issuer, and benefits received for distributing investment products. Other requirements imposed on intermediaries under

the Code of Conduct include requiring intermediaries to incorporate a new clause into client agreements to ensure that the financial products which they solicit to sell or recommend to clients are reasonably suitable for the clients (i.e. the suitability requirement);

- (b) on enhancing product transparency, SFC has set an overall disclosure standard for all offering documents in respect of different investment products being offered to the public in Hong Kong (e.g. introduction of Product Key Facts Statements); and
- (c) SFC established the Investor Education Centre in November 2012 with the mandate of delivering financial education to the public to improve their financial literacy and equip them with the skills needed to make informed financial decisions.

Assessment of the risks of investment products

33. Some members of the Subcommittee including Dr CHIANG Lai-wan have called on SFC to strengthen its work in approving investment products, such as rating investment products based on their risk levels and advising on the suitability of the products for various investors. Dr CHIANG notes that financial regulators in some jurisdictions have assumed the role of rating investment products, which help enhance investors' confidence in the products. Mr CHAN Chun-ying has stressed the need for the Administration and SFC to enhance investor education and publicity of SFC's authorization on investment products so that investors, regardless of whether they are retail investors or PIs, would be aware of the risks involved in various investment products and could make informed decisions on their investment choices.

34. SFC has responded that the suggestion to rate investment products falls outside the remit of the PI regime. Under the current regulatory regime over intermediaries, when conducting the suitability assessment, an intermediary should not merely match a product's risk rating with a client's risk tolerance level as assessed by the intermediary. Rather, the intermediary should carry out due diligence on and develop a thorough understanding of the investment product and ensure the product that it recommends to a client is suitable for him/her under all circumstances. An intermediary should exercise its professional judgement to assess whether the characteristics and risk exposures of a recommended product are suitable for a client after taking into account the client's relevant circumstances, such as the client's investment objectives, investment horizon, investment knowledge and experience, risk tolerance, and financial situation. While SFC has no plan to change this arrangement, it attaches importance to strengthening efforts on investor education. In order to enhance the transparency in authorization of investment products, a list of the investment products authorized by SFC is available on SFC's website.

Recommendation

35. The Subcommittee will not propose amendments to the Amendment Rules. The Subcommittee also notes that the Administration and SFC will not propose amendments to the Amendment Rules.

Advice sought

36. The Subcommittee Chairman gave a verbal report on the deliberations of the Subcommittee at the HC meeting on 29 June 2018. Members are requested to note this written report.

Council Business Division 1
Legislative Council Secretariat
4 July 2018

**Subcommittee on Securities and Futures (Professional Investor)
(Amendment) Rules 2018**

Membership list

Chairman Hon Holden CHOW Ho-ding

Members Hon James TO Kun-sun
Hon Abraham SHEK Lai-him, GBS, JP
Hon Kenneth LEUNG
Hon Christopher CHEUNG Wah-fung, SBS, JP
Dr Hon CHIANG Lai-wan, SBS, JP
Hon CHAN Chun-ying, JP

(Total : 7 members)

Clerk Ms Connie SZETO

Legal Adviser Mr Bonny LOO