

**Bills Committee on Securities and Futures and Companies Legislation
(Structured Products Amendment) Bill 2010**

**Definition of Professional Investors and Update on the Progress on
Reviewing/Amending the Definition**

Purpose

This paper briefs Members on the definition of professional investors related to public offers of structured products, and the progress on reviewing the definition.

Definition of Professional Investors

2. The term “professional investor” is defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) (“SFO”). This term includes specified entities, such as banks and insurance companies set out in paragraphs (a) to (i) of the definition. In addition, paragraph (j) of the definition refers to any person of a class which is prescribed under the Securities and Futures (Professional Investor) Rules (Cap. 571D) (“PI Rules”).

3. The PI Rules include, among others, the following types of high net worth professional investors -

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

4. If an investor is a “professional investor”, the legal restrictions on issuance of advertisements in relation to investments (section 103 of SFO), the making of unsolicited calls (section 174 of SFO) and the communication of an offer in relation to securities (section 175 of SFO) do not apply. Further, the offering of any shares in (or debentures of) a company to professional investors is not subject to the prospectus regime under the Companies Ordinance.

5. The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (“Code of Conduct”) applies to all licensed or registered persons when they are carrying on any regulated activities as defined under the SFO. When an intermediary serves a professional investor as classified under the PI Rules, it should also comply with the requirements under the Code of Conduct. There is a general market misconception that investors with a minimum portfolio of HK\$8 million will automatically be “treated” as professional investors under the Code of Conduct. In fact, under the Code of Conduct, an intermediary should only “treat” an investor as a “Professional Investor” (and thereby be exempt from certain regulatory requirements as set out under paragraph 15.5 of the Code of Conduct, e.g., conducting suitability assessment) if the intermediary has assessed the person’s investment experience and is reasonably satisfied that the investor is knowledgeable and has sufficient expertise in relevant products and markets. Under the existing paragraph 15.3 of the Code of Conduct, an intermediary should have regard to the following factors in conducting the assessment-

- (a) the type of products in which the person has traded;
- (b) the frequency and size of trades (a Professional Investor would be expected to have traded not less than 40 transactions per annum);
- (c) the person’s dealing experience (a Professional Investor would be expected to have been active in the relevant market for at least 2 years); and
- (d) his awareness of the risks involved in trading in the relevant markets.

6. Further, under paragraph 15.4(a) of the Code of Conduct, prior to treating a client as a Professional Investor, an intermediary should provide a written explanation to the relevant client explaining the risks and

consequences of being treated as a Professional Investor. Under paragraph 15.4(b), an intermediary should also obtain a written and signed declaration from the person confirming that the consequences of consenting to being treated as a Professional Investor and the right to withdraw from being treated as such have been explained to him and that he wishes to be treated as a Professional Investor.

7. In a nutshell, pursuant to section 103(3)(k) of the SFO, offering documents of investment products regulated under the SFO which are only targeted to Professional Investors (as defined in the SFO and the PI Rules) need not obtain authorization of the Securities and Futures Commission (“SFC”). However, before offering such products to individual Professional Investors, an intermediary will have to ascertain, as required under the Code of Conduct, that the individual has a portfolio of not less than HK\$8 million, the individual is knowledgeable and has sufficient expertise in the relevant products and markets, and that the individual formally agrees, in writing, that he wishes to be classified as a Professional Investor. In addition, similar to selling any other securities to the rest of the public, intermediaries have to comply with all relevant requirements under the Code of Conduct, for example, in relation to derivative products, the intermediary should still comply with the “know your client” requirement in paragraph 5.3 of the Code of Conduct – i.e., it should assure itself that the individual understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.

8. As a general principle, the Hong Kong Monetary Authority has required authorized institutions (“AIs”) in their sale of investment products including currency-linked, interest rate-linked as well as currency and interest rate-linked instruments to follow standards that are based on the requirements imposed by the SFC on intermediaries in respect of the sale of securities products. Hence, the above requirements on treatment of professional investors also apply to the sale of investment products including currency-linked, interest rate-linked as well as currency and interest rate-linked instruments by AIs.

Progress of Reviewing the Definition of Professional Investors

9. The SFC published the Consultation Paper on Proposals to Enhance Protection for the Investing Public on 25 September 2009. The

consultation included a review of the professional investor regime under the Code of Conduct and the review of the minimum portfolio requirement for an individual to be qualified as a professional investor under the PI Rules. The consultation conclusions were published on 28 May 2010. The current minimum portfolio requirement of HK\$8 million is comparable to other jurisdictions (e.g. higher than that in the United Kingdom and lower than that in Australia and Singapore). It was concluded that there would be no change to the existing minimum portfolio requirement under the PI Rules. Amendments to the Code of Conduct would be made (which will come into effect on 4 June 2011) so that there would be an explicit requirement under the Code that an intermediary should assess a professional investor's knowledge and expertise and the assessment should be in writing and the basis of which must be recorded. Further, separate assessment should be taken if an existing professional investor invests in a different product type or market. Intermediaries should undertake a new assessment where a professional investor has ceased to trade in the relevant product or market for more than 2 years.

10. The PI Rules also set out specific methods (evidential requirements) to ascertain the relevant assets or portfolio thresholds for various types of high net worth professional investors mentioned in paragraph 3 above. For example, to show that an individual has HK\$ 8 million, the PI Rules requires the evidence to be in the form of an auditor's or certified public accountant's certificate or custodian statements issued to that individual within 12 months before the offer date. Currently, the SFC is consulting on proposed refinements to the evidential requirements under the PI Rules. It proposes that, while the minimum value of the relevant assets or portfolio will remain unchanged, firms will be able to use any method to satisfy themselves that an investor meets the required asset or portfolio threshold at the offer date as long as proper records of their assessment processes are kept. To enable firms that wish to continue with existing practices, the current method of establishing the different types of high net worth professional investors under the PI Rules will be preserved. Any amendments to the PI Rules will be subject to negative vetting by the Legislative Council.

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Securities and Futures Commission
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