Subcommittee on the Securities and Futures (Professional Investor) (Amendment) Rules 2011

Q2 In respect of enforcement to safeguard the interests of Professional Investors:-

(a) explain the regulatory role of SFC;

(b) provide a copy of the circular regarding the annual confirmation exercise of Professional Investors issued by SFC in March 2011;

(c) advise whether and when the Hong Kong Monetary Authority (HKMA) has issued the circular to banks or drawn their attention to the circular;

(d) provide details on the courses of action taken by HKMA in respect of enforcement to ensure compliance; and

(e) advise whether standard practice and/or procedures were in place for bank staff to explain to clients the risks and consequences of being treated as a Professional Investor.

A2(a) (1) The SFC is responsible for regulating the securities and futures markets in Hong Kong. In developing and administering the laws and regulations governing such markets, the SFC seeks to establish and maintain a sound regulatory regime that is consistent with international practices taking into account the prevailing market conditions and practices in Hong Kong.

(2) The SFC performs ongoing monitoring of and conducts inspections on licensed corporations from time to time so as to monitor their compliance with relevant laws (eg the SFO and the PI Rules) and regulatory standards under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct").

(3) The SFC also initiates investigations into potential breaches or non-compliance, whether in response to inspection findings or otherwise, such as in the course of handling complaints against licensed corporations.

A2(b) A copy of the Circular to Licensed Corporations and Registered Institutions "Annual Confirmation Exercise of Professional Investors" issued by the SFC on 18 March 2011 is attached for the review of the Subcommittee.

A2(c) The circular "Annual Confirmation Exercise of Professional Investors" was issued by the SFC to both licensed corporations and registered institutions (i.e. banks and other authorized institutions registered with the SFC for carrying on regulated activities) on 18 March 2011. It was therefore not necessary for the HKMA to issue another circular to registered institutions on this matter.

A2(d) During its day-to-day supervision, the HKMA conducts on-site examinations and off-site surveillance to understand the way in which registered institutions carry out their regulated activities and to assess effectiveness of their control systems to ensure compliance with the relevant legal and regulatory requirements. On-site examinations reviewing sales practices in general include checking of the registered institutions' compliance with the relevant legal and regulatory requirements when serving professional investors, where applicable. This typically includes reviewing the registered institution's relevant policies and procedures and sample checking the registered institution's assessment and adherence to the required procedural safeguards for treating a customer as a professional investor. For off-site surveillance, the HKMA collects the number of professional investors as defined under Part I of Schedule 1 to the Securities and Futures Ordinance (SFO) from retail banks through regular survey, and where necessary, follows up with the banks concerned. Any potential non-compliance cases identified in the day-to-day supervision (whether from on-site examinations, off-site surveillance or in the course of handling complaints against registered institutions) will be referred to the HKMA's Enforcement Department for further action where appropriate. Where major breaches or non-compliances are identified, the HKMA may take disciplinary actions against the relevant individual (i.e. staff registered for conducting regulated activities) or, where appropriate, refer to the SFC for enforcement action.

A2(e) It is a standard practice for registered institutions to have procedures in place to provide a written explanation to the relevant clients explaining the risks and consequences of being treated as a Professional Investor as required under paragraph 15.4 (a) of the Code of Conduct.

Q3 On the number of Professional Investors in the market:-

(a) advise whether banks have provided the number of clients ascertained and treated as Professional Investors to HKMA;

(b) provide figures of (a) if available; and

(c) provide the number of Professional Investors involved in complaint cases arising from the incident of Lehman-Brothers bankruptcy.

A3(a) The HKMA collects statistics from the retail banks on the number of professional investors who are their customers as defined under Part I of Schedule 1 to the SFO. The figure reported by each retail bank is a lump sum figure covering the specified entities in paragraphs (a) to (i) of the definition of professional investors in Part I of Schedule 1 to the SFO (mainly institutional investors), as well as high net worth professional investors falling under the Securities and Futures (Professional Investor) Rules.

A3(b) As at 30 June 2011, the total number of professional investors reported by retail banks aggregated to 27,776, equivalent to about 1% of the total number of customer securities accounts maintained with these banks[1].

A3(c) Based on HKMA's information on hand, HKMA has received 21,830 Lehman-related complaint cases. Out of these complaint cases, HKMA has identified 101 cases the complainants of which are professional investors. The SFC has received 235 Lehman-related complaints against brokerages. Out of these complaint cases, SFC has identified 3 cases the complainants of which are professional investors.

Q4 With respect to the sale of investment products by banks and other intermediaries, provide information on the different legal and regulatory requirements imposed on banks/intermediaries or their sales staff in dealing with Professional Investors and non-Professional Investors.

A4 (1) An intermediary could only treat an individual investor as a Professional Investor for the purpose of waiving certain regulatory requirements (*details of which are discussed in paragraph A4(6) below*) under the Code of Conduct under the following circumstances:-

(a) the individual investor, either alone or with any of his associates on a joint account, have a portfolio of not less than HK$8 million or its equivalent in any foreign currency (*i.e. section 3 of the PI Rules*);

(b) in accordance with paragraph 15.3 of the Code of Conduct, the intermediary should assess and be reasonably satisfied that the person is knowledgeable and has sufficient expertise in relevant products and markets (*Please refer to paragraph A4(2) below for the details of the assessment*);

(c) an intermediary should provide a written explanation to the

[1] The number of investors and accounts may entail duplications among the retail banks.

relevant client explaining the risks and consequences of being treated as a Professional Investor, in particular, the information that will not be provided to him. This written explanation should also inform him 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 (*paragraph 15.4(a) of the Code of Conduct*);

(d) an intermediary should obtain a written and signed declaration from that client 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 (*paragraph 15.4(b) of the Code of Conduct);*

(e) the intermediary should have in place procedures to enable it to carry out a confirmation exercise annually to enable it to ensure that the clients who have elected to be treated as Professional Investors continue to fulfil the requisite requirements under the PI Rules (*paragraph 15.4(c) of the Code of Conduct).*

(f) In carrying out the annual confirmation, an intermediary should remind its clients in writing of the risks and consequences of being treated as a Professional Investor, in particular the intermediary is not required to comply with certain regulatory requirements (*please refer to paragraph A4(6) below*) and the right for them to withdraw from being treated as a Professional Investor whether in respect of all products or markets or any part thereof (*please refer to the circular issued by the SFC dated 18 March 2011*).

(2) As referred to in paragraph A4(1)(b) above, under paragraph 15.3 of the Code of Conduct, before waiving the specific regulatory requirements as set out in paragraph 15.5 of the Code (*please refer to paragraph A4(6) for details*), an intermediary should assess and be reasonably satisfied that the individual Professional Investor is knowledgeable and has sufficient expertise in relevant products and markets. In assessing the knowledge, expertise and investment experience of the Professional Investor, an intermediary should have regard to the following -

(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);

(d) the person's knowledge and expertise in the relevant products; and

(e) his awareness of the risks involved in trading in the relevant products and/or markets.

(3) The above assessment should be in writing. Records of all relevant information and documents obtained in the assessment should be kept by the intermediary so as to demonstrate the basis of the assessment.

(4) Under paragraph 15.3A, an intermediary should also undertake a separate assessment prior to treating an existing Professional Investor client as a Professional Investor in a different product type or market.

(5) Moreover, pursuant to paragraph 15.3B, a new assessment should be undertaken where a Professional Investor has ceased to trade in the relevant product or market for more than 2 years.

(6) Paragraph 15.5 sets out the regulatory requirements under the Code of Conduct that may be waived from compliance by intermediaries for Professional Investors which includes the following:-

(a) the intermediary does not need to establish a client's financial situation, investment experience and investment objectives (as required under paragraph 5.1 and paragraphs 2(d) and 2(e) of Schedule 6 to the Code of Conduct), except where the intermediary is providing advice on corporate finance work;

(b) the intermediary does not need to ensure the suitability of a recommendation or solicitation (as required under paragraph 5.2 and paragraph 49 of Schedule 6 to the Code of Conduct);

(c) the intermediary does not need to enter into a written agreement and the provision of relevant risk disclosure statements (as required under paragraph 6.1, paragraph 2 of Schedule 3, paragraph 2 of Schedule 4 and paragraph 1 of Schedule 6 to the Code of Conduct);

(d) for discretionary accounts, the intermediary does not need to (i) obtain from the client an authority in a written form prior to effecting transactions for the client without his specific authority (as required under paragraph 7.1 (a)(ii) of the Code of Conduct); and (ii) explain the authority described under paragraph 7.1(a)(ii) of the Code of Conduct, or confirm it on an annual basis (as required under paragraph 7.1(b) of the Code of Conduct);

(e) the intermediary does not need to inform the client about the intermediary and the identity and status of its employees and others acting on its behalf (as required under paragraph 8.1 of the Code of Conduct);

(f) the intermediary does not need to confirm promptly with the client the essential features of a transaction after effecting a transaction for a client (as required under paragraph 8.2, paragraph 4 of Schedule 3 and paragraph 18 of Schedule 6 to the Code of Conduct);

(g) the intermediary does not need to provide the client with documentation on the Nasdaq-Amex Pilot Program (as required under paragraph 1 of Schedule 3 to the Code of Conduct).

(7) It should also be emphasised that irrespective of whether a client is a professional investor, intermediaries providing services in relation to derivative products, including futures contracts or options, or any leveraged transaction, must still comply with the requirements of paragraph 5.3 of the Code of Conduct (i.e. assuring itself that the client understands the nature and risks of the products and that the client is of sufficient net worth to assume the risks and bear potential losses of trading in the products).

(8) In terms of the investment products that can be offered to potential investors, section 103(1) of the SFO prohibits any person from issuing (or possessing for the purposes of issue) any invitation, advertisement or document that contains an invitation to the public to acquire or dispose of certain investment products unless the issue is authorized by the SFC under section 105(1) or exempted under section 103. As the issuing of such invitations, advertisements or documents to professional investors is exempted from authorization under section 103(3)(k), invitations, advertisements or documents that have not been authorized by the SFC may be offered to professional investors. Non-professional investors should only be issued invitations, advertisements or documents that have been authorized by the SFC, unless an exemption under section 103 applies to that issue, or it does not come within the scope of section 103 because it does not contain an invitation to the public.

(9) We also would like to inform the Legco Subcommittee that paragraph 15.3 of the Code of Conduct on the knowledge, expertise and investment experience assessment criteria *(as set out in paragraph A4(2) above)* has been tightened after considering the views received during the public consultation on Proposals to Enhance Protection for the Investing Public in Q4 2009.

Securities and Futures Commission
Hong Kong Monetary Authority
November 2011

SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會
SFC
證監會

Circular

18 March 2011

Circular to Licensed Corporations and Registered Institutions

Annual Confirmation Exercise of Professional Investors

Given the various exemptions from regulatory requirements available to intermediaries when dealing with clients being treated as Professional Investors under the Code of Conduct[1], the Commission considers that it is of utmost importance that intermediaries should comply with the requirements in paragraph 15 of the Code of Conduct so that the interests of clients are safeguarded.

In this regard, the Commission would like to remind intermediaries that under paragraph 15.4(c) of the Code of Conduct, an intermediary should have in place procedures to enable it to carry out a confirmation exercise annually. In carrying out the annual confirmation envisaged under paragraph 15.4(c) of the Code of Conduct, an intermediary should remind its clients in writing of:-

1. the risks and consequences of being treated as a Professional Investor, in particular the intermediary is not required to comply with the regulatory requirements set out in paragraph 15.5 of the Code of Conduct; and

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

Should you have any queries regarding the contents of this circular, please contact Ms Seine Luk on 2842-7696.

Intermediaries Supervision Department
Securities and Futures Commission

End

SFO/IS/006/2011

[1] Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

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