

LEGAL UPDATE

## New Changes to Hong Kong Professional Investors Regime now in place

Significant changes to the Professional Investor regime in Hong Kong are now effective, from 25 March 2016. This reform to the professional investor regime is brought about 18 months after the Hong Kong Securities and Futures Commission (the "SFC") published its "*Consultation Conclusions on the Proposed Amendments to the Professional Investor Regime*" and "*Further Consultation on the Client Agreement Requirements*" on 25 September 2014 (the "New Professional Investor Regime"). The reform brings about new changes with respect to professional investors who are individuals, and also corporate professional Investors.

All individual investors will now need to be treated in the same way as retail investors, whereby intermediaries will be required to ensure the suitability of a recommendation or solicitation of investment products. When dealing with all individual investors, financial intermediaries must establish the client's financial situation, investment experience and investment objectives, assess the client's knowledge of derivatives and characterize the client based on his knowledge of derivatives, and to enter into a written client agreement.

Previously, financial intermediaries could be exempted from these obligations when dealing with individual professional investors, by asking such individual investors to waive the related investor protection provisions and confirm the willingness to be treated as professional investors. Correspondingly, for investment vehicles, family trusts and "corporate professional investors" that are not institutional investors, intermediaries may only "dis-apply" certain investor protection provisions if the investor passes a new set of assessment criteria on its investment knowledge and sophistication.

### *Significant Changes in Practice to the Professional Investor Regime*

The qualification requirements of "professional investors" are unchanged, and as before, will continue to be those as defined under the Hong Kong Securities and Futures Ordinance (Cap.571) ("SFO") and the Securities and Futures (Professional Investors) Rules (Cap.571D), falling in three categories that are broadly referred to as "Individual Professional Investors"<sup>1</sup>, "Corporate professional Investors"<sup>2</sup> and "Institutional Professional Investors"<sup>3</sup>.

<sup>1</sup> "Individual Professional Investors" refers to any individual who (either alone or with his/her spouse or child on a joint account) has a portfolio of not less than \$8 million (or its equivalent in any foreign currency).

<sup>2</sup> "Corporate Professional Investors" refers to:

- (a) any trust corporation having been entrusted with total assets of not less than \$40 million (or its equivalent in any foreign currency);
- (b) any corporation or partnership having (i) a portfolio of not less than \$8 million (or its equivalent in foreign currency); or (ii) total assets of not less than \$40 million (or its equivalent) in any foreign currency; and
- (c) any corporation the sole business of which is to hold investments and is wholly owned by any one or more of the Individual Professional Investors or such persons described in (a) or (b) above.

<sup>3</sup> "Institutional Professional Investors" are those falling under paragraphs (a) to (i) of the definition of "professional investor" in Part 1 of Schedule 1 of the SFO.

Under applicable provisions of the SFO and rules relating to private placements which allow certain offers of investments, provision of investment services or dealing in securities to be made to or with "professional investors" only, such offers or dealing may still be made with such relevant qualified categories of "professional investors".

However, as mentioned above, intermediaries will now be subject to additional requirements with respect to Individual Professional Investors and Corporate Professional Investors, including as regard suitability assessment in recommendation or solicitation of investment products as well as the need to enter into client agreements that were previously exempted. The result is that the Hong Kong "professional investor" regime will from now on operate very differently in practice when intermediaries offer financial products or enter into investment or securities arrangements with persons who are "professional investors", except for "institutional professional investors" where there is no change in the position.

The regulator's core views are that individuals merit greater investor protection, and having high net worth does not necessarily translate into having sufficient knowledge, experience and sophistication in investments. As such, individuals will henceforth need to be treated in the same manner whether or not they qualify as "individual professional investors" or are "retail investors".

For Corporate Professional Investors, since these may be vehicles through which unsophisticated individual investors make investments or enter into investment arrangements, stricter requirements will also now apply, unless the following criteria are assessed satisfactorily on the financial sophistication of the CPI ("the CPI Assessment"):

- whether the CPI has the appropriate corporate structure and investment process and controls;
- whether the person (s) responsible for making investment decisions has (have) sufficient investment experience; and
- whether the CPI is aware of the risks involved.

#### ***Code of Conduct Requirements to apply fully***

The following requirements under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (SFC) (the "SFC Code of Conduct") could previously be waived for "professional investors", but can now no longer be exempt for all individual investors:

- the need to establish a client's financial situation, investment experience and investment objectives;
- when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for the client is reasonable in all the circumstances;
- the need to assess a client's knowledge of derivatives and characterize the client based on his knowledge of derivatives;
- the need to disclose certain transaction-related information;
- the need to enter into a written agreement and the provision of relevant risk disclosure statements;
- for discretionary accounts, the need to obtain from the client an authority in written form

prior to effecting transactions for the client without his specific authority, the need to explain the authority and the need to confirm it on an annual basis.

These exemptions will now fall away for all individuals, whether retail investors or Individual Professional Investors.

For Corporate Professional Investors, the said exemptions will similarly be dis-applied, unless all three criteria mentioned above for the CPI Assessment are met, a full explanation of the consequences have been provided to the Corporate Professional Investor, and the Corporate Professional Investor has signed a consent agreeing to waive the investor protection afforded under the said requirements of the SFC Code of Conduct which shall be exempted for the Corporate Professional Investor.

The CPI Assessment should be made in writing, and the relevant licensed or registered intermediaries should retain proper records of the assessment and relevant information. A separate assessment is required for each different type of product or market, and a new assessment should be undertaken where the corporate professional investor has ceased to trade in the relevant product or market for more than 2 years.

#### ***Suitability of Recommendation or Solicitation***

Suitability is considered by the Hong Kong securities and futures market regulator as a cornerstone of investor protection, therefore it is now determined that financial intermediaries must ensure suitability of investment recommendation or solicitation when dealing with all individual investors. The suitability obligation can only be exempted for Institutional Professional Investors or those Corporate Professional Investors that pass the CPI Assessment.

According to paragraph 5.2 of the SFC Code of Conduct, having regard to information about the client of which a licensed or registered person is or should be aware through the exercise of due diligence, the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances.

Licensed or registered intermediaries must now also conduct full assessment and characterization of the derivatives knowledge of all individual investors and also corporate investors except those Corporate Professional Investors that pass the CPI Assessment or Institutional Professional Investors, when providing services to clients in derivative products, including futures contracts or options, or any leveraged transaction. Intermediaries are required to assure itself that the client understand the nature and risks of the derivative products in question and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products. Where a client is without knowledge of derivatives and wishes to purchase a derivative product, intermediaries are subject to a duty to explain the relevant risks involved or provide appropriate advice as to whether the transaction is suitable for the client in all the circumstances.

### ***Client Agreement Implications***

As intermediaries must now enter into a written client agreement with all clients who are individuals and also all corporate professional investors except those for which a CPI Assessment has been conducted and agrees to waive the relevant investor protection, the full effects of the new SFC requirements as regard client agreements will apply.

According to the "***Consultation Conclusions on the Client Agreement Requirements***" ("**Consultation Conclusions**") published by the SFC in December 2015, the requirements of which will become fully effective after an 18-month transitional period, financial intermediaries must going forward include a new contractual obligation in client agreements on the suitability of investment recommendations and solicitations. Further, there shall not any contractual term or provision in the client agreement or other document signed or statement made by client at the request of the intermediary which is inconsistent with the Code of Conduct obligations or which mis-describes the actual services provided to a client. (For details of the requirements, please refer to our publication: ***New SFC Requirement Contractual Obligation on Suitability***

(<http://www.vteu.co/2015/12/21/new-sfc-requirement-contractual-obligation-on-suitability/>)

Together, the overall effect is that banks and other financial intermediaries are exposed to greater risk of mis-selling claims if the relevant requirements on suitability and assessment of investing clients are not properly complied with or conducted. The sale and distribution process of financial products must now comply with full due diligence and suitability requirements when financial intermediaries deal with all individual investors or their investment vehicles or entities.

### **Contact Details**

If you would like to know more information or specific advice about the subjects covered in this publication, please feel free to contact the following people or your usual contact at our firm.

#### **Vivien Teu**

#### **Partner**

Tel: (852) 2969 5316

[vivien.teu@vteu.co](mailto:vivien.teu@vteu.co)

This publication is for general guidance only and is not intended to provide legal advice in any specific case. We expressly disclaim any liability for the consequences of action or non-action based on this publication. All rights reserved.

© Vivien Teu & Co – March 2016