

SFC proposes to amend Professional Investor Regime and Client Agreement Requirements

On 15 May 2013, the Securities and Futures Commission (**SFC**) published a Consultation Paper on the Proposed Amendments to the Professional Investor Regime and the Client Agreements Requirements (**Consultation Paper**).

Amongst other things, the SFC revisits the determining thresholds of individual and corporate professional investors (PI) and the level of protection appropriate for different classes of PIs. Second, prompted by its recent thematic findings¹ and the judgment in *Kwok Wai Hing Selina v HSBC Private Bank (Suisse) SA*², the SFC proposes to enhance the minimum content standards for client agreements under the Code of

Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct).

In particular, the SFC proposes to remove the ability to waive certain Code of Conduct requirements (including the suitability assessment) when dealing with individual PIs and their wholly owned investment vehicles and family trusts, and sets standards for waiving certain requirements for non-institutional corporate PIs.

It also proposes that the suitability requirement be incorporated in all client agreements as a contractual term, that client agreements should not contain provisions which are inconsistent with the Code of Conduct, and that client agreements should not be inconsistent with the actual services to be provided to the client.

The consultation period ends on 14 August 2013.

Proposals in Relation to the Professional Investor Regime

Currently, the regulatory structure for the sale of investment products rests upon two pillars, namely the requirements applicable to public offers (such as prospectus registration and disclosure requirements) and the regulation of conduct of intermediaries, including the obligation to assess suitability.

Offers made only to investors that meet the definition of PI in the Securities and Futures Ordinance (**SFO**) and the Securities and Futures (Professional Investor) Rules (**PI Rules**) benefit from a private placement safe harbor and are exempt from the prospectus and registration requirements. Moreover, under the Code of Conduct, intermediaries can dis-apply certain Code of Conduct requirements (e.g. the requirement to assess suitability

¹ See Report on the Thematic Inspection of Selling Practices of Licensed Corporations published by the SFC in October 2012

² The judgment of Reyes J. of the High Court in *Kwok Wai Hing Selina v HSBC Private Bank (Suisse) SA* HCCL 7 of 2010 was handed down on 21 June 2012. The High Court held that not much assistance could be derived by the client in seeking to rely upon the regulatory standards set out in the Code of Conduct. The Code of Conduct cannot override express contractual provisions. It cannot impose duties which, by the clear terms of client account documentation, a bank has not undertaken.

of an investment³) when dealing with certain PIs.

Private Placement

In the case of institutional PIs which are mainly financial institutions and are highly sophisticated in the market, the SFC believes that they should continue to have access to the private placement market. However, the SFC is mindful that corporate and individual PIs who qualify solely by meeting the prescribed monetary thresholds under the PI Rules may not necessarily have the level of financial sophistication to evaluate marketing materials which are not subject to the regulatory standards equivalent to a public offering. The SFC is seeking views from the public on whether corporate and individual PIs should continue to be allowed to participate in private placement offerings and whether the current monetary thresholds for non-institutional PIs (HK\$8million minimum portfolio for individuals and corporations and HK\$40 million minimum total assets threshold for corporations) should be increased, although the SFC currently does not propose to make such changes.

The regulation of structured products was transferred from the prospectus regime in the Companies Ordinance (CO) to the offers of investment regime in the SFO on 13 May 2011. This change also resulted in the removal of several of the safe harbours (e.g. offers made to not more than 50 persons (Limited

Persons Exemption) and offers where the minimum consideration payable by any person for the shares or debentures is not less than HK\$500,000 (Minimum Investment Exemption)) previously available to offers of certain investment products including structured products in the form of shares and debentures under the CO. With the removal of the statutory Limited Persons Exemption for these products, private placements of investment products that do not fall under the CO may rely on the common law limited person safe harbour (which does not have a clear numerical threshold as to what constitutes the "public" for this purpose). Increasingly, private placements offered under the SFO will therefore rely on the PI safe harbour which provides more certainty and in which case the PI Rules are of crucial importance.

Conduct regulation

The SFC stresses that it does not propose any changes to the exemptions applicable to institutional PIs. Currently intermediaries that deal with institutional PIs are automatically exempt from complying with the Code of Conduct requirements below:

- (a) the obligation to assess suitability;
- (b) the need to establish a client's financial situation, investment experience and investment objectives;
- (c) the need to characterize a client based on his knowledge of derivatives;
- (d) the need to disclose certain sales related information;
- (e) the need to enter into a written agreement and the provision of relevant risk disclosure statements;

- (f) 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;
- (g) the need to inform the client about the identity and status of its employees and others acting on its behalf;
- (h) the need to confirm promptly with the client the essential features of a transaction after effecting a transaction for a client; and
- (i) the need to provide the client with documentation on the Nasdaq-Amex Pilot Program.

The PI regime is different for non-institutional PIs (whether corporates or individual investors), in that intermediaries must always conduct an assessment to determine whether the investor is sufficiently knowledgeable and experienced in the relevant products and markets before exemptions can be applied under the Code of Conduct. These investors must also give their consent to the exemptions and be informed of their right to revoke this consent at any time. Corporate or individual PIs can refuse consent to be treated as a PI even if they have been assessed to have sufficient knowledge, experience and investment expertise; they can instead opt for full protection under the Code of Conduct.

Based on the impact of mis-selling cases in Hong Kong the SFC is of the view that individual PIs merit greater protection than corporate PIs. The SFC observes that individual PIs are already offered enhanced protection in certain jurisdictions (e.g. the United

³ Paragraph 5.2 of the Code of Conduct sets out the requirement on intermediaries, when making recommendation or solicitation, to ensure that the suitability of the recommendation or solicitation for the client is reasonable in all the circumstances.

Kingdom and United States) where intermediaries always need to apply suitability requirements when dealing with individual PIs no matter how wealthy the investor is.

The SFC is proposing to require intermediaries to comply with all the Code of Conduct requirements, including the suitability requirement, when dealing with individual PIs, their wholly owned investment vehicles and investment vehicles wholly owned by family trusts.

Conversely, some corporations have dedicated experienced investment personnel who make investment decisions as part of corporate treasury functions which operate in a manner similar to institutional PIs. The SFC considers that intermediaries should continue to enjoy the Code of Conduct exemptions including suitability requirements when dealing with such corporations after conducting a principles-based assessment of knowledge and investment experience and obtaining their consent.

In assessing the knowledge and experience of corporate PIs, the SFC proposes that intermediaries should take into account: (i) the corporate structure, investment process and controls; and (ii) the background of the person(s) responsible for making investment decisions on behalf of the corporation including the investment experience of such person(s). The SFC is proposing to revise the Code of Conduct to accommodate this enhanced knowledge and experience assessment for corporate PIs.

Further, following a principles-based approach the SFC is considering dispensing with the "bright line" test i.e. the current assessment that investors should have traded not less

than 40 transactions per annum and have been active in the relevant market for at least 2 years, because these may not be reliable indicators of the investors' financial sophistication when considered in isolation.

The suitability assessment is emphasized by the SFC to be the cornerstone to investor protection. The SFC is seeking views on the suitability requirements whose detailed description is contained in Appendix B of the Consultation Paper.

Proposals in Relation to Client Agreement Requirements

The proposed client agreement requirements are intended to address the following shortcomings in intermediaries' use of disclaimers and signing of declarations identified in the SFC's thematic inspection of selling practices of Licensed Corporations:

- i. although breaches of the suitability requirement can lead to disciplinary actions by the SFC, the SFC cannot require the intermediary to pay compensation to aggrieved clients. Such breaches also do not enable clients of an intermediary to claim compensation or bring any other claims; and
- ii. some intermediaries include exemption clauses in client agreements which restrict clients to seek compensation, or ask clients to sign declarations or acknowledgements, by "mis-describing" the actual services to be provided. This practice is considered by the SFC to be contrary to General Principle 1 of the Code of Conduct under which intermediaries are

required to act "honestly, fairly and in the best interests of client and the integrity of the market".

Incorporate suitability requirement into client agreements as a contractual term

The SFC is proposing that the suitability requirement in paragraph 5.2 of the Code of conduct (i.e. that an intermediary when making a recommendation or solicitation to a client, should ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances) should be incorporated into client agreements as a contractual term.

No inclusion of clauses which are inconsistent with the Code of Conduct or which mis-describe the actual services provided to clients

The SFC is proposing a new paragraph 6.5 in the Code of Conduct to prevent intermediaries from incorporating any clause, provision or term in the client agreement, or in any other document signed by the client at the request of the intermediary: (i) which is inconsistent with its obligations under the Code of Conduct; or (ii) which mis-describes the actual services to be provided to the client.

The list of questions raised by the SFC is provided in Appendix I.

Contacts

Mark Shipman

T: +852 2825 8992

E: mark.shipman@cliffordchance.com

Matthias Feldmann

T: +852 2825 8859

E: matthias.feldmann@cliffordchance.com

Francis Edwards

T: + 852 2826 3453

E: francis.edwards@cliffordchance.com

Paget Dare Bryan

T: +852 2826 2459

E: paget.darebryan@cliffordchance.com

Donna Wacker

T: +852 2826 3478

E: donna.wacker@cliffordchance.com

Edward Johnson

T: +852 2826 3427

E: edward.johnson@cliffordchance.com

APPENDIX I

The questions raised by the SFC for public comments:

- Should corporate and individual professional investors continue to be allowed to participate in private placement activities?
- Do you think that the minimum monetary thresholds for corporate and individual professional investors should be increased?
- Do you agree that intermediaries should observe the Code without exception when they deal with individuals?
- Do you agree that investment vehicles wholly owned by individuals and by family trusts should be treated on the same basis as individuals under the Code?
- Do you agree that a principles based knowledge and experience assessment should dispense with bright line tests concerning dealing experience?
- Do you have any views on the suitability requirement?
- Do you agree with the SFC's proposals that (i) the Suitability Requirement should be incorporated into client agreements as a contractual term; (ii) 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.

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

Clifford Chance, 28th Floor, Jardine House, One Connaught Place, Hong Kong

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