

# New Hong Kong Professional Investors Reform – Are You Ready?

March 18, 2016

After two years of preparation, the Hong Kong professional investors regime under the SFC Code of Conduct (“**Code**”) will be tightened up this month. We hope this briefing will help you get ready for the changes which will impact the market on 25 March 2016 (except for certain contractual requirements with an impact date of 9 June 2017 – see the section “Effective dates” below).

Readers who are engaged in the corporate finance or investment banking functions will find our key suggestions in the section “Practical solutions for investment bankers”.

## 1. No change to overall legal structure

There is no change to the definition of “professional investor” (“**PI**”) under s.103 of the Securities and Futures Ordinance (“**SFO**”) and the Companies Ordinance prospectus provisions. High net worth individuals and corporations meeting the relevant monetary thresholds continue to fall within the PI safe harbours. Securities may be sold to them as under current law.

## 2. Re-categorising “professional investors” for Code purposes

The “Category A” and “Category B” PIs (in private banking practice) will be reclassified into the following three types:

- **Institutional PIs** – falling under para. (a) to (i) of the definition of PI in s.1 of Part 1, Schedule 1 to the SFO, these include entities such as licensed (or overseas-regulated) securities intermediaries and financial institutions, insurance companies, Mandatory Provident Fund schemes, etc.
- **Individual PIs** – falling under s.3(b) of the Securities and Futures (Professional Investors) Rules (“**PI Rules**”), these are private individuals with an asset portfolio of HK\$8m or more
- **Corporate PIs** – comprising:
  - PIs falling under ss.3(a), (c) of the PI Rules – e.g. trust corporations, corporations or partnerships meeting specified monetary thresholds
  - PIs falling under s.3(d) of the PI Rules – corporate investment vehicles wholly owned by Individual PIs or Corporate PIs

## 3. Dispensations when dealing with PIs

Under the current regime, an intermediary may dispense with the following Code requirements when dealing with Individual PIs and Corporate PIs, provided certain procedures are complied with:

- (i) ensuring the suitability of recommendations or solicitations made to a client
- (ii) establishing the client’s financial situation, investment experience and investment objectives
- (iii) assessing a client’s knowledge of derivatives and characterizing the client accordingly
- (iv) disclosing certain transaction-related information
- (v) entering into a written agreement with the client and providing the client with relevant risk disclosure statements

- (vi) obtaining a written authority from the client in respect of discretionary accounts, and explaining and renewing the authority
- (vii) informing the client about the intermediary itself
- (viii) confirming with the client the essential features of a transaction after execution
- (ix) providing the client with documentation on the Nasdaq-Amex Pilot Program

## 4. Stepping up the safeguards

Bearing in mind that the SFC intends primarily to avoid investor suitability and related issues revealed by the mini-bond incident, their key objective is to reinstate and/or strengthen, for private individuals (and their investment vehicles) as well as corporate investors (except Institutional PIs), many of the marketing safeguards under the Code.

As such, with respect to Code requirements (i) to (vi) above (which the SFC considers as fundamental to investor protection):

- (a) dispensation will be unavailable under the new rules if the client is:
  - an Individual PI; or
  - a Corporate PI that does not satisfy the new, principles-based, Corporate Professional Investor Assessment Criteria as set out in the new para.15.3A (“**CPI Assessment Criteria**”).

We shall call these the “**Excluded PIs**”.

- (b) dispensation will be allowed if:
  - the client is a Corporate PI that satisfies the CPI Assessment Criteria (we shall call this an “**Eligible Corporate PI**”); and
  - the intermediary complies with the procedural requirements set out in the new para.15.3B

With respect to Code requirements (vii) to (ix) in section 3 above (which the SFC regards as more administrative in nature), these may be waived in respect of Individual PIs and Corporate PIs, even Excluded PIs, provided the procedural requirements in para.15.3B are complied with. In brief, these requirements include written declarations and consents obtained from the PI, full explanation of the risks and consequences of PI treatment and the right to withdraw from such treatment.

## 5. CPI Assessment Criteria

The CPI Assessment Criteria in the new para.15.3A have been devised by the SFC to test the knowledge and experience of a Corporate PI. This is a three-pronged test:

- whether the Corporate PI has the appropriate corporate structure and investment process and controls as to making its investment decisions;
- whether the persons responsible for making investment decisions have sufficient investment background; and
- whether the Corporate PI is aware of the risks involved.

The test must be conducted in writing and record-keeping requirements apply to the intermediary. Separate assessments must be made for different product types or markets.

## 6. Suitability of recommendations and solicitations as a contractual undertaking

There is a new prescribed “suitability of products” undertaking (the “**suitability clause**”) that must be inserted in client agreements: “*If we [the intermediary] solicit the sale of or recommend any financial product to you [the client], the financial product must be reasonably suitable for you having regard to your financial situation, investment experience and investment objectives. No other provision of this agreement or any other document we may ask you to sign and no statement we may ask you to make derogates from this clause.*”

## 7. No derogation

Intermediaries will not be allowed to include terms in client agreements that are inconsistent with the Code obligations, or that misdescribe the actual services to be provided to clients. Intermediaries will no longer be able to include non-reliance provisions and statements (including verbal ones) containing inconsistent terms or disclaimer clauses.

## 8. Effective dates

PI classification – 25 March 2016

Suitability clause, prohibition of inconsistent terms, and description of services – as soon as possible but not later than 9 June 2017

### Practical solutions for investment bankers

The Code does not differentiate between selling to a PI and arranging a sale by a PI, so the reforms will affect investment banking practice on both sides of a securities offering where an Individual PI or a Corporate PI is involved. The following are our key practical suggestions.

#### 1. HKIPO underwriting agreements and secondary placing agreements (new issue or block trade)

The usual form “big boy letters” or professional investors treatment notice will continue to work for an issuer / vendor that is an Institutional PI or Eligible Corporate PI, but not for Excluded PIs.

In our view, the usual forms of notice circulating in the market cannot easily be amended in such a way as to allow pre-existing practice to continue for Individual PIs and Corporate PIs. For your day-to-day investment banking practice, the key solutions we propose are as follows:

- For each corporate vendor / issuer of securities that is a Corporate PI, conduct the new CPI Assessment in para.15.3A of the Code.
- Where the vendor is an Eligible Corporate PI:
  - Continue to use the form of PI notice currently used in the market
  - Take the procedural steps specified under para.15.3B in respect of written consent, explanation of consequences, annual re-confirmation, etc.
- Where the vendor is an Excluded PI (i.e. an Individual PI or a Corporate PI that does not meet the CPI Assessment Criteria):
  - Remove the following sections of the PI notice:
    - all the waivers of the Code items except:
      - provision of information about your business, identity and status of employees, etc.
      - prompt confirmation of essential features of a transaction

- provision of documentation on the Nasdaq-Amex Programme
- the statement regarding having knowledge and expertise and being aware of relevant risks
- Retain the statement by the PI that it / he is a PI within the meaning of the Securities and Futures (Professional Investor) Rules.
- Retain the statement regarding having read and understood the consequences of PI treatment, and the right to withdraw from PI treatment
- Retain the statement regarding contract notes, statements of accounts or receipts under the Hong Kong Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules
- Comply with all Code provisions, especially in respect of:
  - Suitability-related requirement (including entering into a written client agreement and providing relevant risk disclosure statements, providing the required transaction related information, making only recommendations or solicitations that meet the suitability test, etc.)
  - Take the procedural steps specified under para.15.3B in respect of written consent, explanation of consequences, annual re-confirmation, etc.
- The same steps should be taken in respect of each potential placee that is not an Institutional PI.

## 2. *The new suitability clause*

Going forward and by no later than 9 June 2017, the suitability clause must be inserted in any client agreement entered into by SFC-licensed intermediaries.

In our view, the underwriting agreements, placing agreements and placing letters typically used in Hong Kong primary or secondary offerings (either debt or equity) do not constitute client agreements for the purposes of the Code. Engagement letters and mandate letters are very likely to be categorised as client agreements and appropriate steps must be taken to ensure they comply with the new Code requirements.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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