

Client Alert

March 3, 2016

New Requirements to Hong Kong Professional Investor Regime to Become Effective on 25 March 2016

Summary

The Hong Kong Securities and Futures Commission (the “**SFC**”) issued a consultation paper titled “Consultation Paper on the Proposed Amendments to the Professional Investor Regime and the Client Agreement Requirements” on 15 May 2013 (the “**First Consultation**”).

On 25 September 2014, the SFC released its conclusions to the First Consultation, detailing a number of significant amendments to the Code of Conduct for Persons Licensed By or Registered with the Securities and Futures Commission (the “**Code**”) with respect to the treatment of certain categories of professional investors, and issued a “Further Consultation on the Client Agreement Requirements” (“**Further Consultation**”). Amendments outlined in the conclusions to the First Consultation will become effective on **25 March 2016**.

On 8 December 2015, the SFC released its conclusions to the Further Consultation (“**Second Conclusions**”) (available in full [here](#)) and decided to proceed with the proposal to require the incorporation of certain provisions into all client agreements. Amendments to the Code set out in Appendix A of the Second Conclusions will become effective 18 months from the date of the Further Consultation, being **8 June 2017**.

Amendments to Professional Investor Regime

Certain key amendments to the Code provided under the First Consultation will come into effect on **25 March 2016**, providing the following:

- the introduction of a requirement that all category B professional investors¹ who are individuals be treated as non-professional investors for the purposes of the Code; and
- that category B professional investors that are corporations may continue to be treated as professional investors for the purposes of the Code where they satisfy a principles-based assessment of knowledge and investment experience and have given their consent to be treated as professional investors.

Currently category B professional investors that meet the requirements of a sophistication test and sign an opt-out statement confirming their status as a professional investor may be treated as professional investors for the purposes of the Code, which allows certain requirements of the Code to be dispensed with by intermediaries, for example, the obligations on the intermediaries to:

- conduct a suitability test

- establish a client's financial situation, investment experience and investment objectives
- assess a client's knowledge of derivatives and characterise the client based on his knowledge of derivatives
- disclose certain transaction-related information
- enter into a written agreement with the client and provide relevant risk disclosure statements
- for discretionary accounts, obtain from the client an authorization 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.

Individual Professional Investors

From 25 March 2016, a sophistication test may no longer be carried out in respect of high-net-worth individuals, regardless of their level of knowledge and experience in financial matters and investing, and such high-net-worth individuals may not confirm their willingness to be treated as professional investors. Intermediaries will be required to comply with all Code requirements without any of the exemptions listed under paragraph (a) to (f) above when dealing with category B professional investors who are individuals.

In respect of other existing Code exemptions, such as the requirements to:

- (i) inform the client about itself (e.g., information about its business, including contact details, services available to clients) and the identity and status of its employees and others acting on its behalf
- (ii) confirm promptly with the client the essential features of a transaction after effecting a transaction for a client; and
- (iii) provide the client with documentation on the Nasdaq-Amex Pilot Program,

the SFC takes the view that these exemptions should continue to be available to intermediaries when serving individual professional investors, provided that intermediaries explain the risks and consequences of these Code exemptions and obtain written client consent.

Corporate Professional Investors

A sophistication test will remain applicable for corporate professional investors, but the current, rather prescriptive, sophistication test, which, briefly, requires an assessment of the investor's experience in the type of product, frequency of trading by the relevant investor, dealing experience, knowledge and expertise in relevant products, and awareness of risks in trading in relevant products or markets, will be replaced by a principles-based test. The SFC acknowledged in the conclusions to the First Consultation that these bright-line tests were not rigidly applied in practice, and, as a result, a principles-based test would be more appropriate.

The new principles-based test, as applied to corporate category B professional investors, including investment vehicles that are wholly owned by individual professional investors and family trusts, will involve the corporate category B professional investor meeting the following criteria, which are as follows:

(i) appropriate corporate structure and investment process and controls, (ii) the person(s) responsible for making investment decisions having sufficient investment background and (iii) awareness of the risks involved. The corporate category B professional investor will also need to consent in writing to the relevant provisions of the Code (set out at (a) to (f) above) being waived in respect of it. This confirmation exercise must be carried out annually.

Client on-boarding processes will be required to be reviewed and updated by all intermediaries so as to ensure compliance with the changes to the Code by 25 March 2016.

Amendments to Client Agreement Requirements

Paragraph 5.2 of the Code provides that intermediaries, when making a recommendation or solicitation, must ensure that the suitability of the recommendation or solicitation for the client is reasonable in all circumstances. In the amendments provided by the SFC under the Second Conclusions, the below clause will be required to be incorporated into client agreements as a contractual term:

“If we [the intermediary] solicit the sale of or recommend any financial product² 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.”

(the “New Clause”)

The SFC considers that it is of paramount importance that the “non-derogation” component of the New Clause is retained to ensure that a client agreement does not contain any disclaimers or terms that would be inconsistent with the New Clause or override other provisions of the Code.

Client agreements will be required to be reviewed and updated to ensure that they are amended to include the New Clause provided by the SFC, since the SFC expects that intermediaries should have revised client agreements re-executed by existing clients or executed in respect of new clients well before the 18-month transitional period for all but a small minority of existing clients.

Investment funds with high net worth individuals as investors will need to have a client agreement with their high net worth investors.

While certain respondents to the Further Consultation queried whether the New Clause requirement will apply to fund managers who do not have any direct contractual relationship with the underlying fund investors, the SFC has confirmed in the Second Conclusions that all intermediaries, including such fund managers, should include the New Clause in their client agreements and that fund managers will be required to have a written client agreement containing the New Clause save, where they deal solely with “Institutional Professional Investors” or “Corporate Professional Investors” as defined in the Code (assuming that such Corporate Professional Investors meet the criteria outlined above).

Intermediaries should note that the existing paragraph 6.4 of the Code, which provides that “A client agreement should properly reflect the services to be provided. Where the services to be provided are limited in nature, the Client Agreement may be limited accordingly...” will remain applicable.

What Should Asset Managers in Hong Kong Do Now?

To the extent that fund managers have not already done so to date and to the extent that such managers offer their funds to high-net-worth individuals, such managers should ensure that they have appropriate procedures in place to comply with the revisions to the Code pursuant to the First Consultation with effect from **25 March 2016**, including to comply with the suitability requirements; the need to establish a client’s financial situation, investment experience and investment objectives; and the requirement for a written client agreement. Managers who have previously had such clients sign opt-out letters will no longer be permitted to do so with respect to high-net-worth individuals.

Fund managers who offer funds to corporate category B professional investors should ensure that they are in a position to carry out the principles-based test and the written confirmation exercise as outlined above.

Fund managers who are involved in soliciting the sale of, or recommending, investment funds to high-net-worth individuals must put in place written client agreements with such investors containing the New Clause. There will be a grandfathering period for repapering existing client arrangements, but the SFC has made it clear that it requires this process to be commenced as soon as possible.

Contact Information

If you have any questions regarding this alert, please contact the Akin Gump Strauss Hauer & Feld lawyer with whom you usually work or

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Hong Kong

¹ “Professional investors” as that term is defined in the Securities and Futures (Professional Investor) Rules (Cap. 571D).

² “Financial product” will be defined under the revised Code as any “securities, futures contracts or leveraged foreign exchange contracts as defined under the Securities and Futures Ordinance,” and the reference to “leveraged foreign exchange” will only be applicable to those traded by persons licensed for Type 3 regulated activity.