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SFC to Re-define Professional Investors Yet Again

A discussion on Consultation Paper on Proposals on Proposed Amendments to the Securities and Futures (Professional Investor) Rules (Cap 571D) issued by the SFC in March 2017 and its implications to the financial industry in Hong Kong.

The Hong Kong Securities and Futures Commission (“SFC”) launched a one-month consultation on proposed amendments to the Securities and Futures (Professional Investor) Rules (Cap 571D) (the “PI Rules”). The Consultation period has ended on 3 April 2017. CompliancePlus has submitted detailed response to the SFC that can be downloaded at <http://www.complianceplus.hk/wp-content/uploads/2013/06/PI-Rules-Consultation-Submission-Apr2017.pdf>.

The proposals include allowing joint accounts with non-associates and assets held in investment vehicles owned by individuals to be counted in ascertaining whether they meet the monetary threshold to qualify as professional investors.

According to the SFC, the proposed amendments are intended to enhance market transparency and promote consistency in the application of the Professional Investor Rules and the key consideration of the proposals is to cater for the business needs of intermediaries and their clients, without compromising investor protection.

If implemented, the present proposals will become the third occasion within past 3 years of the SFC amending the PI Regime, following the introduction of the New PI Regime which provided the new PI Classification and CPI Assessment (effective since 25 March 2016) and the New Suitability Clause in Client Agreements (effective since 9 June 2017).

The current definitions of PI

Under the Securities and Futures Ordinance (Cap 571) (the “SFO”), there are currently two types of professional investors. The first are specified entities set out in paragraphs (a) to (i) of the definition of “professional investor” in Part 1 of Schedule 1 to the SFO (e.g., banks and insurance companies). The second are persons belonging to one of the categories of high-net-worth professional investors prescribed under the Professional Investor Rules. The present consultation paper is concerned with the second type of professional investors.

There are four categories of high-net-worth professional investors, namely:

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- (a) a trust corporation entrusted with total assets of not less than HK\$40 million (or the equivalent in foreign currency);
- (b) an individual who (either alone or with his/her spouse or children in a joint account) has a portfolio of not less than HK\$8 million (or the equivalent in foreign currency);
- (c) a corporation or partnership with either a portfolio of not less than HK\$8 million (or the equivalent in foreign currency) or total assets of not less than HK\$40 million (or the equivalent in foreign currency); and
- (d) a corporation the sole business of which is to hold investments and which is wholly owned by any of the persons falling within paragraphs (a), (b) or (c) above.

The details of the SFC Proposal

The SFC Proposal can be divided into three main areas as follows:

I - Allowing aggregation of certain assets

It is proposed that an individual should be allowed to aggregate the portfolio or share of the portfolio of any corporation the principal business of which is to hold investments and which is wholly or partially owned by the individual at the relevant date when determining whether the individual meets the relevant portfolio threshold to qualify as a professional investor.

It is further proposed that an individual's share of a portfolio held in an account jointly owned by the individual with other persons (including individuals, corporations and partnerships) who are not associates of that individual at the relevant date should be included when determining whether the individual meets the relevant portfolio threshold to qualify as a professional investor.

The current rules only apply to joint accounts which are held together with an associate which is defined as the spouse or any child of the individual and only covers a very limited group of people. The proposition expanded the scope by covering non-associates such as siblings, parents, grandparents or business partners of an individual to facilitate the actual need of the society and the possibilities of non-associates doing business together.

It is also proposed that in determining the share of an individual's portfolio held in a joint account with a non-associate for the purpose of meeting the prescribed threshold, the individual's share is either based on the share specified in the written agreement between the account holders or an equal share of the portfolio in the absence of a written agreement.

We acknowledge the fact that some joint accounts are held in a social context where no written agreement has been prepared at the time of opening. Hence, we suggest that the individual can provide a written declaration made by the holders of the joint account to evident the agreed entitlement to the joint account as an alternative to written agreements.

II - Expanding the definition of corporations to qualify as professional investors

It is proposed that the categories of professional investors should be expanded to include any corporation the principal business of which at the relevant date is to hold investments, where the

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corporation is wholly owned by one or more persons where each of them qualify as a professional investor (under the Professional Investor Rules or Schedule 1 to the SFO).

It is also proposed to allow any corporation to qualify as a professional investor if it wholly owns another corporation that qualifies as a professional investor under the Professional Investor Rules by meeting the asset or portfolio threshold.

Under such proposition, if any individuals or corporations satisfied the relevant asset threshold, companies wholly or partially owned by the parties as well as their subsidiaries and shareholders will all be deemed PIs.

III - Allowing alternative forms of evidence

It is proposed that the evidential requirements stipulated in section 3(a) to (c) of the Professional Investor Rules should be refined to allow certain alternative forms of evidence in ascertaining whether a person meets the relevant assets or portfolio threshold to qualify as a professional investor.

The two alternative forms of evidence are public filings made pursuant to legal or regulatory requirements in Hong Kong or in a place outside Hong Kong and certificates issued by custodians. It is also proposed to allow the use of certificates issued by auditors or certified public accountants for ascertaining the professional investor qualification for corporations, trust corporations and partnerships in addition to individuals.

For public filings that can be accepted as a form of asset proof, it should be noted that the SFC has not prescribed the types or categories of documents that could be regarded as public filings but it shall be expected that possible examples may cover records from the Companies Registry, the Land Registry and the HKEx News. In this respect, the SFC would be expected to provide a non-exhaustive list of examples for Intermediaries to consider as a general guidance, while using terms such as “including but not limited to” to demonstrate that the examples shall not be prescriptive in nature but only as reference for Intermediaries.

The impact of the Proposals

Should the above proposals come into implantation, it is envisaged that more persons will be qualified as professional investors and become eligible to gain access to a wider scope of investment products to both SFC-authorized and unauthorized investment products such as private funds.

Despite the proposals, it should be noted that the SFC has not altered the definition of institutional investors as well as the monetary thresholds and the scope of portfolio that currently apply. In any case, Intermediaries should be reminded of the fact that they remain subject to the suitability requirement and other fundamental requirements when serving them.

With the final outcome and effective date of changes to the PI Rules remain to be pending, Intermediaries should be aware that further changes to policies and documentation for professional investors will be required. It is expected that Intermediaries will need to amend documents including but not limited to compliance manual, PI declaration forms, subscriptions forms and client agreements.

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In fact, in recent years, Intermediaries have already been continuously amending their internal policy in order to cater for the changes on the PI Rules as introduced by the SFC. For the present proposals to be implemented, Intermediaries will be required to further amend the mentioned documents for the third time within 3 years. This will definitely add compliance costs and administrative burdens to Intermediaries such as Independent Financial Advisors, brokerage houses, private banks and fund managers.

Accordingly, we suggest the SFC to offer an 18-month to 24-month transitional period to the industry to get ready for compliance. We are also of the view that the SFC should consult industry organizations and lawyers, compliance consultants to assess the readiness of the industry once the Proposals are adopted and what assistance the SFC can offer to the industry to facilitate implementation.

What to do next?

This SFC Proposal is highly relevant to all SFC licensed corporations and the financial industry of Hong Kong that we recommend the following actions:

- Voice out any feedback or concerns you may have to relevant industry organization even the Consultation is closed now
- Keep track of the development of the Consultation and any SFC Consultation Conclusions are issued
- Keep in contact with your legal advisor to assess the timing for updating or amending offering documents
- Seek advice from your compliance consultant to review the existing compliance framework and/or compliance manual to ensure ongoing compliance

If you have any further questions regarding this issue of CP insights or have any topic you would like us to cover, please submit your response here <https://goo.gl/forms/gDLVThTmxGvMI4r12>.

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We have been providing real time compliance support and proactive recommendations to start-up hedge funds, fund of hedge funds and multi-strategies hedge funds with our solid compliance knowledge.

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