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[online version](http://www.charltonslaw.com/sfc-publishes-consultation-conclusions-on-the-evidential-requirements-under-the-securities-and-futures-professional-investor-rules/)

# SFC Publishes Consultation Conclusions On The Evidential Requirements Under The Securities And Futures (Professional Investor) Rules

## Introduction

The Securities and Futures Commission ("**SFC**") published on 23 February 2011 Consultation Conclusions regarding proposals to refine the requirements for evidencing whether a person qualifies as a high-net-worth professional investor under the Securities and Futures (Professional Investor) Rules (Professional Investor Rules) (Note 1) ("**Professional Investor Rules**"). These proposals were first presented to the market in October 2010, when the SFC released a Consultation Paper on the matter.

The proposals aim to establish a more flexible, principles based approach to assessing whether a person qualifies as a high net worth professional investor under the Professional Investor Rules. This approach involves allowing firms to utilise methods which are appropriate to the situation at hand when ascertaining whether an investor satisfies the relevant assets or portfolio threshold at the relevant date to qualify as a professional investor. Further flexibility is added to the new framework by the fact that firms which prefer the current practices may continue to use the existing methods set out in sections 3(a) to 3(c) of the Professional Investor Rules.

The SFC received a total of 16 written submissions, with the majority coming from market participants and professional bodies. The reaction to the principles based approach was largely a positive one and the SFC intends to implement the proposals outlined in the Consultation Conclusions. The changes to the current regime will be examined in detail in this Newsletter but can be summarised as follows:

* Permitting firms to adopt a principles based approach, which fits with the circumstances in question, when assessing whether an investor meets the relevant assets or portfolio threshold at the relevant date to qualify as a professional investor;
* Retaining the option for corporations of using the current assessment methods in sections 3(a) to 3(c) of the Professional Investor Rules;
* Employing "relevant date" as the time reference for determining whether an investor meets the relevant assets or portfolio threshold to qualify as a high net worth professional investor;
* Broadening the application of section 3(d) of the existing Professional Investor Rules to all three types of high net worth professional investors under sections 3(a) to 3(c), specifically trust corporations, individuals and corporations/partnerships.

Full details of the new regime are available through the Consultation Paper at [*here*](https://www.sfc.hk/sfcConsultation/EN/sfcConsultFileServlet?name=pirules&type=1&docno=1) and the Conclusions at [*here*](http://www.sfc.hk/sfc/doc/EN/speeches/public/consult/PIConPaper23Feb11Final.pdf).

## Background To The Reform

### The Current System

The Securities and Futures Ordinance ("**SFO**") details two varieties of professional investor. First are the entities described 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) and second are the persons who come within the class set out in the Professional Investor Rules. This second group are known as high net worth professional investors and it is they that the Consultation Conclusions are concerned with.

Under the regulatory framework currently in force there are four categories of high net worth professional investors:

* a trust corporation with total assets of not less than HK$40 million (or the equivalent in foreign currency);
* an individual who (either alone or with his/her spouse or children on a joint account) has a portfolio of not less than HK$8 million (or the equivalent in foreign currency);
* 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
* a corporation the sole business of which is to hold investments and which is wholly owned by an individual who (either alone or with his/her spouse or children on a joint account) has a portfolio of not less than HK$8 million (or the equivalent in foreign currency) (i.e., an individual who falls within paragraph (b) above).

As regards the first three types of high net worth professional investors, the Professional Investor Rules prescribe certain evidential requirements, which must be used when assessing whether the relevant assets or portfolio thresholds have been reached. These evidential requirements are:

* For a trust corporation – (i) the most recent audited financial statement prepared in respect of the trust corporation and within 16 months before the relevant date; (ii) one or more audited financial statements, each being the most recent audited financial statement, prepared in respect of the trust or any of the trusts and within 16 months before the relevant date; or (iii) one or more custodian statements issued to the trust corporation in respect of the trust or any of the trusts and within 12 months before the relevant date.
* For an individual – (i) a certificate issued by an auditor or a certified public accountant within 12 months before the relevant date; or (ii) one or more custodian statements issued to the individual (either alone or with his/her spouse or children) within 12 months before the relevant date.
* For a corporation or partnership – (i) the most recent audited financial statement prepared in respect of the corporation or partnership and within 16 months before the relevant date; or (ii) one or more custodian statements issued to the corporation or partnership within 12 months before the relevant date.

#### Problems with the Current Regime:

Market participants have complained that the evidential requirements listed above are overly restrictive, with the effect that it is a complicated process to assess whether a client should be regarded as a professional investor. This has prevented market practitioners from availing of the carve outs from the SFO granted to professional investors. Having considered these views from the market, the SFC commenced the consultation process which has resulted in the new regime under discussion.

## The New Regime

### The Principles Based Approach

As discussed above, the SFC's new regime is founded upon a principles based approach to the consideration of whether an investor meets the relevant assets or portfolio threshold, at the relevant date, to qualify as a professional investor. This flexible approach is designed to permit companies to employ whatever method seems most appropriate to them, in the circumstances at hand, when making this consideration. The SFC state clearly in the Consultation Paper that it will not prescribe what these methods should be, although it does note that firms should maintain proper records of their assessment process. This will enable any firm to show that they have made a reasonable decision in declaring, after the appropriate exercise of professional judgement, that their clients satisfy the relevant thresholds.

These proposals met with widespread approval from respondents, but some issues were raised during the consultation process which merit examination:

#### Assessment Methods

A number of market participants requested advice from the SFC on the standards and processes which should be employed when evaluating the assets and portfolio levels of potential professional investors. More detailed instruction was also appealed for, as market participants wished to know whether specified types of documents or data (such as a company search on corporate client) are acceptable evidence when investigating an investor's potential status as a professional investor. Some respondents called on the SFC to release a non-exhaustive list of such acceptable documentation.

However the SFC stated that although guidance on the standards to be utilized when assessing potential professional investors may increase market certainty, the concept of issuing lists of acceptable documentation for making such assessments ran contrary to the principle based approach on which the new rules are founded. The SFC reiterated its intention to leave maximum flexibility to market participants in their determination of an investor’s status, so long as the means availed of are appropriate in the circumstances and records are maintained.

#### Self-certification

A number of respondents expressed a desire for guidance on the matter of when it would be acceptable to permit a client to self certify as a professional investor. However the SFC refused to issue such specific guidance, noting that firms should have sufficient knowledge of their clients' affairs, under the "know your client" requirements in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, to make such a determination for themselves. The SFC also explicitly stated that it was not ruling out self-certification as an acceptable method of evaluating the assets and portfolio levels of potential professional investors, but that it must be used in appropriate situations.

#### Incorporation of Modifications

Over the last few years the SFC has made several Modifications, under section 134 of the SFO, to the requirements under the Professional Investor Rules. Some respondents requested that the SFC insert those Modifications which are applicable to a wide spectrum of market participants into the Professional Investor Rules. However the SFC declined to act on these propositions, calling attention to the fact that these Modifications were permitted on the basis of particular sets of facts being presented by applicants to the SFO and stating that it had no inclination to alter the manner in which such modifications are granted. Additionally, the SFC declared that the need for Modifications to alleviate the rigidity of the old regime in this area had been addressed by the flexible nature of the new principles based system of assessing an investor’s status.

## Preservation Of Existing Methods

In the Consultation Paper the SFC recommended retaining the current methods of appraising whether or not a client qualifies as a professional investor, a recommendation which received the approval of the majority of respondents. The SFC confirm that market participants may choose to continue to use the existing practices or to avail of the new more flexible system presented in the Consultation Conclusions.

## Use Of "Relevant Date" As The Time Reference For Ascertaining Whether An Investor Meets The Relevant Assets Or Portfolio Threshold To Qualify As A Professional Investor

The majority of respondents approved of the SFC's proposal to use "relevant date"[[1]](#footnote-36) as the time reference for evaluating whether a high net worth professional investor satisfies the relevant assets or portfolio threshold. However a number contended that it is extremely difficult, from a practical standpoint, to procure evidence permitting the appraisal of an investor's assets or portfolio value on a specific date. Requests were made to the SFC to ease the strictness of this rule, in recognition of these difficulties. However these were rebuffed by the SFC, who reiterate in the Consultation Conclusions that although an investor must adhere to the relevant assets or portfolio threshold at the relevant date to qualify as a professional investor, the new principles-based approach imposes no process or evidence that market participants are obliged to follow or acquire on any particular date.

Furthermore, the SFC note that any market participant experiencing complications when attempting to determine an investor’s status on the relevant date may employ the current methods outlined in sections 3(a) to 3(c) of the Professional Investor Rules, which permit the assembling of specific documentary evidence prior to the relevant date, when making said determination.

## Extension Of The Scope Of Section 3 (D) Of The Existing Professional Investor Rules

Most respondents agreed with the SFC's proposal to broaden the application of section 3(d) of the existing Professional Investor Rules, with the effect that any corporation which is wholly owned by one or more individuals or corporations/partnerships, where each of those individuals or corporations/partnerships would qualify as a professional investor under section 3(b) or section 3(c) (as the case may be) of the Professional Investor Rules, will qualify as a professional investor. However some market participants felt that the scope of section 3 (d) should be extended further and include more forms of corporations as professional investors.

The SFC considered the responses of the market and in the Consultation Conclusions agreed to further extend the operation of section 3 (d) of the Professional Investor Rules, so that any corporation which is wholly owned by one or more trust corporations, individuals or corporations/partnerships where each of those trust corporations, individuals or corporations/partnerships would qualify as a professional investor under section 3(a), section 3(b) or section 3(c) (as the case may be) of the Professional Investor Rules, will qualify as a professional investor.

However the SFC refused to extend the application of section 3(d) any further, as to do so would be unnecessary and exceed the ambit of the current consultation. The SFC also repeats the argument here that "*the flexibility provided by the proposed principles-based approach has effectively addressed market participants' concerns with the practical difficulties in ascertaining their clients as professional investors under the current Professional Investor Rules.*"

## Miscellaneous Matters

### Suggestions from market participants outside the scope of the current consultation

A number of recommendations were received by the SFC from respondents with regard to aspects other than the evidential requirements of the professional investor regime. As these were not relevant to the current consultation, the SFC did not consider them.

### Status of existing Modifications / Future applications for Modification

One market participant queried whether Modifications granted prior to the amendment of the Professional Investor Rules will remain in force after the amendment and whether an application for a Modification or waiver of the requirements of the Professional Investor Rules, under section 134 of the SFO, will be permissible subsequent to the amendment of the Professional Investor Rules.

In response to the first query, the SFC stated that the amendments would not affect any existing Modifications. The SFC then noted that if a Modification application concerns sources or types of information and the remedy sought is in fact consistent with the revised Professional Investor Rules, there is no need to make such an application and to do so would be inappropriate. However, the SFC will continue to consider granting modifications in relation to other requirements of the Professional Investor Rules under section 134 of the SFO.

## Implementation

The SFC will now take steps to implement the proposals discussed in this newsletter, via the making of the necessary amendments to the Professional Investor Rules. The revised rules will be gazetted in due course following review by the Department of Justice.

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1. "Relevant date" is defined in section 2 of the Professional Investor Rules as:

   1. in the case of an advertisement, invitation or document described in section 103(3)(k) of the SFO, means the date on which the advertisement, invitation or document is issued, or possessed for the purposes of issue;
   2. in the case of a call described in section 174(2)(a) of the SFO, means the date on which the call is made;
   3. in the case of an offer described in section 175(5)(d) of the SFO, means the date on which the offer is made; or
   4. in any other case which, by virtue of any rules made under the SFO, requires compliance with an obligation, means the date by or on which the obligation is required to be complied with.

   [↑](#footnote-ref-36)