

# Professional Investors: A New Regime for Licensed and Registered Persons and Recent Caselaw

*This past year has seen 2 major developments in the law relating to professional investors. First, the Court of First Instance has determined that the professional investor exemption, frequently used in private placements, applies only where the offering materials on their face state that the securities to be sold are or are intended to be sold only to professional investors. Whilst the determination is now under appeal, as the law has now been stated, it is irrelevant for the purposes of this exemption that procedures are in place to ensure that securities are only sold to professional investors. Secondly, the Securities and Futures Commission is introducing a new regime governing how licensed and registered persons deal with professional investors. This new regime minimizes the ability of licensed and registered persons to waive conduct of business requirements under the Code of Conduct for Persons Licensed by or Registered with the SFC.*

Following a consultation (“**Consultation**”) in May, 2013, in September, 2014, the Securities and Futures Commission (“**SFC**”) introduced a new regime governing how licensed and registered persons must deal with professional investors with effect from March, 2016. The new regime limits the availability of current exemptions from requirements under the Code of Conduct for Persons Licensed by or Registered with the SFC (“**Code of Conduct**”). As a result, licensed or registered persons who deal with professional investors who are not true institutional investors will be subject to greater compliance burdens. Licensed or registered persons who rely on the fact that they deal with professional investors to comply with current laws and regulations should review their existing procedures to ensure that they will be able to comply with the new regime.

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## Professional Investor Definition

Under the Securities and Futures Ordinance (“SFO”), “professional investors” includes both institutional investors and non-institutional investors. Institutional investors include:

- *Regulated Securities Firms* – any person carrying on the business of the provision of investment services regulated under the law of Hong Kong or any place outside Hong Kong;
- *Regulated Banks* – any bank regulated under the law of Hong Kong or any place outside Hong Kong;
- *Regulated Insurers* – any insurer regulated under the law of Hong Kong or any place outside Hong Kong;
- *Investment Funds* – any collective investment scheme authorized by the SFC or similarly constituted under the law of any place outside Hong Kong and, if regulated under the law of such place, permitted to be operated under the law of such place, or any person by whom any such scheme is operated; and
- *Sovereign Bodies* – any government (other than a municipal authority) or any institution which performs the functions of a central bank, or any multilateral agency.

Non-institutional investors include persons who, as a result of their financial position, qualify as professional investors:

- *High Net Worth Individuals* – any individual (either alone or with any of his associates on a joint account) who has a portfolio of not less than HKD 8 million (or its equivalent in any foreign currency);

- *Corporate Professional Investors* – any corporation or partnership who has either a portfolio of not less than HKD 8 million (or its equivalent in any foreign currency) or total assets of not less than HKD 40 million (or its equivalent in any foreign currency); and
- *Trusts* – any trust corporation entrusted under the trust or trusts of which it acts as a trustee with total assets of not less than HKD 40 million (or its equivalent in any foreign currency).

Although the SFC had sought views in the Consultation on whether the monetary thresholds should be raised for non-institutional investors to qualify as professional investors, under the new regime, these monetary thresholds remain unchanged. In other words, the statutory definition of a professional investor remains the same under the new regime as it is now.

## Overview of Framework

In broad terms, the SFO and its subsidiary legislation, together with rules made by the SFC, relax compliance burdens on persons dealing with professional investors on the basis that professional investors do not require the same degree of protection as other investors. These burdens fall into 2 types, namely statutory requirements and non-statutory requirements.

### Statutory Requirements

Statutory requirements include, most significantly, a requirement to obtain SFC authorization for investment offers. Issuers of securities as well as licensed or registered persons selling securities may be exempt from this requirement where the sales are directed at professional investors. Frequently, sales so exempted are referred to

## *Licensed or registered persons dealing with institutional professional investors will continue to be automatically exempt from both the Core Requirements and the Non-Core Requirements.*

as private placements. Private placements are typically used by hedge funds, private equity funds and companies raising equity or debt capital in the public markets.

No changes were proposed in the Consultation to exempt professional investors from statutory requirements other than with respect to private placements. In this regard, although the SFC originally proposed restricting private placements to institutional investors, thereby excluding corporate and individual professional investors from private placements, in the end, the new regime leaves the current position unchanged. As a result, as is presently the case, individual, corporate and institutional professional investors may participate in the private placement market and overall, the statutory regime governing professional investors remains unchanged.

### **Non-Statutory Requirements**

Non-statutory requirements comprise certain requirements under the Code of Conduct. These requirements apply only to persons licensed or registered with the SFC and do not, for example, normally apply to issuers of securities. The most significant of these requirements (“**Core Requirements**”) are:

- *Suitability* – the requirement to establish a client’s financial situation, investment experience and investment objectives, to ensure that recommendations or solicitations are suitable for clients, and to assess a client’s knowledge of derivatives and to classify clients based on that assessment;
- *Client Agreement* – the requirement to enter a written client agreement and to provide relevant risk disclosures;

- *Point of Sale Disclosure* – the requirement to disclose the capacity in which the licensed or registered person acts, any affiliation of such person with the issuer of a product, any monetary and non-monetary benefits received by such person and the terms and conditions under which the client may receive a discount of fees; and

- *Discretionary Accounts* – the requirement to obtain a written authority prior to effecting transactions on a discretionary basis, to explain this authority and to confirm this authority annually.

Other requirements (“**Non-Core Requirements**”) include the requirement to inform a client about a licensed or registered persons identity and status, the need to confirm promptly with the client the essential features of a transaction and the need to provide the client with documentation in respect of NASDAQ-AMEX pilot programme trading.

The new regime focuses on these non-statutory requirements, setting different standards for licensed or registered persons in dealings with institutional, corporate and individual professional investors.

### **Institutional Professional Investors**

Licensed or registered persons dealing with institutional professional investors will continue to be automatically exempt from both the Core Requirements and the Non-Core Requirements.

### **Corporate Professional Investors**

Licensed or registered persons dealing with corporate professional investors (including trusts which qualify as

*Licensed or registered persons dealing with individual professional investors may waive Non-Core Requirements if and only if they comply with Non-Core Waiver Eligibility Conditions but may no longer waive Core Requirements.*

non-institutional professional investors and companies owned by individual professional investors which themselves qualify as professional investors) may waive Non-Core Requirements if and only if they comply with the following conditions (“**Non-Core Waiver Eligibility Conditions**”), namely:

- they must obtain a written and signed client consent to the waiver,
- they must fully explain to the client the consequences of the waiver and the right of the client to insist on the Non-Core Requirements,
- they must inform the client that he is being treated as a professional investor in a particular product or market and that the client may withdraw from being treated as a professional investor whether in respect of all products or markets or any part thereof, and
- they must carry out an annual confirmation exercise to ensure that the client continues to satisfy statutory requirements for eligibility as a professional investor and to remind the client of the consequences of the waiver, the existence of the waiver and the right of the client to withdraw from being treated as a professional investor whether in respect of all products or markets or any part thereof.

Licensed or registered persons dealing with Corporate Professional Investors may waive Core Requirements if and only if they comply with the Non-Core Waiver Eligibility Conditions above as well as the following conditions (“**Core Waiver Eligibility Conditions**”):

- the client has an appropriate corporate structure and investment process and controls (*e.g.* whether the client has a specialized function responsible for investment decision making);

- the person(s) responsible for making investment decisions on behalf of the client have sufficient investment background (*e.g.* investment experience); and
- the client is aware of the risks involved which is considered in terms of the person(s) responsible for making investment decisions.

For this purpose, the licensed or registered person should conduct a written assessment for different product types or markets and should keep a record of such assessments. If the client ceases to trade a product or market for more than 2 years, the licensed or registered person should conduct a new assessment.

## Private Placements to Professional Investors

Under the SFO, s. 103, unless authorized by the SFC or exempted, it is an offence for a person to issue an advertisement, invitation or document which to his knowledge is or contains an invitation to the public to enter into or offer to enter into an agreement to acquire or subscribe for securities or to acquire an interest in a collective investment scheme. One exemption (“**PI Exemption**”), under s. 103(3)(k), is for advertisements, invitations or documents made in respect of securities or interests in any collective investment scheme that are or are intended to be disposed of only to professional investors. Another exemption (“**CO Exemption**”), under s. 103(2)(ga), is for advertisements, invitations or documents that relate to an offer which is exempt under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (“**CMPO**”). Under the CMPO, an offer to professional investors may be exempt provided certain conditions are satisfied.

*[I]ssuers of securities and collective investment schemes should ensure that each and every advertisement, invitation or document states, on its face, that the securities or interests in such schemes are or are intended to be disposed of only to professional investors, failing which the PI Exemption may not be available.*

In *Securities and Futures Commission v. Pacific Sun Advisors Ltd.* [2014] HKCFI 133, [2014] 1 HKLRD 1168, the court held that the PI Exemption merely requires that an advertisement, invitation or document state on its face that the securities or interests in collective investment scheme are or are intended to be disposed of to professional investors. No argument was made under the CO Exemption. As a result, it was not open for the defendant, a fund manager, to argue that it was exempted from the requirement for SFC authorization under s. 103(3)(k) on the basis that it had carried out a process to ensure that all investors investing in its fund were in fact professional investors. The court stated:

*“The SFC has a duty, to be exercised so as effectively to protect the investing public, in relation to such advertisement, invitation or document. Except possibly in wholly exceptional circumstances, and it is plain that no such circumstances exist in the present case, the SFC, in order to be able to exercise this duty effectively, has to be able to see from the advertisement, invitation or document itself whether it is, by its terms, confined to professional investors to the exclusion of other members of the investing public. Section 103(3)(k) is concerned*

*with the advertisement, invitation or document itself and not with what may or may not be the arrangement or intended arrangement behind it.”*

The Court of Final Appeal has granted leave to appeal this decision and the appeal is to be heard in March, 2015. Nevertheless, at least for the time being, issuers of securities and collective investment schemes should ensure that each and every advertisement, invitation or document states, on its face, that the securities or interests in such schemes are or are intended to be disposed of only to professional investors, failing which the PI Exemption may not be available. This will be particularly important where the CO Exemption does not apply (e.g. in the case of limited partnership vehicles commonly used for private equity).