

# **Consultation Paper on Code of Conduct for Regulated Persons Serving the Professional or Sophisticated Market**

## **Introduction**

1. The suggestion that dealers and advisers serving “professional investors” should operate under a lighter regulatory framework was proposed in the Commission’s Consultation Paper on Review of Licensing Regime issued in June 1999. Section 7.4.5 of that Consultation Paper advocated that sophisticated clients should be well able to protect their own interests, and that requiring dealers and advisers to observe the full investor protection regime might impose an unnecessary burden and cost. It was proposed that the Commission should clarify its expectations of intermediaries acting on behalf of professional or sophisticated clients and that the “Code of Conduct for Persons Registered with the Securities and Futures Commission” should be amended accordingly. The proposal has received widespread market support.
2. This Paper proposes specific areas of the Code of Conduct which, with client consent, may be waived for regulated persons dealing with professional investors. The Paper sets out a proposed definition of the term “professional investors” for these purposes. It also sets out the procedures registered persons will have to follow in order for these specific areas to be waived.
3. In modifying the requirements under the Code of Conduct as it applies to professional or sophisticated investors, the Commission wishes to facilitate the provision of services without unnecessary regulatory burden. There are certain areas in which we consider it appropriate to assume that professional investors can, if they so choose, look after their own interests without the need for mandated protection through regulation.
4. The Paper considers the concept of “professional investor” in the context of the requirements of the Code of Conduct. The Commission also invites comment on the general applicability of the concept to Rules that the Commission may make. There does not appear to be any impediment to extending the concept to SFC Rules.

## **Code of Conduct**

5. The Code of Conduct sets out the guiding principles for conduct of business by regulated intermediaries. It indicates the manner in which, in the absence of any particular consideration or circumstances, the Commission proposes to perform its functions of ensuring that all regulated persons are fit and proper in relation to the manner in which they conduct the business for which they are licensed.

6. The Code of Conduct sets out seven general principles that have been developed and recognized by the International Organization of Securities Commissions and which are fundamental to the undertaking of a regulated person's business. The general principles relate to:
  - Honesty and Fairness
  - Diligence
  - Capabilities
  - Information About Clients
  - Information For Clients
  - Conflicts of Interest
  - Compliance
7. The Code of Conduct provides guidance on the manner in which intermediaries should perform their functions having regard to the need for investor protection, the maintenance of systemic market stability and market integrity.
8. The appropriateness of relaxing business conduct requirements as they pertain to professional or sophisticated clients is internationally accepted. In the United Kingdom, the Financial Services Authority has proposed to:
  - i) "establish a framework for conduct of business regulation that is defined primarily by the expertise of the counterparty";
  - ii) prepare a new Code for dealings between professionals in a wide range of products"; and
  - iii) "adopt a supervisory approach that will continue to be 'light touch' for dealings between professionals".

In a similar measure, in March 2000, the Forum of European Securities Commissions issued a standard on "Categorisation of Investors for the Purpose of Conduct of Business Rules". This addressed the implementation of Article 11 of the Investment Services Directive requiring that regard should be had to the professional nature of the person for whom a service is provided.

### **Specific Areas of the Code of Conduct that may be Relaxed**

9. The Commission proposes that the following specific areas of the Code of Conduct may be relaxed when dealing with or advising professional investors:

#### Information About Clients

10. C5.1 of the Code of Conduct provides that a regulated person shall take all reasonable steps to establish the true and full identity of each of his clients, and of each client's financial situation, investment experience, and investment objectives. In respect of professional clients, the need to establish their financial situation, investment experience and investment objectives may not serve any substantial purpose. This requirement may therefore be removed.
  - 10.1 For greater clarity, it is not proposed that the requirement to establish the true and full identity of clients be removed. This is required under the Money Laundering Guidance Notes Issued by the SFC in 1997, and will remain a requirement under the Code of Conduct.
  - 10.2 The exception suggested in paragraph 10 above is also not intended to be available for registered persons providing advice on corporate finance work. Under those circumstances, registered persons are still expected to perform the required due diligence irrespective of the nature of their clients. As an example, registered persons acting as financial advisers to an offeror under the Hong Kong Code on Takeovers and Mergers are expected to ascertain the financial situation and investment objectives of their clients. Corporate finance work for these purposes has been defined in the Code of Conduct for Corporate Finance Advisers.
11. C5.2 of the Code of Conduct stipulates that having regard to information disclosed by a client and other circumstances relating to the client which the registered person is or should be aware of through the exercise of due diligence, the registered person shall, when making a recommendation or solicitation, ensure the suitability of such recommendation or solicitation for that client as is reasonable in all circumstances. This requirement was established to protect retail investors. As a consequence, it may be removed in respect of well-informed professional clients.

#### Client Agreement

12. C6.1 of the Code of Conduct provides that a regulated person shall ensure that a written agreement (Client Agreement) is entered into with a client before any services are provided to that client. The regulated person is also required to ensure that the Client Agreement is in a language understood by the client, and to explain to the client the contents of the client agreement. These are client protection measures aimed at the retail investor, and as such may appropriately be removed in respect of clients who are professional investors. The Commission has frequently been told by those who act as intermediaries for institutional clients that those clients often simply refuse to sign standard client agreements in any event. It also follows that the requirement for the respective ancillary risk disclosure statements (for clients trading in securities, in futures contracts or options, and in the Growth Enterprise Market) are not appropriate for professional investors.

#### Information for Clients

13. C8.1 of the Code of Conduct states that a regulated person shall provide clients with adequate information about the firm including its business address, any relevant conditions or restrictions under which the regulated person conducts business, and the identity and status of employees and others acting on its behalf with whom the client may have contact.
14. C8.2 of the Code of Conduct states that unless specifically agreed otherwise in writing by the client, after a regulated person has effected a transaction for a client, the regulated person shall endeavour to confirm promptly with the client either orally or in writing the essential features of the transaction.
15. C8.3 of the Code of Conduct states that without prejudice to the contract note provisions of the Securities Ordinance<sup>1</sup> and Commodities Trading Ordinance<sup>2</sup>, a regulated person shall provide each client with a regular statement of account, which shall be at least quarterly, in relation to the client's transactions and related dealings and also provide such a statement on request by the client.
16. It would seem that these three provisions go to individual client protection in the retail sector of the market. In respect of professional clients, such provisions may not be necessary and could be removed without undermining the regulatory framework. It is proposed that for professional investors, they will be able to waive all or some of these provisions, and be able to determine the services they wish to be provided with.
17. With regard to the proposed exception in respect of C8.3 above, this would not be available to registered persons providing share margin finance to clients. Under the Securities (Margin Financing) (Amendment) Ordinance 2000, account statements are required to be provided to clients irrespective of the nature of the clients.

#### Rebates, Soft Dollars, and Connected Transactions

18. No change is proposed in respect of rebates, soft dollars or connected transactions.
19. C13.1(c) states that a regulated person who acts for a client in the exercise of investment discretion may receive goods or services (i.e. soft dollars) from a broker in consideration of directing transaction business on behalf of such client to the broker only if the client has consented in writing to the receipt of such goods and services.
20. C13.2(a) states that a regulated person described in C13.1 who intends to receive and retain cash or money rebates in relation to client transactions may retain such rebates only if the client has consented in writing to such retention of rebates.

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<sup>1</sup> In particular, the requirements under sections 75, 75A and 77.

<sup>2</sup> In particular, the requirements under sections 45A and 45B.

21. These two provisions serve to prevent the abuse of rebates and soft dollar practices by investment managers and are aimed at the retail investment management market. The provisions also guard against the possibility that regulated persons may provide services that are not in the best interests of the client, in order that the regulated persons may benefit through receipt of soft dollars. It has been argued that the safeguard provided by requiring such prior consent might be removed for professionals with reliance placed on disclosure to the client upon receipt of goods or services.
22. The Commission notes, however, that section 9 of the Prevention of Bribery Ordinance and the policy that underlies it, would appear to rule out, for all practical purposes, any approach based on subsequent disclosure. Therefore, no change is proposed in this area.

### **Definition of “Professional Investors”**

23. The term “professional investor” has not been defined in any Ordinance, subsidiary legislation or code. Although there is an indirect reference to a professional investor in section 3(1) of the Securities Ordinance as “a person whose business involves the acquisition and disposal, or the holding, of securities”, this categorisation is considered too broad or general to be used in the present context. Similarly, any classification essentially based on quantitative means, as used in other jurisdictions (like the United States<sup>3</sup> or United Kingdom<sup>4</sup>) may not be entirely suitable in the local context.
24. A workable model may take the form of a hybrid of the two approaches mentioned above. It is proposed that the term “professional investors” for the purpose of compliance with the Code of Conduct should be limited to the following group of entities:

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<sup>3</sup> Pursuant to Regulation D of the Securities Act of 1993, the term “Accredited Investor” includes, amongst others, i) a corporation with total assets in excess of US\$5 million; ii) a natural person whose individual net-worth, or joint net-worth with that person’s spouse, exceeds US\$1 million; iii) a natural person who had an individual income in excess of US\$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of US\$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; and iv) a trust with total assets in excess of US\$5 million whose purchase is directed by a sophisticated person.

<sup>4</sup> Pursuant to The Financial Services Act 1986 (Investment Advertisements) (Exemptions) Order 1996 on investment advertisements, certain persons are considered “sufficiently expert to understand the risks involved”. These persons include, amongst others, i) a corporation or unincorporated association having more than 20 members or is the subsidiary of a holding company which has more than 20 members, it, or any of its holding companies or subsidiaries, has a called up share capital or net assets of not less than £500,000; ii) a corporation other than one described above, it or any of its holding companies or subsidiaries has a called up share capital of not less than £5 million; iii) an unincorporated association having net assets of not less than £5 million; and iv) a trustee of a trust where the aggregate value of the cash and investments which form part of the trust’s assets (before deducting the amount of its liabilities) is £10 million or more at any time during the previous two years.

- a. persons registered with or declared exempt by the Commission or persons whose regular business is the provision of investment services and which are licensed or regulated in another jurisdiction;
  - b. entities authorized by the Commission (exchanges, clearing houses);
  - c. authorized institutions under the Banking Ordinance or other credit institutions that are licensed or regulated in another jurisdiction;
  - d. insurance companies authorized by the Insurance Authority or which are licensed or regulated in another jurisdiction;
  - e. trustee companies under the Trustee Ordinance;
  - f. collective investment schemes and the management companies of such schemes;
  - g. pension funds and the management companies of such funds;
  - h. investors (private individuals or corporations) having a portfolio of at least USD 5 million (or equivalent) in securities and having declared themselves as professional investors; and
  - i. national governments and international and supranational institutions such as the World Bank, IMF and regional development banks.
25. The Commission invites comment upon its proposed definition. In particular, subparagraph h is perhaps the most controversial. The inclusion of high net worth individuals in such definitions is common in other jurisdictions but the definitions vary widely. Setting the correct threshold is important and there is a concern that even the wealthy will not necessarily be sophisticated enough to protect their own interests.
26. The Commission believes that the designation of clients as “professional” should not be limited to entities regulated in Hong Kong, hence the proposal to include overseas regulated entities. The Commission is not inclined to adopt an approach under which it recognises overseas jurisdictions for these purposes.

### **Clients’ Right of Refusal**

27. The Commission takes the view that prior to treating relevant clients as professional investors for the purpose of the Code of Conduct, a registered person must:
- Explain to the clients concerned the consequences of being treated as a professional investor, in particular, to identify the information that will not be provided;
  - Sign a statement indicating that he has provided such explanation to his clients;
  - Receive from the clients a statement that the consequences have been explained to him, and that he had understood the explanation; and
  - Receive a declaration from the clients that they wish to be treated as professional investors.

28. In order to properly explain to a private individual the consequences of being treated as a professional investor, an intermediary will need to make an initial assessment of that client's financial situation, investment experience and investment objectives as required under C5.1 of the Code.
29. In the event a client declares that he wishes to be treated as a professional investor, then such declaration must also state whether the client wishes to be so treated with respect to all or just some of the provisions stated above. If the declaration is only for certain provisions, then it must state clearly with regards to which provisions the client is to be treated as professional investor.
30. After the declaration, it is the responsibility of the professional client to look after its own interests with respect to these specific provisions. However, the client may always revert back to the higher level of protection afforded by the Code of Conduct generally by revoking the declaration. Revocation of the declaration should be accompanied by appropriate notice period.

### **Consultation**

31. The Commission welcomes any comment industry practitioners and members of the investing public may have on the issues raised in this Paper. Submissions should be sent by 15 September 2000. Submissions should be sent by way of e-mail to [lic-enquiry@hksfc.org.hk](mailto:lic-enquiry@hksfc.org.hk) or by post to the SFC at

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