THE LAW SOCIETY OF HONG KONG 香港律師會

CONSULTATION PAPER ON THE PROPOSED AMENDMENTS TO THE PROFESSIONAL INVESTOR REGIME AND THE CLIENT AGREEMENT REQUIREMENTS

The Law Society's Submissions

Issues relevant to the Professional Investor regime and proposed enhancements to the Professional Investor regime

***Question** 1: Should Corporate and Individual Professional Investors continue to be allowed to participate in private placement activities?*

Law Society's response:

We are of the view that Corporate and Individual Professional Investors (**PIs**) should continue to be allowed to participate in private placement activities.

The Commission has noted the concern that such PIs may not have sufficient knowledge to make informed decisions to participate in private placements given the lower level of information disclosed by issuers in a private placement.

We believe the Commission's concern may be unfounded; private placements invariably involve regulated intermediaries or advisers, who advise the Individual PIs or Corporate PIs, and private placement agents all of whom are themselves bound by standards of conduct – together with the fact that there will also normally be a certain level of disclosure of information by issuers about the terms and risks of the product in related private placement documentation.

Further, such activities are in line with other jurisdictions which have significant financial market presence, such as Singapore and the United States. If the amended regime deviates from international standards, Hong Kong will lose its competitiveness as an international financial centre. Many of the financial firms operate in a global platform meaning such private placement activities could be shifted away from Hong Kong as a result.

***Question** 2: Do you think that the minimum monetary thresholds for Corporate and Individual Professional Investors should be increased?*

Law Society's response:

We would agree with the Commission's conclusion that it is inappropriate to require the Knowledge and Experience Assessment criteria to be satisfied in addition to the monetary threshold in the context of a private placement.

We also agree, and as mentioned in our response to the Commission's *Consultation Paper on Proposals to Enhance Protection for the Investing Public* issued in December 2009, we do not think there is a basis to change the current threshold. In particular, given that the Hong Kong market has historically been characterized by high levels of volatility, setting a higher threshold may be particularly problematic for capital raising activities (and offering generally) in an adverse market; companies struggle to raise needed capital during such times and paradoxically, history has shown that such times are generally the best times to invest in the market.

***Question 3**: Do you agree that intermediaries should observe the Code without exception when they deal with individuals?*

Law Society's response:

We are supportive of the Commission in its proposal not to change the exemptions applicable to Institutional PIs. However we do not support the proposal that intermediaries should observe the Code without exception when they deal with individuals. We are of the view that to do so would be regressive and inconsistent with Hong Kong's desire of becoming a private banking hub in the region.

Individual PIs vary in sophistication and experience and indeed services required from their financial advisers. A one size fits all approach would therefore not be appropriate. We believe that to retain optionality as to whether to be treated as a PI or not, together with an intermediary's prior requirement to conduct assessment of sophistication, is an appropriate framework even in the case of Individual PIs. It is however still open to an intermediary to adopt a higher standard.

Therefore we are of the view that individuals who have the sophistication and means should have the option of waiving the application of such requirements.

***Question 4**: Do you agree that investment vehicles wholly owned by individuals and by family trusts should be treated on the same basis as individuals under the Code?*

Law Society's response:

As with Individual PIs we do not support that intermediaries should observe the Code without exception where their clients are investment vehicles wholly owned by individuals and by family trusts. Subject to our comments in relation to Question 5 we are of the view that a knowledge and experience assessment of the client can be undertaken; these types of vehicles can vary significantly in terms of purpose and resources available to them – internally and externally. Many investment vehicles owned by individuals or family trusts are controlled by or managed by investment professionals or retained the services of an

external adviser. The option to treat (and be treated) as a PI should be retained.

***Question 5**: Do you agree that a principles-based Knowledge and Experience Assessment should dispense with bright line tests concerning dealing experience?*

Law Society's response:

In principle, we agree it is sensible to adopt a principles-based approach, rather than a tick-box one.

However, we query the practical application of the proposed considerations an intermediary should take into account, for example identifying the person(s) and their background of those responsible for the investment decisions, and indeed the process and controls in relation to the investment process. As the Commission is fully aware many family trusts are discrete investors in many cases and this level of information may not be easily available. It should be open to an intermediary to look at a variety of factors. Care should also be taken that any guidance provided by the Commission does not inadvertently result in creating another bright line test – which we believe was not the intention when previous revisions were made to the knowledge and experience assessment in the Code.

To ensure that the operationalization / implementation of the proposal is practicable and without creating too much uncertainty in the market, we suggest further clarification be provided on the following:

(a) The requirement in the new paragraph 15.3(b) of the Code involves assessing the investment experience of the person responsible for making the investment for the Corporate PI. Would the Commission be satisfied if the investment experience is spread out among several persons within the Corporate PI such that each person on his own may not satisfy the requirement, but they would have the necessary experience collectively?

(b) For the purpose of avoiding disruption in the market, the Commission should consider putting in place grandfathering arrangements with regard to existing Individual PIs and Corporate PIs who will continue to have the ability to opt out of being a PI.

***Question 6**: Do you have any views on the Suitability Requirement?*

Law Society's response:

The Commission asked whether the Suitability Requirements provide adequate protection to investors, whether any refinements should be considered / introduced and whether investor protection and compliance costs on intermediaries are well-balanced.

We would also like to repeat our concerns that increasing compliance costs and regulatory hurdles could be detrimental to the development of Hong Kong's private banking industry and to the interests of investors who may end up being denied access to the "best" products which are appropriate for their needs, and/or forced into products which are

either more expensive or less liquid, or encouraged to invest outside Hong Kong in places where they may not benefit from the same level of regulatory protection.

Aside from the above, we have no comment as these are largely questions for the industry.

Proposed amendments to client agreement requirements

***Question** 7: Do you agree with the above proposals in relation to the client agreement?*

Law Society's response:

We do not agree with the proposals in relation to the client agreement. The proposals have the effect of depriving an intermediary from relying on contractual disclaimers in client agreements. For example, in a situation where a client makes his own investment decision, he could currently contract with the intermediary concerned acknowledging that the intermediary is not responsible for the suitability of the investment. This option will no longer be available if the proposal is implemented. A related concern is in situations where an intermediary provides a mere expression of view on a product -which is not intended (or indeed at the time understood) to be advice nor does it contain sufficient information to be construed as advice - may no longer be able to rely on disclaimers.

We are also of the view that the proposals go to certainty; to the extent that an intermediary and the client agree that their relationship is execution-only and that there is no duty to advise on suitability, the position under the contract is certain. Introducing a duty to advise on suitability brings in uncertainty as to exactly what the scope of the intermediary's duty is and exactly what steps it needs to take to satisfy that duty. The fact that an intermediary would, in practice, conduct suitability checks pursuant to current regulatory requirements should not be a presumption that it was the intermediary's intention and that of its clients to create an advisory contractual relationship.

In the event that a contract mis-describes the actual services provided to clients, a client would potentially have an action against the intermediary for misrepresentation in any event and therefore the new paragraph 6.5 of the Code is unnecessary. In any event, contractual provisions are already subject to the control under the Unconscionable Contracts Ordinance (Cap. 48) and the Control of Exemptions Clauses Ordinance (Cap. 71), as well as the very well developed common law principles on contract and tort; such legal framework should not be interfered with by the Commission. Similarly it should be possible to rely on proper disclosure in relation to product characteristics and risks.

Further, by requiring an obligation to be a contractual duty (on top of it being a regulatory duty) might potentially open a floodgate of litigation, of particular concern, is unmeritorious litigation initiated to attract publicity.

Overall, we are of the view that imposing restrictions on what can or cannot be included in a client agreement in the manner proposed goes against the principle of freedom of contract. Although the Code of Conduct prescribes the minimum content of client agreements, the current requirements merely set out some factual information; it does not go to the extent of prescribing the scope of contractual obligations, as the Commission's current proposal is seeking to do i.e. the current position does not breach the common law

principle of freedom of contract which the proposal does. If such an obligation as proposed is ultimately deemed necessary (which we would strongly request it isn't), we are of the view that due to the significance of the proposal this should be done by way of legislation. Similarly, if it is compulsory for an intermediary to advise on suitability in all cases, it would mean that a client is no longer free to choose execution-only services or discretionary management services. The parties should be free to contract as they see fit.

We note also that the Commission has not identified other jurisdictions with similar requirements, neither has it explained the unfairness suffered by clients in the current environment.

If implemented, the Commission may wish to consider whether to limit the application of this proposal to certain type of investors. There may be practical consequences if the proposal applies to all Corporate PIs and Individual PIs that are agreeable to be treated as a PI (having met a suitability assessment), for example, there may be an impact on international standard form documentation such as ISDA agreements.

The Law Society of Hong Kong
Investment Products and Financial Services Committee
20 August 2013