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Suitability Requirement – Now a Contractual Obligation on Licensed and Registered Persons

The Securities and Futures Commission (the "SFC") mandated the incorporation of the Suitability Requirement into client agreements as a contractual term. Coupled with the requirement not to include clauses in client agreements that are inconsistent with the Code of Conduct or which mis-describe the actual services provided to clients, the SFC intends the new requirements to give aggrieved investors a contractual right to claim damages and to preclude use of disclaimers. Whilst the new requirements will come into effect in June 2017, the SFC expects all financial intermediaries subject to the requirements to start reviewing and revising their client agreements immediately to ensure timely completion of the exercise, and take necessary steps to revise or re-execute their client agreements with existing clients.

Background

Back in May 2013, the SFC issued a Consultation Paper on the Proposed Amendments to the Professional Investor Regime and the Client Agreement Requirements. Among other recommendations, it proposed making the requirement to ensure suitability of products for clients a contractual obligation on licensed and registered persons. The Suitability Requirement is set out in paragraph 5.2 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commissions (the "Code") which provides:

> *"Having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances."*

Paragraph 5.2 has regulatory effect only in that the SFC can carry out disciplinary action against a financial intermediary that breaches paragraph 5.2, but does not give aggrieved investors a contractual right to seek compensation against the financial intermediary. The new requirements are intended by the SFC to fill "an obvious gap through giving aggrieved investors a contractual right to claim damages".

This article summarises the new requirements imposed by the SFC and the practical implications on licensed and registered persons.

The New Clause

The SFC has decided to require all intermediaries to incorporate the clause set out in new paragraph 6.2(i) of the Code (the "New Clause") into client agreements as a contractual term. The New Clause reads as follows:

> *"If we [the intermediary] solicit the sale of or recommend any financial product to you [the client], the financial product must be reasonably suitable for you having regard to your financial situation, investment experience and investment objectives. No other provision of this agreement or any other document we may ask you to sign and no statement we may ask you to make derogates from this clause."*

The SFC has also provided a definition for "financial product" as any securities, futures contracts or leveraged foreign exchange contracts as defined under the Securities and Futures Ordinance. Regarding "leveraged foreign exchange contracts", the requirement is only applicable to those traded by persons licensed for Type 3 regulated activity (and hence, it does not apply to authorised institutions under the Banking Ordinance). The definition of "financial product" is set out as an explanatory note to paragraph 6.2(i).

Further, a new paragraph 6.5 will also be inserted to prohibit the inclusion of clauses which are inconsistent with the Code or which mis-describe the actual services provided to clients in a client agreement or any other document signed or statement made by the client at the request of a licensed or registered person.

Practical Implications

By imposing the new requirement, the SFC aims to enhance investor protection, especially for retail investors, in light of Hong Kong court cases (including two landmark cases in 2012 and 2013) upholding disclaimers and non-relevant clauses in client agreements in favour of financial institutions in relation to allegation of mis-selling by aggrieved clients.

The basis upon which the Hong Kong cases were decided can be traced back to the decision in the English landmark case *J.P. Morgan Chase Bank v. Springwell Navigation Corporation* [2008] EWHC 1186. In *Springwell* the defendant bank successfully defended the mis-selling claim by relying on the disclaimers set out in the contractual documents. Although *Springwell* turns on its facts, it demonstrated that English courts were inclined to uphold disclaimers and non-reliance clauses in investment agreements and not willing to interfere with the parties' freedom of contract.

In the two Hong Kong cases, the courts adopted the same approach and upheld the contractual estoppel defence raised by the defendant financial institutions and the "execution-only" clauses in the contractual documents, and ruled in favour of the financial institutions in both cases. In one case, the court further rejected the argument by the plaintiff that professional duties were expressly incorporated into contracts by reference to the Code, clarifying that the Code does not have the force of law and express terms of the contract shall prevail over the Code requirements.

The new requirements mean that *Springwell* and the Hong Kong cases above will offer limited assistance to financial institutions in the future. The non-derogation clause (the second sentence of the New Clause) and the "do not mis-describe your actual services" requirement in paragraph 6.5 of the Code together render non-reliance or "execution-only" (if the institution actually makes solicitation or recommendation of financial products) provisions ineffective. Financial institutions can no longer defend mis-selling claims by relying on contractual estoppel and aggrieved investors can seek contractual remedy under the client agreements.

Concluding Remarks

The SFC has taken a major step towards investors protection. Licensed and registered persons are now under a contractual duty to solicit the sale of or recommend financial products that are reasonably suitable for a client having regard to his financial situation, investment experience and investment objectives. Breach of this contractual duty will entitle an aggrieved client to claim compensation.

Financial institutions are recommended to start reviewing and revising their client agreements without delay.

The development is also noteworthy for insurers of financial institutions as their insureds potentially face greater risk of claims and their ability to rely on disclaimers and non-reliance clauses will be limited.

Contact Us

For enquiries related to this Legal Update, please contact the following persons or your usual contact at our firm.

Tow Lu Lim
Partner
T: +852 2843 4490
E: tl.lim@mayerbrownjsm.com

Sara Or
Partner
T: +852 2843 2268
E: sara.or@mayerbrownjsm.com