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SUITABILITY OBLIGATION IN CLIENT AGREEMENTS

The latest changes to the compulsory content of client agreements will expose intermediaries to heightened litigation risk. Intermediaries are well advised to not only update their documentation but also review their whole selling process including product due diligence.

THE SFC CONSULTATION CONCLUSIONS

The SFC has announced that it would press ahead with its decision to require intermediaries to include a suitability clause in most of their client agreements. There is a transitional period of 18 months (to 9 June 2017) for intermediaries to update their client agreements (for both new and existing clients), although the SFC expects intermediaries to begin the client agreement review process immediately.

The SFC has decided to add a new paragraph 6.2(i) to the Code of Conduct, requiring intermediaries to include the following suitability clause in most of their client agreements:

> "*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 term "financial product" in the suitability clause refers to any securities, futures contracts or (in the case of trading by persons licensed for Type 3 regulated activity only) leveraged foreign exchange contracts as defined under the SFO.

A new paragraph 6.5 will also be added to the Code, prohibiting intermediaries from incorporating any clause in their client agreements that is inconsistent with their Code obligations. This will, for example, preclude a clause, requiring a client to acknowledge that no reliance is placed on any recommendation made or advice given by the intermediary, unless the client is an institutional professional investor or a corporate professional investor who has demonstrated a sufficient level of investment sophistication.

HEIGHTENED LITIGATION RISK

At first sight, the regulatory changes would seem to be stating the obvious. Even without such changes, paragraph 5.2 of the Code requires an intermediary to ensure reasonable suitability of its recommendation or solicitation to its clients. At law, where an intermediary voluntarily assumes the responsibility to advise a client on the suitability of a financial product, it would be liable to compensate the client if the financial product were in fact not suitable to that client.

Despite the initial impression, the regulatory changes are expected to expose intermediaries to heightened litigation risk. Although an intermediary who has voluntarily assumed responsibility to ensure suitability may be liable for making an unsuitable recommendation to its clients, the law also permits an intermediary to expressly disclaim such responsibility by contract. For example, the parties may agree that the intermediary would only provide execution services and that the client would exercise independent judgment without reliance on any recommendation of the intermediary.

The regulatory changes, therefore, effectively compel intermediaries to assume by contract the responsibility of ensuring suitability of a financial product, unless their clients are institutional professional investors or sufficiently sophisticated corporate professional investors.

In view of the regulatory changes, an intermediary will naturally be exposed to litigation risk if a recommended financial product is in fact unsuitable to a client. Indeed, an intermediary can be dragged into prolonged litigation with a disgruntled client, if the client can raise a barely arguable case of unsuitability to prevent its case being struck out at the interlocutory stage.

MANAGING THE RISK

Intermediaries are well advised to manage the heightened litigation risk. We can see 2 ways to mitigate the risk – proper documentation and review of the selling process.

In terms of documentation, intermediaries will be required to include a suitability clause in each of their client agreements. Although they cannot derogate from their suitability obligation insofar as individual investors (professional or otherwise) and most corporate professional investors are concerned, it is entirely legitimate for intermediaries to expressly disclaim any suitability obligation with respect to institutional professional investors and sufficiently sophisticated corporate professional investors. For intermediaries operating across different jurisdictions, it is also entirely legitimate for intermediaries to disclaim any suitability obligation with respect to transactions that do not fall within the Hong Kong regulatory regime.

In terms of the selling process, intermediaries may have to review it from start to finish. In the case of a financial product that is inherently very risky, it may be sensible to ask from the start whether reward from recommending or soliciting the sale of such a product would be sufficient to compensate the heightened litigation risk.

Intermediaries may also have to strengthen their existing compliance framework or introduce new procedures in view of the regulatory changes.

Intermediary is also recommended to read the latest 2 circulars concerning suitability obligations both dated 23rd December 2016 issued by the SFC to which the frequently asked questions on compliance with and triggering of suitability obligations are annexed. In the frequently asked questions, among other things, the following issues are clarified with illustrative examples:

(i) suitability obligations;

(ii) "know your client" requirements;

(iii) product due diligence; and

(iv) when suitability obligations are likely to be triggered.

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