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SUITABILITY REQUIREMENT TO BECOME MANDATORY PROVISION OF CLIENT AGREEMENTS UNDER SFC CODE AMENDMENTS

Introduction

The Securities and Futures Commission (**SFC**) published its Consultation Conclusions on the Client Agreement Requirements (the **Consultation Conclusions**) on 8 December 2015.¹

After extensive consultation, the SFC has published a new clause which intermediaries are required to include in all client agreements. The new clause (**New Clause**) requires that intermediaries ensure that any financial product solicited for sale or recommended to a client is reasonably suitable for the client having regard to its financial situation, investment experience and investment objectives. It is based on, but distinct from, the obligation on intermediaries to ensure the reasonable suitability of recommendations or solicitations for clients (the **Suitability Requirement**) under paragraph 5.2 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code**). The New Clause will give investors a contractual right to claim damages under the client agreement where the intermediary does not comply with the requirement.

Other amendments to the Code will prohibit:

- the inclusion of non-reliance provisions in client agreements or elsewhere which require clients to acknowledge that they do not rely on intermediaries' advice or recommendations; and

- any misdescription of the services to be provided to clients.

All client agreements, including those with existing clients, must include the New Clause and comply with the new Code requirements on or before 9 June 2017. The SFC expects intermediaries to start reviewing and revising their client agreements immediately so that revised client agreements can be made available as soon as possible for execution by all new clients. Intermediaries' existing clients will need to enter into revised client agreements, either by execution of new agreements or amendments to their existing agreements as soon as possible.²

Background and timeline of proposals

The initial consultation paper³ proposing amendments to the professional investor regime and client agreement requirements was published on 15 May 2013. In the consultation paper, the SFC proposed incorporating the Suitability Requirement into client agreements as a contractual term.

After considering comments from the public, the SFC modified its proposals and published the Consultation Conclusions on the Proposed Amendments to the Professional Investor

¹ <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=14CP7>.

² See paragraph 8 of the Consultation Conclusions.

³ See the SFC's "Consultation Paper on the Proposed Amendments to the Professional Investor Regime and the Client Agreement Requirements" at <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=13CP1> and our June 2013 newsletter, "SFC Publishes Consultation Paper on the Professional Investor Regime", at <http://www.charltonslaw.com/sfc-publishes-consultation-paper-on-the-professional-investor-regime/>.

Regime and Further Consultation on the Client Agreement Requirements (**Further Consultation Paper**) on 25 September 2014.⁴

In the Further Consultation Paper, the SFC invited comments on a draft New Clause which was proposed to be incorporated into client agreements pursuant to a new requirement under the Code.

The proposed New Clause read:

"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."

In the further consultation period, the SFC received 12 submissions from the public, including industry associations, professional bodies and market participants. More representations were received following the end of the further consultation process made by interested parties, which were reviewed and considered by the SFC.

A detailed summary of the submissions is provided by the SFC in the Consultation Conclusions.

Consultation Conclusions and Code Amendments

The New Clause

The draft New Clause was accepted with a qualification. It now reads:

"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."⁵

⁴ See our October 2014 newsletter: "SFC Publishes Consultation Conclusions on Amendments to the Professional Investor Regime and Further Consultation on Client Agreement Requirements" at <http://www.charltonslaw.com/sfc-publishes-consultation-conclusions-on-amendments-to-the-professional-investor-regime-and-further-consultation-on-client-agreement-requirements/>.

⁵ See paragraph 6.2(i) in Appendix A of the Consultation Conclusions.

Note: "Financial product" means any securities, futures contracts or leveraged foreign exchange contracts as defined under the SFO. Regarding "leveraged foreign exchange contracts", it is only applicable to those traded by persons licensed for Type 3 regulated activity.

The New Clause is required to be included in client agreements by new paragraph 6.2(i) of the Code. The definition of "financial product" was inserted following respondents' requests for a clarification of the term. The SFC recommends intermediaries to either insert a footnote to the New Clause in their client agreements or reflect the definition in the definitions section of their agreements.

The "non-derogation" component of the New Clause is intended to prevent the purpose of the New Clause being defeated by disclaimers or other terms included in the client agreement or elsewhere. The SFC noted that some intermediaries have been able to circumvent liability in the past by relying on broadly drafted disclaimers in their client agreements.

Scope

Respondents to the consultation queried whether the New Clause will apply to corporate finance advisers.

The SFC confirmed in the Consultation Conclusions that the New Clause will apply to all intermediaries, although in practice, it will be redundant in situations where the intermediary's business does not involve soliciting the sale of, or recommending, financial products. An intermediary which acts under a restricted mandate that does not involve soliciting the sale of, or recommending, financial products, will have the discretion to consider whether the inclusion of the New Clause is necessary under existing paragraph 6.4 of the Code. Paragraph 6.4 of the Code requires client agreements to properly reflect the services to be provided, but where the services to be provided are limited in nature, the client agreement can be limited accordingly. The Consultation Conclusions provide that the requirement to include the New Clause is unlikely to apply in a standard corporate finance mandate which does not involve soliciting the sale of, or recommending, financial products.⁶ However, the SFC envisages that the situations where intermediaries can rely on paragraph 6.4 of the Code will be limited.

⁶ See paragraph 35 of the Consultation Conclusions.

As regards professional investors, under the new professional investor regime which takes effect on 25 March 2016,⁷ intermediaries will be entitled to certain exemptions from the Code's requirements in relation to Institutional Professional Investors and Corporate Professional Investors (as defined under the new paragraph 15.2 of the Code). These include a discretion to waive the need to enter a client agreement when dealing with these classes of Professional Investors under new paragraph 15.4 of the Code. Intermediaries dealing with Corporate Professional Investors will need to comply with the assessment requirements set out in new paragraph 15.3A and with new paragraph 15.3B of the Code in order to rely on the paragraph 15.4 exemptions. The Consultation Conclusions confirm that if an intermediary chooses to enter into a client agreement with Institutional Professional Investors and Corporate Professional Investors, it is not required to include the New Clause as the requirement for a client agreement can be waived.⁸ It is not however clear whether an intermediary would need to comply with new paragraphs 15.3A and 15.3B where the client agreement is with a Corporate Professional Investor.

The Consultation Conclusions also provide that the SFC would not expect the ISDA master agreement, which is a master service agreement mainly for derivative transactions between sophisticated institutional clients, to include the New Clause.

Effect

Currently, a breach of the Code's Suitability Requirement can result in the SFC taking a disciplinary action against the intermediary. However, the SFC cannot require the intermediary to pay compensation to aggrieved clients for losses resulting from breaches of the Code. The New Clause will give aggrieved investors a contractual right to seek redress.

Non-Reliance Clauses

New paragraph 6.5 of the Code prohibits intermediaries from incorporating any clause, provision or term in the client agreement or in any other document signed or statement made by the client at the request of the intermediary which:

- i) is inconsistent with the intermediary's obligations under the Code. The note to paragraph 6.5 states that this precludes any clause or other provision by which a client acknowledges that no reliance is placed on the intermediary's recommendation or advice; or
- ii) misdescribes the services to be provided to the client.

Timeline for compliance

The amendments to the Code will come into effect on **9 June 2017**.

However, the SFC expects all intermediaries to commence reviewing and revising their client agreements immediately to ensure timely completion of the exercise. The 18-month transitional period is to cater for circumstances where intermediaries, despite their best efforts, face practical difficulties arranging for the re-execution of agreements with existing clients. Intermediaries are expected to complete the exercise well before the end of the transitional period for all new clients and for all, but a small minority, of existing clients.

⁷ Please see the Further Consultation Paper and our October 2014 newsletter referred to in footnote 3 above

⁸ See paragraph 36 of the Consultation Conclusions.

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