The Duty on Suitability: Developments in Hong Kong on Mis-selling and Case Law Analysis

Article Synopsis

The issues of suitability and mis-selling continue to be in regulatory focus. In Hong Kong, a series of measures to enhance protection for the investing public was first rolled out in May 2010, including the introduction of the requirement that financial intermediaries should assess a client's knowledge of derivatives which impacts the suitability standard to be applied. Hong Kong regulators have since further reviewed requirements on suitability assessment and selling practices on investment products, and made significant changes to the professional investors' regime which will be effective 25 March 2016. In the latest development, intermediaries will now be required to include a contractual duty on suitability in client agreements. On the other hand, in recent years there have been a number of court decisions in the UK, Hong Kong and Singapore on claims of mis-selling of financial products by banks.

This Article provides an overview of the key developments and requirements in Hong Kong on the subject, together with an analysis on notable case law and a review in light of the recent developments in Hong Kong.

On 8 December 2015, the Securities and Futures Commission ("**SFC**") of Hong Kong published its ***"Consultation Conclusions on the Client Agreement Requirements"*** ("**Consultation Conclusions**"), requiring licensed financial intermediaries to include a new clause in their client agreements on the suitability of investment recommendations and solicitations.

The required new clause[1] 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."*[2]

The SFC Code of Conduct[3] will be amended to incorporate this minimum content

[1] The new clause is to be incorporated into client agreements pursuant to the new paragraph 6.2(i) under the Code of Conduct for Persons Licensed by or Registered with the SFC.
[2] "Financial product" refers to any "securities, futures contracts or leveraged foreign exchange contracts as defined under the SFO (Securities and Futures Ordinance)." In relation to "leveraged foreign exchange contracts", the new clause is only applicable to those traded by persons licensed for Type 3 regulated activity (which excludes authorized financial institutions, i.e. banks).
[3] Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

requirement for client agreements. In addition, a new paragraph will also be inserted into the Code of Conduct to disallow any contractual term or provision in the client agreement or other document signed or statement made by client at the request of the intermediary which is inconsistent with the Code of Conduct obligations or which misdescribes the actual services provided to a client.

There is an 18 months transitional period (i.e. 9 June 2017 being 18 months from 8 December 2015) for all intermediaries to comply with the new requirements, although the SFC expects that *"all intermediaries will commence reviewing and revising their client agreements immediately, as well as to make revised client agreements available as soon as possible so that new clients can execute them and existing clients can amend or replace their existing agreements."*[4]

The intended effect of the new requirements is that banks and other financial intermediaries will now be under a contractual obligation on suitability of investment recommendations and solicitations of financial products, and will no longer be able to use non-reliance clauses as a defence to a mis-selling claim.

As set out in the SFC's response in the Consultation Conclusions:

> *"The New Clause is derived from the Suitability Requirement under the Code, which is the cornerstone of investor protection. This requirement has been in place for many years and intermediaries should be fully aware of their compliance obligations under it. However, because the Suitability Requirement is limited to being a regulatory obligation, the SFC can only take disciplinary action against the relevant intermediary which has breached it; it cannot require the intermediary to compensate aggrieved investors from losses arising from such breach. The New Clause aims to enable aggrieved investors to seek redress as a contractual right under the client agreement in such a situation."*

Suitability Requirements

The SFC Code of Conduct contains the relevant standards of conduct that are applicable equally to financial institutions which are registered persons with the SFC and entities licensed by the SFC including for example investment managers, securities brokers, and banks conducting regulated activities ("**SFC Regulated Persons**"), based on principles that are expected to underpin the conduct of securities business in Hong Kong and impose general requirements of honesty, fairness and due diligence onto banks and firms to act in the best interest of clients. Under the Code of Conduct, SFC Regulated Persons will need to ensure that any representations and information provided to clients are

SFC Regulated Persons will now be required to include a new clause in client agreements which imposes a contractual obligation (as opposed to merely a regulatory obligation) to ensure suitability of investment recommendations and solicitations.

[4] Comment from SFC's Chief Executive Officer, Mr Ashley Alder on the Consultation Conclusions.

accurate and not misleading. In addition, a SFC Regulated Person is under a general requirement to ensure the suitability of the recommendation or solicitation to clients, when making a recommendation or solicitation.

In 2010, the SFC introduced changes to the Code of Conduct which imposed specific requirement for SFC Regulated Persons to assess a client's knowledge and expertise of derivatives as part of know-your-client procedures. This requirement applies except for professional investors who are institutional investors. SFC Regulated Persons providing services in derivative products (including futures contracts or options or any leveraged transactions) are required to ensure that the client understands the nature and risks of the products and has sufficient net worth to assume risks and bear potential losses of trading in such products.

For banks and financial institutions also regulated by the Hong Kong Monetary Authority ("**HKMA**"), the HKMA's Circular of 30 July 2014 ***"Issues and good practices in relation to the sale of investment products"*** contains requirements for conducting adequate product due diligence for thorough understanding of the investment products for solicitation or recommendation to customers, and for having adequate controls in place to ensure suitability of any investment solicitation or recommendation.

Therefore, when conducting selling activities of investment products to clients, financial institutions regulated by HKMA and SFC Regulated Person have a duty to ensure that the investment products are suitable for their clients.

Case Law Analysis on Mis-selling Claims

Following the 2009 global financial crisis, there have been several cases of mis-selling claims against banks in Hong Kong, as well as cases in the courts of the United Kingdom and Singapore.

In the English Court of Appeal case of *Rubenstein v HSBC Bank plc (2012) EWCA Civ 1184*, which was a case following the collapse of the Lehman Brothers in September 2008, the bank was held liable for mis-selling of a bond issued by AIG which was invested in an enhanced variable rate fund. In this case, the Court of Appeal found that the investor was risk averse and had emphasised to the bank that he would not wish to risk his capital, to which he was told by the bank that the investment was "the same as a cash deposit". The court at first instance initially found that the losses suffered were too remote as it was a result of unforeseeable "extraordinary and unprecedented financial turmoil". The first instance judge also examined whether the bank had merely provided information to the investor or had provided "advice". The court at first instance found that where the investor had asked for investment recommendations, the bank's response constitutes "advice" unless there is an express "execution-only" disclaimer, of which there was none in this case.

The Court of Appeal found that the bank had breached its duty of care and skill by not recommending a more conservative option of investment to the investor. It was held that the bank was in breach of its statutory duty under the conduct of business (COB) rules pursuant

to the UK Financial Services and Markets Act 2000, the statutory purpose of which was to afford a measure of carefully balanced consumer protection to the 'private person'. The bank had a duty to understand the client and the product recommended, but the investor suffered loss as a result of following a recommendation to enter into an unsuitable investment the risk of which the investor was misled. In the circumstances, the loss which the investor suffered was not unforeseeable and hence not remote for the bank to be liable for.

In the *Rubenstein* case, it should be noted that the "advisory" role of the bank in question was not disputed, and the bank was found liable pursuant to a breach of statutory duty.

In mis-selling claims, the Courts have typically considered factors such as the degree of sophistication of the investors and the factual matters in relation to allegations of breach of contractual and/or tortious duties of care, negligent misrepresentation and breach of regulatory duties by the banks.

In *Field v Barber Asia Limited (2000) HCA 7119* in Hong Kong, the Court held that the investment adviser was negligent in advising the investor, where an inexperienced investor had engaged a financial advisor to invest her savings using a conservative strategy. The financial advisor persuaded the investor to adopt a high-risk investment strategy, which ultimately led to her losing all her investment savings. The Court, having considered that the financial advisor was never paid by the investor but only received commission from companies whose products the investor had acquired through the financial advisor, found that there was no contract (express or implied) between the investor and the financial advisor. However, the Court found that the financial advisor had been negligent in advising the investor by failing to adhere to the investor's instructions and also to warn the investor of the risks involved. The Court found that the financial advisor breached its duty of care to the investor, and in its judgment, the Court stated:

> *"…if an investment advisor assumes the responsibility of providing advice to a plaintiff, and knows or ought to know that the plaintiff is likely to rely on that advice, a duty of care is likely to arise. Pertinent factors to take into account will also include the relative skill and knowledge of the parties, the context in which the advice is given, whether the giver of the advice is doing so completely gratuitously or is getting a reward (whether in some direct or indirect form) and whether or not there are any express disclaimers of responsibility."*

The reference to the question whether or not there are any express disclaimers of responsibility in the Court's statement is significant, as banks typically rely on standard clauses in the contracts, such as non-reliance, non-advisory and exclusion of liability clauses as part of their defence to mis-selling claims. Hence, in the *Field* case, the case may be said to have turned on the fact that there was no contract between the investor and the financial advisor. In another example, in the Singapore case of *Deutsche Bank AG v Chang Tse Wen* (2013) SGCA 49 it was held that where there are no exceptional factual circumstances (e.g. facts which give rise to a voluntary assumption of duty) and the bank's role is contractually defined, the Court is unlikely to infer an additional advisory duty of care in the relationship

between the bank and the investor.
In a number of other cases as outlined below, in the context of circumstances where there were found to be contractual arrangement between the bank and investor as regard the investment , the Courts held that banks could rely on non-reliance clauses or exclusion of liability clauses.

In a landmark decision of *Springwell Navigation Corporation v JP Morgan Chase Bank (2010) EWCA 1221*, the English Court held that the bank could rely on the exclusion of liability clause in the contract, to enable the bank to exclude liability for any actionable representations which fell within the Misrepresentation Act 1967 and for claims of negligent misstatement. It was found that the contractual documentation between the parties precludes Springwell from claiming that the bank had breached its general advisory duty to the bank, under contractual estoppel from asserting that any actionable representations were made by the bank (or its employees) or placing any reliance on the bank. Further, whilst rejecting that the relationship between the parties were advisory in nature, the Court held that the plaintiff's sophistication as an investor, the lack of any evidence to show that there was any advisory obligation between the parties and the existence of disclaimers, were factors that the Court took into account in its decision that the bank did not owe a general duty of an advisory nature to *Springwell* regarding the appropriateness of its investments.

Similar principles have been applied leading to similar result in several other UK cases and also in Singapore. In *Orient Centre Investments Ltd and another v Societe Generale* (2007) 3 SLR(R) 566 the Singapore Court also upheld some English Court decisions[5] that non-reliance clauses can immunize banks and financial institutions from liability for misrepresentations, and that contractual terms precluded the existence of an advisory relationship or that any duty of care was otherwise assumed by the bank.

However the validity of non-reliance clauses and its effectiveness have been challenged in the Singapore decision of *ALS Memasa and another v UBS AG* (2012) SGCA 43. In *ALS Memasa*, the Singapore Court of Appeal granted an application by two elderly investors against the lower court's decision to strike out their claim against the bank for damages for misrepresentations. The investors claimed that the bank had no authority to purchase the investment product on their behalf and that the bank officers have misrepresented the exact nature of, and the risks inherent to, the investment product in order to induce the investors to affirm the purchase. In reaching its decision, the Court of Appeal questioned whether the non-reliance clauses in the nature of exclusion clauses are subject to the Unfair Contract Terms Act (Chapter 396), and the relevance of illiteracy of the investors. The Court stated the views that:

> *"[i]n the light of the many allegations made against many financial institutions for 'mis-selling' complex financial products to linguistically and financially illiterate and unwary customers during the financial crisis 2008, it may be desirable for the courts to reconsider whether financial institutions should be accorded full immunity for such 'mis-conduct' by*

[5] *Titan Steel Wheels Limited v The Royal Bank of Scotland Plc* (2010) EWHC 211; *Peekay Intermark Ltd v Australia and New Zealand Banking Group Ltd* (2006) 2 Lloyd's Rep 511.

relying on non-reliance clauses which unsophisticated customers might have been induced or persuaded to sign without truly understanding their potential legal effect on any form of misconduct or negligence on the part of the relevant officers in relation to the investment recommended by them."

This indicates that the Singapore courts may be more sympathetic towards unsophisticated investors in mis-selling claims against banks. The level of sophistication of the investor in question is a factor often taken into account, especially as the duty to advise on suitability is one for investor protection, as was found in *Rubenstein*. The extent of obligation may thus differ for investors of different nature and investment experience. In Hong Kong, as under the Code of Conduct, investors are generally categorized as either "professional investors"[6] or "non-professional investors", with certain requirements subject to available exemption for "professional investors".

Kwok Wai Hing Selina v HSBC Private Bank (Suisse) SA (2012) HKEC 903 and *DBS Bank (Hong Kong Limited) v San-Hot HK Industrial Company Limited and Hao Ting (2013) HKEC 352* are two Hong Kong cases which should be considered on this point. In both cases, the investor bought investment products recommended by the bank, and upon suffering losses, sued the bank alleging breaches of duties. The Court decided in favor of the banks, and reached the conclusion that the investors had reached their own decisions after taking into account recommendations and views made by their investment managers. In *Selina Kwok*, the Court found that the relationship was defined by the contract between Ms Kwok and HSBC, and that existence of duties owed by HSBC is negated by the express terms of the account booklet and risk disclosure statement. In *DBS v San-Hot*, the Hong Kong Court upheld non-reliance and non-advisory clauses in bank documentation signed by the customer, and also found that the SFC Code of Conduct does not have force of law and duties thereunder should not contradict the express terms of the contract between the parties.

In *DBS Bank (Hong Kong) Limited v Sit Pan Jit (2009) HCA 382*, recently decided in April 2015, the Court found that the investor's claims of misrepresentations were unfounded, and held that even if the misrepresentations had been proved, the investor is contractually estopped or prevented from asserting any form of inducement or reliance upon any representations by the bank on the basis of the non-reliance clauses found in the bank's terms, applying *DBS Bank v San-Hot,* and that in considering the extent of the bank's fiduciary, contractual and tortious duties in respect of the sale of financial products to their customers, the Court will not readily infer a duty of care to advise into commercial relationships.

Following the above analysis, it can be understood that the SFC's intention in introducing the new requirements pursuant to the Consultation Conclusions is in light of and in response to such case law.

[6] As defined pursuant to the Securities and Futures Ordinance.

Implications of the New Clause

As a result of the new clause now required, investors may now seek to rely on the client agreements to seek redress against banks as a contractual right. The new clause imposes contractual obligations on banks and intermediaries on suitability of investment recommendations and solicitations (as opposed to only regulatory obligations under the Code of Conduct). By also requiring no other terms or provisions in the contract may derogate from this contractual obligation, banks and financial intermediaries may no longer be able to rely on non-reliance clauses as an estoppel to limit their duties and obligations to investors. The principles in *DBS Bank v San-Hot* and *DBS v Sit Pan Jit* could be no longer applicable.

Banks and financial intermediaries may no longer be able to rely on non-reliance clauses to limit their duties and obligations to clients.

Instead, the focus of attention on any potential claims brought by investors will shift to the actual issue of suitability of the financial products which have been sold to them by the banks and/or intermediaries. As the phrase "reasonably suitable" is an objective standard, it will be decided by the Court as to the particular facts of each case in applying the standard to the prevailing circumstances. The SFC has also stated that any future Court decisions would constitute referable guidance on the interpretation of the suitability obligations under the new clause, which the SFC will take into account as precedents.

However, there remains a trigger point for the regulatory or contractual duty of suitability obligation, which is the making of solicitation or recommendation. In other words, where a SFC Regulated Person has not solicited the client or made a recommendation to the client in relation to a product or transaction, the duty does not arise.[7]

The new requirements should also be considered in the context of expanded requirements with respect to certain categories of "professional investors". While the suitability requirement has always applied to retail clients (i.e. "non-professional investors"), with effect from 25 March 2016, the suitability requirement will also apply to (a) professional investors who are individuals, and (b) certain trusts and corporate investors (e.g. those not engaged in investment activity in business and not qualified under an assessment on the knowledge, experience and investment process).[8] Correspondingly, while it was previously possible to be exempted from a need to enter into a client agreement when dealing with "professional investors", with effect from 25 March 2016, the exemption will no longer apply for such categories of individual professional investors and corporate professional investors.

[7] This should be contrasted with the express requirement in the Code of Conduct to warn a client about derivative product, provide appropriate advice whether the transaction is suitable and only in the best interest of the client when dealing with clients who are non-professional investor and without knowledge of derivatives, even where there has not been solicitation or recommendation to the client.

[8] According to the SFC "Consultation Conclusions on the Proposed Amendments to the Professional Investor Regime and Further Consultation on the Client Agreement Requirements" issued 25 September 2014.

Strategies to Adopt – What is Good Practice?

Accordingly, in view of the new expanded requirements on suitability and with respect to dealing with individual and corporate professional investors, when dealing with investors and clients, banks and intermediaries should be reminded to conduct a thorough assessment on the background, knowledge, investment experience, expertise, financial situation, and, in the case of corporate professional investors (other than institutional professional investors), the investment decision process and controls.

Bank and intermediaries should assess the risk profile of the investors and be mindful of applicable suitability obligations, solicit or recommend only products where the nature and risks are fully understood by the advisor as well as the investor, and disclose all relevant risk factors.

Where the relationship between the banks and investors is not advisory in nature, it is advisable that the banks make clear in the relevant documentation and communications that any opinions expressed by the banks are not representations or recommendations, nor do they carry any implied representation, for example.

In determining whether the financial products are suitable for investors, and whether there have been any solicitation, recommendation or misrepresentations to investors, the Court will consider the factual circumstances and conduct of the parties. It is therefore important that banks keep contemporaneous records of any communications with customers or investors, whether in written form or recording of verbal statements.

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