

LEGAL UPDATE

SFC Further Guidance on Suitability Obligation

Following the regulatory changes in 2016 that enhanced suitability requirements on licensed persons when soliciting or recommending investment products to clients, the Hong Kong Securities and Futures Commission (SFC) has on 23 December 2016 issued two sets of Frequently-Asked-Questions (FAQs) to clarify and provide further guidance to the industry on meeting the suitability obligation.

The first set of *FAQs on Triggering of Suitability Obligations* clarifies the circumstances under which the suitability obligation would apply. The second set of *FAQs on Compliance with Suitability Obligations by Licensed or Registered Persons* provides further guidance on the SFC's expectations on satisfying the suitability obligation.

Background

The suitability obligation is often referred to as the cornerstone of investor protection. Under the SFC Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct), it is a requirement of the SFC that a licensed or registered person, when making a recommendation or solicitation, shall ensure that the recommendation or solicitation for the client is reasonable in all the circumstances, 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.

Under enhanced investor protection measures introduced by the SFC following lengthy consultations that extended several years back, new changes were brought about and effective in March 2016, whereby licensed or registered persons would need to comply with the suitability obligation for all individual investors regardless of whether the individual investors are "professional investors" as defined under the Securities and Futures Ordinance (SFO), and also for corporate investors unless the corporate investors are professional investors established as being sufficiently sophisticated under the Corporate Professional Investors Assessment (CPI Assessment) provisions of the Code of Conduct (For details, please refer to our previous [update](#) on the professional investors regime). Suitability obligation could previously be exempted subject to certain conditions, which exemption has now mostly ceased to apply. Further, licensed or registered persons are also now required to incorporate in client agreements a new clause providing for contractual obligation on suitability, unless an exemption from having a client agreement applies (such as for institutional professional investors or for corporation professional investors that pass the CPI Assessment), compliance of which is expected by June 2017 (For details, please refer to our previous [update](#) on the contractual obligation on suitability).

Key Points on Triggering Suitability Obligation

While the suitability obligation shall apply where a licensed or registered person is making a recommendation or solicitation, whether there is any recommendation or solicitation (thereby triggering the obligation) would depend on the facts and circumstances of each case. In the *FAQs on Triggering of Suitability Obligations*, the SFC outlines some factors relevant to be considered to analyze the content and context of communications with clients and some examples on when suitability obligations are likely or unlikely to be triggered.

<i>Factors to consider</i>	<i>Some examples (non-exhaustive)</i>
Whether the communication to client is only factual, fair and balanced information on a product, information about a market or industry	Discussion with client on overall market environment, industry, sector trends or general financial and investment information, basic investment concepts etc., or discussion with client on merits of investing in certain geographical areas or asset classes only, <u>not</u> likely to trigger suitability obligation
Whether the communication contains representation involving invitation or inducement to act or invest	Factual information about specific listed company or specific fund or bonds at client's request, or provision of alerts on updates of factual information about certain listed company, <u>without</u> any prior communication or accompanying message seeking to solicit or recommend the client to trade, <u>not</u> likely to trigger suitability obligation
Whether the communication is targeted to specific clients (such as providing specific recommendation or factual information on products shortlisted based on the client's circumstances or specifications provided by the client)	After provision of factual information about a listed company, follow-up with a call to a client and recommending to buy or sell stock, or discussion with a client or selected group of clients on merits of particular product and implicitly/explicitly presenting the product as being suitable, likely to trigger suitability obligation
Whether the communication is part of a series of multi-step solicitation or recommendation process	(i) If after the wide dissemination of research report on a listed stock, a follow-up call is made to client with recommendation to client to buy or sell the stock, this is likely to trigger suitability obligation;

Discretionary Services

The SFC expressly indicates in the *FAQs on Triggering of Suitability Obligations* that licensed or registered persons that provide discretionary account services are also subject to the suitability obligation, referring to such services as involving the making as well as execution of recommendations. This responds to some doubts in the industry as to whether and how suitability obligation shall be complied for discretionary accounts.

Licensed or registered person providing discretionary managed account services according to an agreed mandate or predefined model portfolio should ensure that the mandate or portfolio is established as suitable to the client, pursuant to a suitability assessment based on the circumstances of the client. The account shall be managed within the parameters of the established mandate or model portfolio, and the mandate or portfolio model should be reviewed with the client on a regular basis and reflect any updates to the client's circumstances.

Accordingly, licensed investment managers providing discretionary management services should also have in place relevant systems and practices for obtaining information on the client's circumstances in order to apply suitability assessment when establishing the mandate, and for regular review.

Updated Guidance on Compliance with Suitability

According to the SFC, the *FAQs on Compliance with Suitability Obligations by Licensed or Registered Persons* replaces the previous FAQs on suitability issued by the SFC on 8 May 2007 in providing further guidance on the standards of conduct expected by the SFC for satisfying the suitability obligation. The practical considerations covered are not intended to be exhaustive, however licensed or registered persons should consider their own circumstances and review their existing systems and practices in light of the FAQs.

With respect to the effect of the FAQs, the SFC stipulates that compliance with the FAQs may be taken into account by the SFC in determining whether a licensed or registered person is fit and proper to conduct the relevant regulated activities.

According to the FAQs, suitability obligation covers:

- knowing your client;
- understanding the investment product to be recommended to a client;
- providing reasonably suitable recommendations by matching risk return profile of each investment product with the personal circumstances of each client to whom it is recommended;
- providing all relevant material information to clients and help make informed investment decisions;
- employ competent staff and provide appropriate training; and
- document and retain the reasons for each investment recommendation made to each client.

The FAQs further sets out clarifications on the expectations on the "how" for complying with these additional stipulations, such as the know-your-client requirements, assessing clients' attitude towards risks, for conducting product due diligence, what may be reasonably suitable recommendations, and helping clients make informed decision. Licensed or registered persons should consider the [SFC FAQs in detail](#) and seek advice where needed on matters relevant and if in any doubt about the application and requirements of the suitability obligation and the FAQs.

Contact Details

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