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By e-mail: client_agreement@sfc.hk and post

Intermediaries Supervision Department
Securities and Futures Commission
35/F, Cheung Kong Center
2 Queen's Road Central
Hong Kong

Dear Sirs

Further consultation on the Code of Conduct client agreement requirements

We refer to the Commission's consultation ("**Further Consultation**") on the proposed "New Clause" proposed for the minimum content requirements for client agreement, as set out in the Code of Conduct for Persons Licensed by or Registered with the Commission ("**Code of Conduct**").

The Hong Kong Association of Banks ("**HKAB**") has considered the proposals, together with the explanations provided by the Commission, in the Further Consultation in consultation.

In summary, HKAB has the following concerns with the proposed New Clause:

1 **Dual track standards with uncertain outcomes** - if implemented, the New Clause will create an unsatisfactory legal and regulatory scenario involving two distinct suitability standards: one established by and interpreted by the Commission and the Hong Kong Monetary Authority, and the second implemented in contract and interpreted by Hong Kong Courts, leading to uncertain outcomes.

2 **Broad and ambiguous language** - the language of the New Clause contains broad and ambiguous language that is open to interpretation.

3 **Documentary fragmentation** - there are legal and practical considerations that will result in the fragmentation of customer documentation.

4 **Inappropriate mechanism** – the New Clause creates ambiguity rather than a fairer client agreement; furthermore if there is a need to create private rights of action for Code of Conduct requirements, the most appropriate route is legislative amendment.

We would be pleased to engage in further discussions with the Commission in relation to the Further Consultation if required.

Thank you again for this opportunity to provide you with HKAB's feedback. Should you have any questions, please contact our Manager .

Yours faithfully

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Further Consultation on the Client Agreement Requirements issued by the Securities and Futures Commission

Submission of The Hong Kong Association of Banks

24 December 2014

Introduction

This paper sets out the views of The Hong Kong Association of Banks ("**HKAB**") in relation to the proposed amendments to the Client Agreement Requirements set out in the Further Consultation on the Client Agreement Requirements issued by the Securities and Futures Commission ("**SFC**") in September 2014.[1]

With the assistance of King & Wood Mallesons, we have examined the proposals outlined by the SFC in the Consultation Paper and provide our answers in the "HKAB's response" section of this written submission. In particular, we have considered the "New Clause" proposed for certain client agreements, which is proposed to state:

> *"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]

We would be pleased to engage in further discussions with the SFC in relation to its proposals and to provide further industry input where necessary.

Unless otherwise specified, capitalised terms used in our response have the meaning given to them in the Consultation Paper.

Executive Summary

HKAB strongly believes in ensuring Hong Kong's continued competitiveness as an international financial centre.

To achieve this, the financial services industry requires clarity as to the standards to which it is subject. In this respect, developments in financial services regulation in Hong Kong should follow the principles of the rule of law, which include certainty. Due process, including legislative involvement, should be followed where material changes to rights and obligations are proposed.

With this in mind, HKAB has concerns about the proposed New Clause. Specifically:

(a) ***dual track standards with uncertain outcomes*** - if implemented, the New Clause will create an unsatisfactory legal and regulatory scenario involving two distinct suitability standards: one established by and interpreted by the SFC (and, in the case of HKAB members, the Hong Kong Monetary Authority ("**HKMA**"))[3] and the second implemented in contract and interpreted by Hong Kong Courts. These will not follow a consistent track as they are tested with new facts and circumstances and, in the case of the New Clause, specific cases over time;

(b) ***broad and ambiguous language*** - the language of the New Clause exceeds the scope of section 5.2 of the Code of Conduct for Persons Licensed by or Registered with the SFC ("**Code of Conduct**") and contains broad and ambiguous language that is open to interpretation;

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1 Consultation Conclusions on the Proposed Amendments to the Professional Investor Regime and Further Consultation on the Client Agreement Requirements, 25 September 2014 ("**Further Consultation**").

2 Paragraph 51, Further Consultation.

3 In light of suitability obligations imposed by the HKMA in relation to non-SFO regulated products.

(c) ***documentary fragmentation*** - there are legal and practical considerations that will result in the fragmentation of customer documentation, if the New Clause is required to be included in the client agreement required by the Code of Conduct. This is unsatisfactory for several reasons, including (importantly) from a client perspective; and

(d) ***inappropriate mechanism*** - HKAB believes that the current framework for investor protection strikes the right balance between investor protection, regulatory involvement and investment choices and responsibility. However, if the SFC believes that:

(i) client agreements need to be "drafted so that they are fairer",[4] HKAB does not agree that the New Clause achieves this aim, because it creates ambiguity rather than clarity in client agreements; and/or

(ii) there is a need to create private rights of action in relation to Code of Conduct requirements, the most appropriate route is legislative amendment. This allows for a more considered approach with an appropriate legal framework that provides greater certainty to key stakeholders.

Based on our review, we also consider that the proposal is unprecedented in comparable sophisticated jurisdictions. HKAB therefore urges the SFC to rethink this proposal and we welcome the opportunity to discuss it further. Further details are set out under "HKAB's response" below.

HKAB's response

We provide the following comments on the proposal for the New Clause, raised in paragraphs 51 to 55 of the Further Consultation.

Dual track standards - potential divergence in interpretation between courts and regulators

1 Suitability has regulatory origins

1.1 HKAB agrees that the concept of "suitability" is a useful aspect of investor protection.[5]

1.2 However, suitability has been developed in a *regulatory* context internationally,[6] with input from market participants, and propagated in various codes and circulars. This has been achieved with limited judicial or legislative involvement, if any.

1.3 In Hong Kong, the concept of suitability has been implemented chiefly through:

(a) section 5.2 of the Code of Conduct ("**Suitability Requirement**"), which applies to solicitations and recommendations of products that fall within the scope of the Code of Conduct: that is, products that fall with the scope of regulated activities under the Securities and Futures Ordinance (Cap. 571) ("**SFO**"), subject to waivers permitted under section 15 of the Code of Conduct in relation to certain professional investors;

(b) related questions and answers published by the SFC,[7] which interpret the Suitability Requirement ("**Suitability FAQs**"); and

(c) in respect of HKAB members, the HKMA's circular dated 13 July 2009 entitled "Selling of Investment Products", which expanded the Suitability Requirement to investment products that are not regulated by the SFO ("**HKMA Expanded Requirement**").

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4 Paragraph 50(e), Further Consultation.

5 Per paragraph 21, Further Consultation.

6 See for example, the final report issued by the International Organization of Securities Commissions' (IOSCO) on "Suitability Requirements with respect to the Distribution of Complex Financial Products"

7 "Questions and answers on suitability obligations of licensed and registered persons who are engaged in financial planning and wealth management business activities ("FAQ")" issued by the SFC on 8 May 2007.

1.4 Various other circulars, statements, findings and negotiated settlements inform the Hong Kong market's understanding of "suitability", including in the context of particular business lines, such as private banking.[8] Collectively, these materials create a discrete body of regulation and industry practice that define how products can be marketed and sold in Hong Kong.

1.5 Critical to the success of this regulation is certainty. It is essential that there is an understanding between regulators, financial services providers and investors about what an appropriate sales process looks like. This understanding can only be achieved where there is consistency, ongoing dialogue and a known 'rule book'.

2 Court treatment of suitability likely to diverge

2.1 Judicial interpretation of suitability is nascent and limited to a handful of cases internationally, with no Hong Kong authority. Courts are not limited by market practice or regulatory standards in their contractual interpretation, and this raises the spectre of divergent interpretation.

2.2 From a review of international authorities, some divergences are already beginning to emerge in judicial interpretations of suitability. We have identified the following issues, by way of example:

(a) Courts have been developing divergent views on what intermediaries must do to satisfy the suitability requirement; in one English case, the High Court used the standard of a prudent financial advisor, having regard to the particular client's portfolio leverage, equity exposure and diversification,[9] but in another Australian case, the standard was reasonable grounds for the intermediary to believe that the product was suitable.[10]

(b) The phrasing of the New Clause allows courts to decide that reasonably suitable requires taking into account other factors which are not currently considered by the New Clause, the Code of Conduct or related materials.[11]

(c) Imposing a suitability requirement into contractual provisions also means that damages will be subject to the contractual principles of causation and remoteness,[12] adding another layer of interpretation, and increasing the likelihood of divergent interpretation.

2.3 Our concern here links to the SFC's own observation that "[t]he potentially relevant ordinances which are associated with consumer protection are not designed specifically for the securities context, and their efficacy would need to be adjudicated in particular cases before the courts." The same will occur if the New Clause is mandated.

3 Unsatisfactory and uncertain result

3.1 In light of the considerations set out in paragraphs 2 and 3, if implemented, the New Clause will create an unsatisfactory legal and regulatory scenario, with two separate and distinct suitability standards:

(a) the first being the (regulatory) Suitability Requirement, as established and interpreted by the SFC and, in the case of HKAB members, expanded by the HKMA; and

(b) the second being the (contractual) New Clause, as interpreted by Hong Kong Courts in the event of litigation.

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8 Per the SFC's circular dated 17 July 2012, entitled "Compliance with Suitability Obligations".
9 See *Zaki & Ors v Credit Suisse (UK) Ltd.* [2011] EWHC 2422 (Comm).
10 See *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65.
11 See *Zaki & Ors v Credit Suisse (UK) Ltd.* [2011] EWHC 2422 (Comm).
12 Current cases have considered these requirements from tort law as they were based on professional negligence, but similar requirements exist in contract law.

3.2 These standards will not follow consistent tracks as they are tested with new facts and circumstances and, in the case of the New Clause, specific cases over time. This is because Hong Kong Courts would not be bound by regulatory guidance such as the Suitability FAQs.

3.3 The inevitable upshot is that financial institutions will be subject to different and potentially conflicting expectations in relation to the marketing and sale of financial products in Hong Kong.

3.4 The following paragraphs articulate additional concerns that HKAB has in relation to the drafting of the New Clause and other material considerations.

Language breadth and ambiguities

Aside from the fundamental question as to whether or not the New Clause should be imposed in client agreements required by the Code of Conduct, the language of the New Clause materially exceeds the present scope of section 5.2 of the Code of Conduct and contains broad and ambiguous language that is open to interpretation.

Reliance on definitions would be necessary, which both complicates client agreements and negates the value of the current principles-based approach to regulation under the Code of Conduct, which we suggest has worked well. In this respect, HKAB disagrees that the New Clause is "clear, certain and...a self-contained contractual term".[13] The following paragraphs illustrate why this is not the case.

4 "Solicit" and "recommend"

4.1 First, the terms "solicit" and "recommend" ("**Trigger Terms**") are not concepts that have a settled legal definition under Hong Kong law. Even in the regulatory context, they remain open to debate.

4.2 For example, certain members have raised concerns about whether and how the Trigger Terms apply in connection with the application of the Suitability Requirement in the following situations, in addition to those raised in HKAB's first round submission to the SFC:

(a) Mass marketing initiatives that are not directed to specific clients and are therefore not tailored to their individual needs and circumstances.

(b) An intermediary recommends particular products in compliance with the Suitability Requirement, but the customer proactively requests, on their initiative, another specific product.

(c) Orders made on an 'execution only' basis, where the product is identified by the client, and the intermediary is only responsible for placing the order. This includes where the client places the order through a call-centre or e-platform, and staff of the intermediary has no direct contact with the client placing the order.[14]

4.3 These situations are ones where the Suitability Requirement is either unclear or inapplicable, and the New Clause does not articulate an explanation for their interpretation. Members are of the view that the current regulatory position already involves points upon which there remain differing views in the market, without considering the additional layer of complexity to which the vagaries of contractual interpretation would add if this proposal were to proceed.

4.4 In any event, a regulatory explanation of particular points of uncertainty or the suitability obligation generally would not bind a Hong Kong Court.

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[13] Paragraph 53, Further Consultation.

[14] See Recommendation 14 of the HKMA's circular titled "Applicability of Enhanced Measures to Sales of Investment Products to Private Banking Customers" dated 20 January 2012

5 "Any financial product"

5.1 Second, the New Clause refers to "any financial product". While "financial product" is defined in Part 1 of Schedule 1 to the SFO to refer to regulated products,[15] that would not be evident on a plain reading of that term within the context of a client agreement. Rather, it suggests a much broader concept that substantially exceeds the current scope of:

(a) the Suitability Requirement, which is limited by the scope of the Code of Conduct, which applies to a "client", a defined term in the SFO that links to the provision of activities that constitute regulated activities under the SFO; and

(b) the Expanded HKMA Requirement, which refers to "investment products which are not regulated by the SFO, such as currency and interest rate linked deposits and derivatives".

5.2 Indeed, there is a substantial risk that this term could be interpreted to capture basic banking products such as plain vanilla deposits and loans.

5.3 To avoid this interpretation, client agreements would either need to cross-reference the definition of "financial product" in the SFO or include lengthy definitions in the client agreement,[16] neither of which is ideal from a customer experience perspective. Even then, the New Clause would go beyond what the Suitability Requirement currently requires – for example, all structured products fall within the definition of "financial product" in the SFO, but they technically may not fall within the scope of the Suitability Requirement because the sale of structured products does not automatically trigger a regulated activity. This demonstrates the real legal and practical issues with implementing the proposal. Please also refer to paragraph 7, where we describe the issue of documentary fragmentation.

6 "Reasonably suitable"

6.1 Third, HKAB is of the view that the current phrasing of "reasonably suitable" is overly broad and open to divergent interpretation. It leaves open the possibility of considering many factors of suitability that are inconsistent with current regulatory standards and market practice, leading to uncertainty in the financial services industry.

6.2 Again, the Suitability FAQ and related materials will not bind a Hong Kong Court and this term is likely to assume a new interpretation as a matter of common law. We therefore disagree with the view that "the New Clause is also entirely justifiable as a contractual term as it is not in itself mandating the intermediary to behave in a particular way".[17] Over time, case law will determine what actions need to be taken to meet this standard.

Documentary fragmentation

7 Documentary fragmentation is likely and will affect clients

7.1 As a general proposition, HKAB members try to streamline their client documentation to enhance consistency, minimise overlap and improve client experience overall. This means that a client agreement required for Code of Conduct purposes[18] may also embody terms relating to other products and services, such as basic deposits, loans, cheque facilities and simple non-leveraged foreign currency transactions.

7.2 Currently, section 6 of the Code of Conduct contains reasonably basic requirements relating to information disclosure: for example, information in relation to an intermediary and client information, as well as general guidance on the description of products. As substantive

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15 Specifically, any securities, any futures contract, any collective investment scheme, any leveraged foreign exchange contract or any structured product, each as further defined in the SFO.

16 While the definition of "financial product" is reasonably simple on its face, it cross-refers to a number of other lengthy definitions.

17 Paragraph 53, Further Consultation.

18 Which HKAB interprets as being the core client agreement required when SFO-regulated services are being provided to clients, pursuant to section 6.1 of the Code of Conduct (except where an exemption is available pursuant to section 15.5(b) of the Code of Conduct), which governs the overall relationship between the client and the intermediary in relation to such services.

provisions only apply in respect of specific products, the wide scope of "client agreement" requirements in section 6 of the Code has not been an issue.

7.3 However, the requirements of the New Clause change this situation significantly. The New Clause imposes substantiative requirements imparting positive obligations on the intermediary and the prospect of civil liability.

7.4 HKAB is concerned that incorporating the Suitability Requirement into all client agreements without qualification, in the form of the New Clause, will have an extraordinarily wide potential reach. This could extend the Suitability Requirement to activities and services for which it was never intended and produce anomalous results. For example, members may be required to insert the New Clause into client agreements for services such as deposits, related account services, and non-leveraged foreign currency transactions. HKAB is of the view that these products, many of which are longstanding and uncontroversial in nature, are appropriately and deliberately beyond the SFO regime, the Suitability Requirement and the HKMA Expanded Requirement

7.5 If the New Clause is required to be included in the client agreement required by the Code of Conduct, members may therefore be forced to consider separating terms and conditions that relate to SFO-regulated activities from others, to ensure that the New Clause is not interpreted in an unintentionally broad manner. This would result in documentary fragmentation, which is unsatisfactory for several reasons, including (importantly) from a client perspective.

New Clause is an inappropriate mechanism

8 Current approach strikes the right balance

8.1 HKAB believes that the current framework for investor protection strikes the right balance between investor protection, regulatory involvement and investment choices and responsibility.

8.2 Furthermore, while HKAB recognises that Hong Kong Courts would, over time and potentially with the assistance of expert witnesses and interveners, provide guidance on the New Clause through their decisions, judicial interpretations are case-specific – any other observations or commentary are merely "*obiter dicta*", which are not binding on future decisions. Given the myriad of potential specific situations that could arise, numerous cases would need to be adjudicated upon before the scope and meaning of the New Clause is reasonably defined from a legal perspective.

8.3 The judicial process means that it will take substantial time, potentially several years, for such litigation to be adjudicated upon, especially where appeals are factored in. This will occur at substantial cost to intermediaries, clients and potential interveners such as consumer groups. We expect a number of cases will settle directly or through mediation before judgment, setting no binding precedent for other industry participants to follow, which perpetuates a lack of legal certainty.

8.4 This puts well-established market practices at risk, which could persist for a number of years.

9 New Clause does not result in "fairer" contracts

9.1 The SFC notes in the Further Consultation that the New Clause:

> *"is principally aimed at redressing a current imbalance in the way client agreements are being drafted so that they are fairer."*[19]

9.2 HKAB does not agree that the New Clause achieves this aim, because it creates ambiguity rather than clarity in client agreements. The concept of fairness in client agreements is very closely aligned with clarity.

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[19] Paragraph 50(e), Further Consultation.

10 Private rights of action are more appropriately housed in legislation

10.1 If the SFC believes that there is a need to create private rights of action in relation to Code of Conduct requirements, the most appropriate route is legislative amendment. This allows for a more considered approach with an appropriate legal framework that provides greater certainty to key stakeholders.

10.2 In this respect, it is our observation that legislative provisions that provide for a private right action have highly detailed, term-by-term definitions of the relevant conduct in question, rather than leaving matters up to the courts. For example:

(a) for the civil regime relating to market misconduct in the SFO, substantial guidance is given on each of the elements, including for insider dealing, "connected with the corporation", "inside information" and "listed securities" specific to that section; and

(b) the Trade Descriptions Ordinance (Cap. 362) provides lengthy definitions of the terms "trade description", "trade mark" and "false trade description", as well industry-specific provisions to capture market practice in the goldware industry. There is also flexibility for the government bodies to name and describe certain products as falling within certain categories.

10.3 Bearing in mind that the private right of action for market misconduct is a product of law (not a Code of Conduct provision), we would expect that that provisions imparting analogous civil liability for breaches of the Suitability Requirement to have the same amount of detail, formality and flexibility.

Conclusions and next steps

11 New Clause is fundamentally inappropriate

11.1 In light of the numerous issues set out above, the HKAB is of the view that there are substantial legal and practical difficulties to implementing and interpreting the New Clause and does not achieve the stated aims of the SFC in the Further Consultation. As a result, its implementation would neither enhance financial services compliance in Hong Kong nor promote the interests of Hong Kong as an international financial centre.

11.2 HKAB maintains that, to extent it is necessary for private investors to seek recourse for the breach of the Suitability Requirement, the appropriate method is to legislate a private right of action. The scope of a legislative right of action can be clearly defined, and refined with the benefit of input from all stakeholders, as part of the legislative process.

12 Next steps

12.1 HKAB is open to discussing any aspect of this response with the SFC.

12.2 We also urge the SFC to take its time in consulting all views of the financial community regarding the New Clause. Moreover, as we understand that the SFC is currently undergoing a review of the Suitability Requirement, HKAB suggests postponing further consultation and implementation of the New Clause until the SFC completes this review.

12.3 We also ask:

(a) to be involved in further consultation relating to the Suitability Requirement, to address current interpretative concerns on the regulatory side; and

(b) that to the extent that any other mandatory provisions are proposed for client agreements, the terms used are carefully drafted in such a way that the relevant requirement is clear, referable to objectively ascertainable information, expressly contemplative of a best-efforts approach, does not include value-laden terms and ultimately, does not cause a potential divergence of interpretation between regulatory and legal requirements.

12.4 We look forward to the SFC's response.