

**IFPHK's Response to the Securities and Futures
Commission's Further Consultation on the Client Agreement
Requirements**

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Institute of Financial Planners of Hong Kong (IFPHK) Profile





Background

IFPHK was established in June 2000 as a non-profit organization for the fast-growing financial industry. It aims to be recognized in the region as the premier professional body representing those financial planners that uphold the highest standards for the benefit of the public.

The IFPHK is the sole licensing body in Hong Kong authorized by Financial Planning Standards Board Limited to grant the much-coveted and internationally-recognized CFP^{CM} Certification and AFPTM Certification to qualified financial planning professionals in Hong Kong and Macau.

It represents more than 6,800 financial planning practitioners in Hong Kong from such diverse professional backgrounds as banking, insurance, independent financial advisory, stockbroking, accounting, and legal services.

Currently there are more than 147,000 CFP certificants in 25 countries/regions; the majority of these professionals are in the U.S., Canada, China, Australia and Japan, with more than 4,800 CFP certificants in Hong Kong.

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IFPHK's interest in this consultation

The IFPHK responded to the Securities and Futures Commission's (the "SFC's") consultation paper on the proposed amendments to the professional investor and the client agreement requirements in August 2013. Based on the comments from the industry, the SFC launched a further consultation on client agreement on 25 September 2014. In light of the above, the IFPHK has a vested interest in the Consultation Paper and wishes to express its views on the further consultation.

IFPHK's representation

The IFPHK was founded by 30 members (the "Founding Members") in order to raise the standards of financial planners and highlight the importance of sound financial planning advice.

The IFPHK currently has 47 Corporate Members including banks, independent financial advisors, insurance companies, and securities brokerages. With our Corporate Members providing a full spectrum of the client services and products, the IFPHK is well positioned to understand the needs, concerns and aspirations of the financial planning community.

SFC Consultation

On 25 September 2014, the Securities and Futures Commission (the “SFC”) released consultation conclusions on proposed amendments to the professional investor regime and launched a further consultation on client agreement requirements. The consultation period ended on 24 December 2014.

Having reviewed all of the comments received during the consultation, the SFC has decided to proceed with the proposal not to allow intermediaries when serving individual professional investors to be exempt from the suitability requirement and other fundamental requirements that have a significant bearing on investor protection under the Code of Conduct for Persons Licensed by or Registered with the SFC (the “Code”)

Other features of the revised professional investor regime include the following:

- individual professional investors and corporate professional investors will continue to be allowed to participate in private placement activities;
- the minimum monetary threshold for qualifying as individual professional investors and corporate professional investors will be maintained at the current levels; and
- a principles-based criteria will replace the specific tests now used to assess whether exemptions to the Code requirements apply when intermediaries serve corporate professional investors.

The amendments relating to the professional investors regime will become effective on 25 March 2015.

In response to market feedback, the SFC has modified its proposals on client agreement requirements and seeks to further consult the public on the wording of a proposed new clause to be incorporated into all client agreements as a contractual term. The SFC considered the respondents’ views and its responses are as follows:

- The SFC disagreed that prescribing a term in a client agreement would be contrary to the legal principle of freedom of contract.
- The SFC agreed that the obligations under the Code are distinct from the contractual obligations under a client agreement. Hence, the SFC recommended that instead of requiring each client agreement to cross-refer to the Suitability Requirement, a new self-contained clause that is more amenable to interpretation by the courts should be prescribed for inclusion in the client agreement.
- In response to some respondents’ comments that the proposed Code change is so significant that it should be done by legislation, the SFC pointed out that section 169 of the Securities & Futures Ordinance (“SFO”) provides that the SFC may publish codes of conduct for the purpose of giving guidance relating to the practices and standards with which intermediaries and their representatives are ordinarily expected to comply.
- The SFC disagreed with some respondents’ comments that there are adequate legal remedies available to aggrieved investors under common law and other applicable ordinances. The SFC pointed out that there are cases that indicate common law remedies are negated by express contractual terms and the courts are reluctant to imply obligations contrary to express contractual

provisions or impose a contractual duty which the intermediary has not expressly undertaken under a client agreement. Thus, the SFC believed that the current framework should be further enhanced.

- In response to comments that the proposed changes will potentially open the floodgates to vexatious and frivolous litigation, the SFC proposed a new clause that is principally aimed at redressing a current imbalance in the way client agreements are being drafted so that they are fairer.

In light of the above, the SFC proposed the following new clause to be inserted into 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.”

According to the SFC, the above new clause is formed based on the following key elements:

1. The clause will only be triggered upon an intermediary soliciting the sale of or recommending a specific financial product to the client where the solicitation or recommendation is not reasonably suitable for the client. It should be a question of fact that the court is entirely capable of adjudicating.
2. The requirement that the financial product must be “reasonably” suitable imports an objective standard which is both sufficiently precise and entirely familiar so as to facilitate adjudication by the court.
3. The factors about the client to which an intermediary has to have regard are clearly stipulated, being his financial situation, investment experience and investment objectives.

IFPHK's Submission

In the IFPHK's previous submission, the IFPHK highlighted the following regarding the proposal of referencing suitability requirements in the client agreement:

- The IFPHK considered that unlike quantitative requirements such as the "bright line test", whether a recommendation is suitable to a client is judgmental which could lead to different interpretations. By incorporating suitability requirements in all client agreements as contractual terms, intermediaries could face an increasing number of disputes with clients. It will expose intermediaries to higher legal and litigation risk.
- Besides, the suitability is only relevant when there is advice. Although there is no defined execution-only regime like the one under the Markets in Financial Instruments Directive ("MiFID"), intermediaries such as traditional securities brokerage services are offering purely transaction-only services. Suitability assessment is irrelevant to intermediaries that are providing "execution-only" services.
- The collapse of Lehman Brothers and the high degree of political involvement in the event highlighted the risk of moral hazard. With the proposed changes on client agreements, investors may be left with the perception that they can resolve through the court on any risky or irresponsible investment decision made by them, which may be contrary to the purpose of establishing the Financial Dispute Resolution Centre ("FDRC") and the Investor Education Council ("IEC"). The former is intended to enhance consumer protection by providing more accessible and affordable alternative dispute resolution channels. The latter is established to improve the financial literacy and capability of investors so as to help them make sound financial decisions through the provision of holistic financial education across the entire financial sector.

The IFPHK thinks that the proposed new clause is a better suggestion compared to the previous proposal, because:

- The sentence "*the financial product must be reasonably suitable*" is a clearer and more concrete description compared to the previous proposal.
- The factor about the client to which an intermediary has to have regard are stipulated as the client's financial situation, investment experience and investment objectives, so the scope of liabilities to an intermediary has been limited to a certain extent.
- The sentence "*If we [the intermediary] solicit the sale of or recommend any financial product to you [the client]*" suggests that the new clause only applies to intermediaries who will solicit the sale of or recommend any financial product to clients. Intermediaries such as traditional securities brokerage services who offer purely transaction-only services will not fall into the regime.

The IFPHK understands the rationale behind the SFC's proposal of protecting investors against unfair contractual terms. Nevertheless, the IFPHK still has certain concerns on the new clause that the SFC may wish to clarify with the industry:

- Despite the clause contains clearer description, it still lack of definitive criteria. For instance, “reasonably suitable” is based on factors like the client’s financial situation, investment experience and investment objectives. All these terms do not have an objective definition and subjected to interpretation by the courts. The SFC may wish to make the clarification in an FAQ.
- As mentioned in the previous submission, there is no defined execution-only regime like the one under the Markets in Financial Instruments Directive (“MiFID”) in Hong Kong, however, there are reasons to assume that only licensed corporations engaging in Type 4 Advising on Securities and Type 5 Advising on Futures Contracts Regulated Activities will be applicable to the proposed changes. The SFC may wish to make the clarification in an FAQ.
- The IFPHK always advocates the concept of financial planning and regards suitability as the cornerstone of investor protection. Conducting proper suitability assessment is the main role of a financial planner. Indeed, one of the requirements in the Rules of Conduct of the IFPHK’s Code of Ethics and Professional Responsibility is that the *“financial planning professional shall make and/or implement only recommendations that are suitable for the client”*. Despite our principle of promoting the importance of suitability, the Code of Ethics and Professional Responsibility do not have a rule that mandate financial planners to insert suitability requirements into client agreements. The Rule only requires that if the services include financial planning or material elements of the financial planning process, prior to entering into an agreement, the financial planning professional shall provide written information and/or discuss with the client the following:
 - the obligations and responsibilities of each party under the agreement with respect to defining the client’s objectives, needs and priorities;
 - gathering and providing appropriate data;
 - examining the result of the client’s current course(s) of action without changes;
 - the formulation of any recommended actions;
 - the implementation responsibilities for the financial planning recommendations; and
 - the responsibilities for reviewing the financial planning recommendations.

The IFPHK only requires that the financial planning agreement shall specify the parties to the agreement, the date of the agreement and its duration, how and on what terms each party is able to terminate the agreement and the services to be provided as part of the agreement. Thus, it is the SFC’s responsibility to clearly explain to the industry the reason behind imposing prescriptive requirements in client agreements.

- Although the SFC explained that investors in Singapore and the UK are able to seek redress and damages by exercising their statutory right of action for breaches of similar requirements as in the proposals, no abuse of process has been reported. The IFPHK still considers that the priority is to encourage investors to use an alternative resolution regime. In 2013, the Financial Dispute Resolution Centre (“FDRC”) received 31 applications for mediation services. The FDRC has sufficient capacity to handle more mediation cases, and thus investors should be encouraged to use the mediation services under the FDRC for claiming amounts not exceeding HK\$500,000.

