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Hong Kong court ruling on mis-selling will drive scrutiny of private wealth relationships

Sep 15 2017 Ajay Shamdasani, Regulatory Intelligence

A landmark decision by Hong Kong's Court of Appeal on the obligations that advisers owe to private wealth customers will require the territory's banking and financial institutions to exercise greater scrutiny over the products they sell, industry officials said. The comments followed the recent dismissal of an appeal by the Bank of Singapore against a judgment of the local Court of First Instance (CFI), which found that the bank had breached its advisory duties to private wealth customers (Chang Pui Yin v Bank of Singapore Limited [2017] HKEC 1493).

"The question with the sale of any financial product is whether banks are following and implementing best practice. Judgments like this one, coupled with the Securities and Futures Commission [SFC]'s increasingly hard line in this area — reflected in particular with the introduction of the suitability clause as per the SFC's Code of Conduct — highlight the risks to banks if this is not done," said Gareth Hughes, partner at Ashurst in Hong Kong.

"Legal and compliance teams should, therefore, carry out regular surveillance to ensure that sales staff are fully complying with policies on acceptable sales practices. This includes the need for risk profiles to be accurately and properly recorded, and that the risk level of financial products is accurately assessed to ensure that they are only sold to customers with a corresponding risk appetite," Hughes said.

"The new SFC Code of Conduct requirements should help institutions find a better compliance pathway to aligning contractual provisions and the services actually provided," said Syren Johnstone, a principal lecturer at the University of Hong Kong's (HKU) Faculty of Law. Johnstone said the schism in mis-selling cases was, in part, about when it was right to apply contractual estoppel "where the customer has no bargaining power over the terms of the contract".

The Court of Appeal's decision in this case is unusual in that Hong Kong courts have generally sided with institutions in mis-selling cases, local lawyers said.

"Although the Court of Appeal overturned the CFI's finding that the non-reliance and non-advisory clauses in the bank's customer agreements did not apply to the customer's account, it held that the bank could not rely on these clauses as they

were unconscionable under the Unconscionable Contracts Ordinance (UCO) and an unreasonable exclusion of liability under the Control of Exemption Clauses Ordinance (CECO)," Ashurst said in an alert summarising the case.

"This judgment could spur dormant mis-selling proceedings back to life. Plaintiffs that have suffered losses as a result of alleged financial services mis-selling will be hopeful that they too can rely on the UCO and CECO," the alert said.

The judgment has also highlighted the potential implications of the SFC's "suitability clause" for client agreements, which became mandatory from June 2017 onwards. To prevent future claims, it will therefore be essential for firms to have compliance procedures in place to ensure customer risk profiles are correctly recorded and to monitor the activities of sales staff.

"In-house counsel dealing with any pre-existing claims should carefully assess the underlying facts to determine whether the plaintiffs may be able to successfully rely on the UCO and CECO. Following the Court of Appeal's decision, it is not enough to simply rely on non-advisory and non-reliance clauses in customer agreements to defend mis-selling claims," the alert said.

Compliance implications

Some predicted the net result would be to push more checks into compliance and legal.

"Instead of relying on bankers' training and bank policies, this case makes room for compliance to be used as a checker function to give a four-eyes check," said Maya Deering, manager at Maven Due Diligence in Singapore.

"This would ensure that individuals truly are experienced investors when sold complex products and question any scenario whereby a banker signs off on behalf of a client," she said.

The decision indicates that courts may lean toward a "substance over form" approach to interpreting "non-reliance" and "non-advisory" clauses, compliance experts said. These clauses are commonly inserted into boilerplate contract templates as a blanket exclusion of liabilities by alleging that the client accounts were "execution-only", said Josephine Chung, director of CompliancePlus Consulting in Hong Kong.

Since the court had ruled that such disclaimers would be deemed unconscionable and thus non-actionable, financial institutions now need to ensure from the outset that any services or advice provided to clients comply with the new rules, Chung said.

The SFC made the inclusion of a suitability clause in client agreements mandatory as of March 2016 and since then, it has been a contractual obligation for financial institutions to consider the financial situation, investment experience and investment objectives of clients when selling any financial products.

Chung said a breach of this obligation would entitle aggrieved clients to claim compensation through a contractual claim.

She said firms should ensure they had proper internal compliance policies in place, and that all employees — and particularly front-line staff responsible for sales, account-opening and order placing — were familiar with the procedures. This should be monitored closely by the compliance team, she said. She also advised firms, where applicable, to make audio recordings of client communications as additional evidence to written documents, since this had proved important in past court cases.

Firms should also ensure they had clear procedures for reporting complaints to management or compliance, and complaints were not covered up.

Mis-selling still a problem

Such cases beg the question as to why mis-selling still appears to be so pervasive almost 10 years after the global financial crisis, and especially after the Lehman minibonds affair that affected investors in regional financial hubs such as Hong Kong and Singapore.

"Other than appeal cases, most of the Lehman minibonds series of court cases have already been settled and the floodgate of cases seems to have come to a halt. As contract claim cases have a limitation period of six years under the Limitation Ordinance (Cap 347), it is also unlikely that we will be seeing new cases of Lehman minibonds investors coming to court," Chung said.

She said, however, the Bank of Singapore appeal ruling might prompt investors who had experienced mis-selling to seek to rely on the decision.

She said that, with the new suitability clause requirement coming into force, it remained unclear how Hong Kong courts would interpret the duties owed by institutions in assessing the suitability of clients.

Financial institutions must remain vigilant

Since the 2008 financial crisis, Hong Kong institutions have adapted their sales practices to mitigate the risks both to themselves and customers, including in response to new regulatory requirements, but practitioners stressed it was important for firms to remain vigilant as memories of the crisis faded.

"Memories can fade over time, so it will be important for financial institutions to remember the lessons learned from the financial crisis and to keep those risks in mind, even during periods of relative market stability," said James Comber, partner at Ashurst in Hong Kong.

"While there are opportunities to mis-sell, bankers will always take them, and while there are opportunities to 'mis-buy', clients or investors will always take them. Having been in the region for most of this decade it is hard for me to pinpoint why it is a 'local' problem other than this region continues to grow by taking opportunities and using differences. Unfortunately, this, like any other regulatory guidelines, will be implemented differently by each bank, and differently across jurisdictions," Deering said.

One possible solution, therefore, might be for regulators to adopt a far more prescriptive approach. Deering this, "would take away ambiguity and banks' opportunity to compete with each other on 'client friendliness' in accordance with their risk appetite. It would also take away the bank's responsibilities of ensuring they are doing the right thing so [it is] clearly not the best solution."

A spokesman for the SFC said the regulator had nothing further to add.

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