Mitigating the risk of regulatory complaints and claims resulting from recent market volatility

20 March, 2020

Debevoise & Plimpton's Hong Kong litigation team has significant experience of advising wealth management firms and commercial banks in disputes with customers. In this bulletin, we draw on our experiences and pick out some steps that can be taken to mitigate the risk of regulatory complaints and claims arising from the recent market volatility triggered by the COVID-19 pandemic.

Background

As a leading financial centre, Hong Kong has a large wealth management industry and non-exchange traded investment products have long been popular with retail investors. Following the Lehman Brothers "mini-bond crisis" in 2008 / 2009, the Securities & Futures Commission (**SFC**) tightened its regulation of the sale and recommendation of "complex products". In particular, paragraph 5.5 was introduced to the Code of Conduct[1] which requires intermediaries to ensure that a complex product is suitable for a customer and that sufficient information and risk warnings are given. Further, since June 2017, intermediaries have been required to include a "suitability clause"[2] in customer agreements stating that the intermediary is precluded from derogating from their suitability obligations.

In recent years, the volume of sales of structured products has grown rapidly. According to the SFC's most recent survey[3], the aggregate transaction value of sales in 2018 was $508 billion, compared to $380 billion in 2016. The SFC has also noted that investors have "*bigger risk appetites*" due to the then favourable market sentiment and the "*amounts for equity-linked products increased by 102% and for non-investment grade corporate bonds by 65%.*"

[1] Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

[2] Clause 6.2(i) of the Code of Conduct

[3] Survey on the Sale of Non-exchange Traded Investment Products (December 2018)

The SFC has been closely monitoring firms engaged in the sale of structured products and has routinely issued guidance to intermediaries. Notably, in January 2018, the SFC issued a circular reporting that it had "*identified a number of compliance failures during its on-site inspections and investigations of the distribution of complex bonds and structured products*"[4] and in December 2018 the SFC issued a circular reminding "*intermediaries to observe the requirements governing selling practices, including the suitability obligations under the Code of Conduct, when they distribute structured products and corporate bonds with complex features or high risks*"[5].

Given the SFC's fundamental role in protecting investors, the SFC will undoubtedly be keeping a close eye on recent market developments.

Recent market volatility

The Cboe Volatility Index (VIX Index) measures volatility over the coming 30 days and is colloquially known as the "fear gauge". On 16 March 2020, the S&P 500 tumbled 12% before recovering by 4% leading the VIX index to spike at 82.69. The previous record high was 80.86 on 20 November 2008.

This volatility would have caused significant losses to equity-linked structured products, particularly those products with internal leverage or a multiplier effect. Where such products are purchased using external leverage, customers are likely to have been required to post further margin to cover book losses. Failures to meet margin calls can result in investments being terminated or "closed out", resulting in losses being crystalised.

Mitigating the risk of regulatory complaints or claims

When customers experience losses, there will be an inevitable uptick in complaints and claims against intermediaries that sold or recommended the investments. A large proportion of such complaints will relate to the suitability of the relevant investment, but complaints can also arise in relation to the procedures that intermediaries are required to follow in handling investments that need to be managed or terminated. We set out below some steps that might help mitigate the risk and impact of customers making regulatory complaints or bringing claims:

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[4] Circular to all licensed corporations Compliance failures in the distribution of fixed-income and structured products (25 January 2018)

[5] Circular to intermediaries Distribution of complex and high-risk products (7 December 2018)

1. The first obvious step is to ensure that the various departments within an intermediary work closely together. We regularly see issues arising from miscommunication between departments, which have different sets of priorities. Customer complaints can also be aggravated if they are not escalated appropriately by relationship managers. Therefore, regular communication between relationship managers, risk, credit, compliance and legal departments is key.

2. Ensuring that close-out procedures are consistent with contractual terms and that such procedures are understood and followed properly. In our previous experience, avoidable errors are made in failing to give correct notification to customers of margin calls or applying the incorrect close-out procedure.

3. As ever, relationship managers should keep a record of any discussions with customers in which advice or recommendations are given. This is particularly important in times of market stress. Further, in circumstances where an intermediary is exercising its contractual rights, this should be communicated clearly to customers and with reference to the relevant contractual provisions.

4. Documentary records of advice given at the time an investment recommendation is made can be crucial to defeating claims or addressing concerns about regulatory compliance. Therefore, it is essential that relevant documentary records are preserved and that any routine document destruction is put on hold. This will require documentary preservation notices to be issued quickly and to the relevant personnel.

5. In circumstances where there are a significant number of complaints, consider establishing a protocol for dealing with complaints fairly and efficiently. Some financial institutions establish criteria for accepting complaints (and offering redress) or rejecting claims.

6. Where complaint handling is conducted by non-lawyers, consideration should be given to protecting privilege as well as when more serious complaints should be escalated to the legal department. This can protect documents from disclosure in court or regulatory proceedings.

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If you would like to discuss any of the matters raised in this bulletin, please do not hesitate to contact us.

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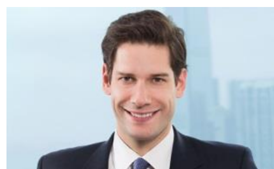
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