

Liability Determination of Financial Institutions' Breach of Suitability Obligations Take the Obligation to Inform and Explain as an Example

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ABSTRACT

The Suitability Obligation is an essential legal institution in the financial market to protect investors. The Minutes of the National Court Work Conference for Civil and Commercial Trials in 2019 ("The Minutes") has made detailed provisions on the liability determination of financial institutions for violating suitability obligations. However, some of the provisions in "The Minutes" still have a large room for discretion. Different courts hold different opinions in judgments, and scholars also have different attitudes, especially related to the obligation to inform and explain ("the obligation"), one of three criteria for judging the performance of the Suitability Obligation. Basing on the analysis of relevant cases from 2016 to 2021, and combined with the comparative study of laws in different countries, this paper takes "the obligation" as the starting point, and analyzes relevant issues about the liability determination of financial institutions' breach of Suitability Obligations. During the research process, the author found the loopholes of the current provisions and the significance of cases. Furthermore, the author puts forward suggestions to improve the measurement standards to effectively promote the unification of the judging rules. These suggestions can improve the litigation mechanism to protect investors, and ultimately promote the construction of a healthy financial market.

Keywords: *Financial institutions, Suitability obligation, Liability determination, Obligation to inform and explain, Judicial adjudication*

1. INTRODUCTION

The Suitability Obligation in the field of financial law originated from the self-discipline rules of NASD. One of the reasons why its potential usefulness in realizing higher standards of moral behavior was valued was that NASD found that a regulatory system mainly relying on the information disclosure system was not enough to ensure the effective protection of the interests of investors[1]. In China, the earliest provision on the Suitability Obligation was the Interim Measures for the Administration of Personal Financial Services of Commercial Banks issued by the China Banking Regulatory Commission in 2005. Up to now, although various regulatory agencies have systematically regulated the financial institutions' performance of Suitability Obligations, there are still many problems in terms of the subject of liability, objective elements, causality, the burden of proof, and the scope of damage compensation. The provisions are not clear enough, and the attitudes of different courts are inconsistent in

practice, resulting in limitations in the protection of investors.

Considering the length and the importance of the content, this paper mainly uses empirical research method to study the difficult problems related to the objective elements in the liability determination. The degree to which financial institutions fulfill "the obligation" will directly affect the degree to which investors know the risks and benefits of the financial products and services they purchase. Therefore, this paper mainly makes a detailed analysis of "the obligation", which is the core issue of the objective elements. The author searched the relevant cases from 2016 to 2021 with the keywords of "suitability obligation", "suitability doctrine" and so on in two databases, including China Judicial Document Network and Wolters Kluwer. As of 20th August, 2021, more than 1000 judgment documents have been obtained. The author dealt with these large number of cases as follows: firstly, simply de duplication by comparing the case numbers. Secondly, considering the particularity of

financial institutions as the subject of responsibility. Thirdly, reading the main part of each case for relevantscreening. Ultimately, classifying and analyzing the relevant cases. At the same time, this paper will also use the research method of comparative law to deeply analyze the measurement of “the obligation”. The author will propose some suggestions to promote the perfection of the national financial system, the unification of judicial rules and the protection of investors' rights and interests.

2. SUBJECTIVE STANDARD AND OBJECTIVE STANDARD

2.1.The specific meaning of the two standards

As for how to measure whether financial institutions have fulfilled “the obligation”, “The Minutes” clearly defined the judgment standard of the combination of “the objective standard” and “the subjective standard”. The so-called objective standard refers to whether “the obligation” is fulfilled according to the general understanding of general rational people. It can be understood that when performing the obligation, financial institutions should make the wording clear, simple and accessible, and can be comprehended by ordinary rational people. Besides, the subjective standard refers to judging whether “the obligation” has been fulfilled by analyzing the personalized situation of each investor. Therefore, financial institutions should inform and explain to varying degrees after fully knowing the understanding capability of each investor until the investor can comprehend relevant information.[2][3].

2.2.Advantages and disadvantages of the two standards in application

In judicial adjudication, judges apply objective standard can quickly and formally recognize whether financial institutions have fulfilled “the obligation”, but ignore the personal characteristics of investors, which will increase the risk of financial institutions undertaking responsibility. On the contrary, the application of subjective standards can reduce the risk of financial institutions. However, because the conditions of investors vary from person to person, judges need to spend more time to comprehensively review whether the financial institutions have fully informed and explained the investors about the benefits and risks of financial products or services, and whether the investors comprehend the contents of the notice and make investment decisions on this basis. Accordingly, under the premise of inversion of the burden of proof, the difficulty of proof of financial institutions will increase significantly. It should be noted that since there are advantages and disadvantages of two standards, their application cannot be excluded only because of severity or inconvenience.

3. PRACTICAL FUNCTION OF “THE PRINCIPLE”

3.1.Manifestation of “The Principle” in practice

The purpose of “The Minutes” is to standardize the difficult problems in civil and commercial trials, including the liability determination of financial institutions for violating the Suitability Obligations. In this issue, the measurement standard of “the obligation” is essential, so it is necessary to clarify it. Virtually, in many cases involving the Suitability Obligation in the past, many judges have adopted the combination of “objective standard of general rational people” and “subjective standard of consumers”, which is just stipulated in black and white in “The Minutes”. For instance, in the judgment of the Supreme People's Court in the case of “(2018) No. 5679”, judges said that “financial institutions should determine the degree of obligation to inform and explain according to the risk of products and the personal conditions of investors, such as past investment experiences, education level, etc. combining the objective criteria that general people can understand and the subjective criteria that investors can understand. Therefore, the judges finally determined that the original judgment did not distinguish the different situations of different investors, and it was inappropriate to require the financial institution to bear the same proportion of responsibility for all investors involved.

3.2.The significance of defining “the principles” by “the minutes”

It can be seen that “The Minutes” has stipulated “The Principle”, which is of great significance. Above all, it can provide judges with guidance in practice, avoid different attitudes of different courts, resulting in different judgments in the same case, and then enhance the transparency and predictability of relevant trials as well as improve the judicial credibility. Take the “(2019) No. 3178” case tried by the Beijing Higher People's Court as an example, the judges applied objective standards and ignored numerous subjective facts. For instance, the high frequency of the investor's purchase of financial products, accumulation of investment experiences, evaluation as an investor that suitable for purchasing the product, and mastery of financial legal knowledge. Basing on this perspective, the judges directly determined that the Enji branch of China Construction Bank violated the Suitability Obligations that should be undertaken as a commission agent, and should compensate the investor for all losses suffered due to the purchase. However, if the judges consider subjective factors such as the previous investment experiences, and under “The Principle”, the branch can claim that its improper promotion behavior has not affected the independent decision of the investor, and ask for relief of responsibility. Through the case analysis, it

can be found that after “The Principle” was established in “The Minutes”, the attitudes of various courts gradually tended to be consistent, the situation of applying different standards to draw different and even contradictory conclusions gradually decreased, and there were more statements of the combination of two standards in the judgments. In addition, it can combine the advantages of two standards and eliminate the disadvantages as far as possible, so as to make the judgment on whether financial institutions perform the Suitability Obligation more comprehensive and convincing. It is also a balance between the risk of bearing responsibility for the financial institution and the difficulty of proof.

4. PROBLEMS IN THE PROVISIONS OF “THE MINUTES”

It should be noted that “The Minutes” merely stipulates the two concepts of “objective standard” and “subjective standard”, which still does not solve the problem of how to grasp the standards in judicial practice, and judges still have great discretion. For example, in the above “(2019) No. 3178” case, although the investor is a judge in the financial field and has relevant knowledge and experiences, the judges did not simply determine that the investor should have a higher risk identification standard from the perspective of subjective criteria, but determined that the financial institution had failed to fully perform “the obligation”, and order it to bear the responsibility based on objective criteria in combination with the case conditions such as “the investor was evaluated as conservative”. Therefore, in order to achieve practical unification, the refinement of the measurement standard of “The Principle” will be discussed below.

5. FURTHER REFINEMENT OF MEASUREMENT STANDARDS

In order to give better play to the positive impact of “The Minutes” on the unified judgment scale and reduce the disputes caused by excessive discretion, it is necessary to summarize the standards for judges to determine whether financial institutions violate the Suitability Obligation under “The Principle”. Such detailed standards can be stipulated in future legislation or judicial interpretation.

5.1. Comparative analysis

It is mentioned in the introduction that the Suitability Obligation originated in the United States. Many American scholars gave a relatively unified definition of the suitability doctrine[4], but there are slight differences in expression. Norman S. Posner defined the suitability rule as a requirement for securities corporations, that is, securities brokers and dealers who provide advice to investors can only recommend securities that they have reasonable reasons to believe are suitable for the

investor[5]. Louis Loss and Joel Seligman have a similar definition: “securities corporations are obliged to recommend securities that meet the objectives and specific needs of specific customers”[6].

Since the establishment of FINRA in 2007, the United States has gradually established a unified rule system on suitability management. The most influential Rule 2111 stipulates the basic rules and supplementary rules. According to Article 5 of the supplementary rules (“Supplementary Provisions on the elements of Suitability Obligation”), Rule 2111 consists of three main obligations, including rational-basis suitability, i.e. “Know Your Products” (“KYP”), customer-specific suitability, i.e. “Know Your Customers” (“KYC”), and quantitative suitability. It can be seen that the United States adopts “The Principle”. For “KYC”, the basic rules of Rule 2111 and Rule 2090 made more detailed provisions. The former specified the investment profile, the latter clearly proposed “KYC” rule. These provisions, especially the “including but not limited to” provision on investment profile in the basic rules, can provide a reference for Chinese judges in adjudication.

5.2. Overview of case analysis

The author analyzes the relevant cases in China from 2016 to 2021 and summarizes the standards on which judges make judgments in practice. Limited to space, the author lists some of the most representative arguments: “financial institutions should sell appropriate products or services to appropriate investors in appropriate ways”, “financial institutions should focus on selling products with different risk levels according to the risk tolerance of investors, so as to avoid unnecessary losses caused by the lack of professionalism of investors”, “when promoting products, financial institutions should take the initiative to master customers’ risk preference, risk perception and tolerance, assess customers’ financial status, provide appropriate products for customers to choose, and reveal relevant risks”.

5.3. Expatriation of refining “The Principle”

To sum up, there will be some refinement to “The Principle”.

First of all, the “objective standard of general rational people” can be refined as follows: the relevant personnel of financial institutions should perform reasonable diligence obligations, that is, they should understand the characteristics, risks and benefits of the products they recommend, and can reasonably delimit the risk level on this basis. Moreover, learning from the requirements of “Know Your Products” in Rule 2111, and ensuring that their suggestions are suitable for at least some investors.

Then, the “subjective standard of consumers” can be detailed as follows: When financial institutions

recommend products to investors, they should base their understanding of basic information on investment motives, risk perception, business background, and past investment experience. The salesperson should ensure that the recommended product has a reasonable basis in consideration of the investor's financial situation, so as to meet the needs of specific investors. Based on the provisions of Rule 2111, "The Minutes" describes it as "KYC" and "appropriate sales", which means that financial institutions should match the risk tolerance of investors with the risk level of financial products or services according to certain principles, and comprehensively consider the needs of investors for personal capital liquidity and other aspects, so as to guarantee that the right products are sold to the right investors. This requires financial institutions not only to complete the procedures of requiring investors to read the risk notice and fill in the forms and sign under the guidance of objective standard, but consider investors' investment attitude and other personal characteristics and make appropriate notification in good faith in line with their real situation. It should be emphasized that the risk assessment must be targeted, not just a general assessment that has nothing to do with financial products or services.

6. CONCLUSION

With the development of the financial market, financial products are becoming increasingly abundant. Due to information asymmetry and the limitations of their own experiences, knowledge and ability, investors often cannot really understand the risks and benefits when purchasing financial products or receiving relevant services on their own, and usually need to rely on the promotion and explanation of financial institutions. Therefore, it is vital to strictly regulate the performance of Suitability Obligations by financial institutions to ensure that investors make independent decisions based on full understanding of benefits and risks. The most important thing is to further improve the legislation and add more detailed provisions. At the same time, financial institutions are required to follow up in time and revise the internal supporting operation guidelines. Based on increasingly perfect provisions, it is necessary to rigorously require financial institutions to adhere to "The Principle" and satisfy the demand of "KYP", "KYC" and "appropriate sales" Only in this way can financial institutions fulfill their obligations of suitability, and eventually achieve the premise of "seller's due diligence" and realize "buyer's self-responsibility".

Nowadays, Suitability Obligation is a topic that very popular in China due to the introduction of new provisions such as some articles in Securities Law and "The Minutes". Strengthening Suitability Obligations management is one of the most significant works of the compliance department of securities companies—one of

the major financial institutions. The main task of the department recently is striving to set more detailed indicators and build a comprehensive system to measure the performance of Suitability Obligations accurately and quantitatively. Therefore, pure theoretical analysis is inadequate, and a comparative analysis of the existing cases, especially the cases before and after the introduction of new provisions are indispensable. Moreover, the researches should not be limited to the objective elements, but also refer to typology of causality, clarification of burden of proof, and determination of the scope of damage compensation. In a nutshell, the author will also comply with the trend and conduct more sufficient research in the future.

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