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Via e-mail to: investmentppts_review@mas.gov.sg

Re: Consultation on Review of the Regulatory Regime Governing the Sale and Marketing of Unlisted Investment Products.

The CFA Institute Centre for Financial Market Integrity¹ and CFA Singapore are pleased to comment on the *Regulations on Sale and Marketing of Unlisted Investment Products*, put forward by the Monetary Authority of Singapore on 12 March 2009. The CFA Institute Centre represents the views of investment professionals to regulators and standard setters worldwide on issues that affect the practice of financial analysis and investment management, as well as the integrity of global financial markets. CFA Singapore represents more than 2,200 investment professionals in Singapore, and is a member society of CFA Institute.

General Comments

We commend MAS for addressing the regulatory regime relating to the sale and marketing of unlisted products by financial institutions in Singapore, paying particular attention to retail investors. We note the Basel Joint Forum in its October 2008 Paper on Customer Suitability and Sales of Retailed Structured Products observed that “How financial firms approach the sales of financial products and services is at the core of consumer confidence in financial markets, and subsequently has implications for firm's financial soundness and financial system stability as well as investor protection.” It further adds “concerns about the impact of mis-selling are arguably an area where concerns about system stability and investor protection meet”. Accordingly, the manner in which financial products are sold is critical to maintaining investor confidence and system stability.

As the consultation paper pays particular attention to retail investors, we would request that the MAS elaborate on what “retail investors” comprises. We assume this excludes professional investors, expert investors and probably accredited investors. However, clarity on the subject would be helpful to the industry, particularly in light of the proposed Complex Investment Product regime. We note in this regard that the recently issued MAS Guidelines

¹ The CFA Institute Centre for Financial Market Integrity is a part of CFA Institute. CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 94,000 members, who include the world's more than 82,500 CFA charterholders, as well as 136 affiliated professional societies in 57 countries and territories. More information may be found at www.cfainstitute.org.

on Fair Dealing extend to all clients, whether retail or otherwise. We support this position.

CFA Institute and CFA Singapore have long held that a fundamental principle of ethical investment practice is that the best interests of the investing client must take precedence over the interests of investment professionals and their employers. This responsibility and the need for full disclosure of conflicts of interest are clearly stated in the CFA Institute *Code of Ethics* and *Standards of Professional Conduct* by which CFA Institute requires all of its individual members and candidates to abide. These Codes and Standards form the basis of our response to the Proposed Consultation Paper.

Our Position on the Consultation Paper

We believe that the proposed enhancements address the issues of main concern to the protection of retail investors. They are also consistent with the principles embodied in CFA Institute's *Standards of Professional Conduct*, in particular "Duties to Clients", "Investment Analysis, Recommendations, and Actions" and "Conflicts of Interests" – written for its CFA Institute members and candidates to abide by, but relevant to finance professionals globally – which we outline and paraphrase below.

Standard III: Duties to Clients

- A. **Loyalty, Prudence, and Care.** Investment professionals have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests. In relationships with clients, Members and Candidates must determine applicable fiduciary duty and must comply with such duty to persons and interests to whom it is owed.
- B. **Fair Dealing.** Investment professionals must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.
- C. **Suitability.**
1. When investment professionals are in an advisory relationship with a client, they must:
 - a. Make a reasonable inquiry into a client's or prospective clients' investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.
 - b. Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
 - c. Judge the suitability of investments in the context of the client's total portfolio.
 2. When investment professionals are responsible for managing a portfolio to a

specific mandate, strategy, or style, they must only make investment recommendations or take investment actions that are consistent with the stated objectives and constraints of the portfolio.

Standard V: Investment Analysis, Recommendations, and Actions

A. Diligence and Reasonable Basis. Investment professionals must:

1. Exercise diligence, independence and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

Standard VI: Conflicts of Interest

A. Disclosure of Conflicts. Investment professionals must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and their employer. Investment professionals must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

We believe that determining the client's needs and always acting in the best interest of the client are fundamental to the adviser-client relationship. Given the increasing level of interest of retail investors in financial products, instruments and securities, we emphasize the importance of making sure that clients receive relevant information that allow them to adequately assess the opportunities and risks of, and to thus set reasonable expectations from, their investments. We have long held the position that those who either lack information or who do not understand the information that is available to them are at a distinct disadvantage in buying or selling securities or any other financial product. Information is the lifeblood of the capital markets; as such, it must be presented to every participant with clarity and in a context that enhances, rather than obscures, its true meaning.

While the consultation paper covers a wide range of issues, our response will focus on proposals related to (i) strengthening fair dealing in the sale and advisory process, (ii) complex investment products, and (iii) promoting more effective disclosure.

Fair Dealing in the Sale and Advisory Process

Q10(a): MAS seeks views on the proposal to require distributors to put in place formal written policies and procedures to assess the nature of a new product and assess its suitability for targeted customer segments.

Q10(b): MAS seeks views on the proposed due diligence questions.

Q10(c): MAS invites suggestions on how to enhance the due diligence process for new products.

The CFA Institute's *Standard of Practice Handbook* lists the following recommended procedures for compliance to our Standard of Practice V(A) on "Diligence and Reasonable Basis" when carrying out investment analysis, recommendations and actions.

- Establish a policy requiring that product due diligence and product recommendations have a basis that can be substantiated as reasonable and adequate. A review committee should be appointed to review and approve all new products and recommendations prior to external distribution to determine whether they meet the criteria as established in the policy
- Develop detailed, written guidance that establishes due-diligence procedures for judging whether a particular product or recommendation has a reasonable and adequate basis.
- Develop measurable criteria for assessing the quality of the product, including the reasonableness and adequacy for the basis of any recommendation and the accuracy of recommendations over time, and implement compensation arrangements that depend on these measurable criteria and that are applied consistently to all advisers and sales staff.

We support the distributor setting up a process internally, such as an independent product review committee, to ensure thoroughness and consistency of the due diligence process. The committee or process will determine whether reasonable efforts have been taken to cover all pertinent issues in the assessment of a new product for distribution. Over time, we would hope and expect that the due diligence process for customer and product suitability used by originators of such investment products and distributors of such products may converge. In practice, the originators of the product are most familiar with the product risk characteristics and would be best placed to provide a clear and accurate description of how the product is designed to work and which would be the target clientele groups the product is suitable for accordingly. In practice, the distributors of the product have immediate and direct contact with the end client and would be well placed to perform customer suitability, after reviewing and being conversant with the product risk characteristics. The end client is best served if a proper assessment of product risk suitability and client suitability is performed and both originator and distributor (in the case where they are separate institutions) have a common platform for looking at such risks. In cases where the originator and distributor are in the same institution but most commonly would be in different departments, it is up to the financial institution concerned to ensure an end to end process is in place to ensure the product it has structured and marketed is suitable for its clients. Accordingly, we support both the distributor and originator having policies and procedures to assess the nature of a new product and ensure it is suitable for the counterparty/client it is selling it to.

Q11: MAS seeks views on the proposal to enhance existing documentation requirements by requiring FAs to set out in more detail the basis for their recommendation.

Q12: MAS seeks views on the proposal that representatives make reasonable enquiries to obtain key information from the customer.

Q13: MAS seeks views on the proposal to make it an obligation for FA companies to put in place effective systems and internal controls to ensure that their representatives fulfill these obligations.

A major part of the problem and solution is the advisory process in an advisory relationship. In an advisory relationship, our members and candidates are required to gather client information at the inception and formulate a written investment policy statement (IPS). We believe that a full understanding of a client's financial situation and investment objectives is fundamental to the adviser's responsibility for making suitability determinations. The CFA Institute's *Standard of Practice Handbook* lists the following recommended procedures for compliance to our Standard of Practice III(C) on "Suitability", which CFA Institute members and candidates must take when formulating an investment policy for, or offering an investment advice to, the client.

- Client identification—(1) type and nature of clients, (2) the existence of separate beneficiaries, and (3) approximate portion of total client assets.
- Investor objectives—(1) return objectives (income, growth in principal, maintenance of purchasing power) and (2) risk tolerance (suitability, stability of values).
- Investor constraints—(1) liquidity needs, (2) expected cash flows (patterns of additions and/or withdrawals), (3) investable funds (assets and liabilities or other commitments), (4) time horizon, (5) tax considerations, (6) regulatory and legal circumstances, (7) investor preferences, prohibitions, circumstances, and unique needs, and (8) proxy-voting responsibilities and guidance.
- Performance measurement benchmarks.

The process for coming up with an IPS is outlined in Appendix 1. Once an IPS is established, an advisor can then assist in developing an appropriate strategic asset allocation and investment program for the client. These can be presented as part of the IPS document or in separate documents. The IPS should be reviewed at least annually. It should also be reviewed if there are material changes to a specific investment decision or changes in the client's circumstances such as health, liquidity needs or tax status.

A suitability review can only be done effectively if the client fully discloses his complete financial portfolio, including those managed outside of the advisory relationship. If information is withheld, the suitability analysis must be done based on the information provided, and the client be informed that the analysis carried out and recommendation provided is based on incomplete information.

We recommend that MAS consider requiring distributors to incorporate due diligence based on the IPS criteria set out in the CFA standards in assessing suitability for individual customers as part of the advisory process. In addition there should be a regular review of the IPS, such as annually. This will also be a useful record for future disputes on asset allocation and investments made. We also recommend that investor education programs highlight the utility of an IPS in assisting the investor in making informed decisions.

Q17: MAS invites suggestions on how remuneration structures can better align the interests of representatives with those of customers.

We agree that there are practical implementation issues with regards to disclosing details of remuneration schemes² of sales representatives to customers. The design of incentives structures is the responsibility of senior management and is better dealt with under the Fair Dealing Guidelines. We welcome and support the proposals in the Guidelines.

We note that the HKMA has indicated that they intend to perform thematic reviews of remuneration policies of financial institutions to ensure that they are aligned to the long term interests of shareholders. The UK FSA is also reviewing remuneration policies of financial institutions and may consider imposing higher capital requirements for institutions whose remuneration policies are short term in nature or do not align with longer term interests of stakeholders. We support MAS requiring financial institutions' boards and senior management ensuring that remuneration structures take quality and compliance issues into account and are not skewed towards financial targets only.

We further support that there should a balanced approach to remunerating policies that include both sales volumes and quality of service, taking into consideration complaints by customers and compliance training. It was noted in the report from the Joint Forum of International Regulators in April 2008 on “Customer Suitability in the Retail and Sale of Financial Products and Services” that only 60 per cent of the firms surveyed took into account compliance issues in remuneration policies. This indicates there is room for improvement in the remuneration practices of financial institutions. We consider that remuneration is a key area that should be correctly aligned as remuneration determines behaviour. It would be fruitless and disingenuous to prescribe rules for quality, compliance and fair dealing when compensation does not take into account or reward such behaviour.

Conflicts of interest can also arise in remuneration structures when bonuses are paid on short-term performance, trailing commissions, incentives and referral fees. Incentive structures for frontline sales staff may have an impact on their approach to market certain “buckets” of products to their clients. Standard VI of our Code and Standard requires adequate disclosures of firms’ policies in the firms’ promotional literature be made available to clients. This is to enable clients to make an assessment of whether such conflicts are managed and not detrimental to the client’s interest.

² Remuneration schemes may include indirect remuneration that may be based on the sales production of an office or group of individuals.

Complex Investment Products

Q18(a): MAS seeks views on the proposal to define a complex investment product based on whether or not derivatives are embedded in the investment product.

Q18(b): MAS invites suggestions on how the definition of “complex investment products” may better capture the differences between simpler and more exotic derivatives.

We are of the view that the definition of “complex investment product” may be problematic in practice. We believe that the issue is risk, rather than complexity. For example, the investment strategy for a three-time leveraged fund could be implemented using either futures/forward contracts or using leverage. The former would be considered complex, but not so with the latter despite the risks to the investor being identical.

Another example that complexity does not necessarily imply riskiness is the following. A complex investment product that combines a long position in equity markets with a long-dated protective put is “complex” by these standards, but is safer than a publicly-traded unit trust. This and convertible bonds are examples of equity positions which embed derivatives but have limited downside risks.

The issue at hand is risk and leverage rather than complexity through the use of simple or exotic derivatives. The products we consider risky are those with limited upside return and unlimited or substantial downside risk such as stock/ equity and foreign exchange accumulators. Typical higher risk profiles in the structured products on the market would be where the investor has effectively sold the equivalent of a short option position to the financial institution, and earned a higher return through the option premium. We would recommend that MAS reconsider the definition of complex investment products. The key concern would be to have a higher standard of care with higher risk products, rather than complex products per se. While some complex products may be higher risk, some are not. MAS could also consider a carve-out from the requirement to conduct due diligence for such products where the products are clearly lower risk. Such carve-outs could include any product where the investor is in a long hedged option position and include products such as convertible bonds.

Q19: MAS seeks views on the proposal to require the sale of complex investment products to be allowed only with advice.

There are limitations to investor education and customer understanding of complex investment products and hence most customers would need advice before purchasing such products. Requiring investment advisors to conduct “suitability tests” as part of the advisory process is important to determine the suitability of any investment in the context of a

customer's total portfolio. Whilst this should be the norm there are customers who might want to purchase these products at a lower fee and without advice. We should therefore not restrict investor choices as they are entitled to a wide range of options in investing and managing their portfolios.

For investors who want to purchase complex investment products under "execution only" service we recommend that MAS review the standards of "Appropriateness" tests under the UK Markets and Financial Instruments Directive (MiFID) rules. This is a lower standard of care compared to suitability tests but would at least require the distributor to obtain information from the customer regarding his knowledge and experience in investing in similar complex investment products. This, together with the Product Highlights Sheet, should provide a basis for the customer to make informed decisions.

Q20: MAS seeks views on the proposal to require distributors to put in place additional safeguards to ensure that representatives do not sell complex investment products to customers with limited knowledge of investment products.

As mentioned in point 10c, we recommend that an independent product review process or committee be established by the distributor to ensure thoroughness and consistency of the due diligence process. The committee will determine whether reasonable efforts have been taken to cover all pertinent issues in the assessment of a new product for distribution.

Q23: MAS seeks views on the proposal to require distributors to ensure that representatives undergo training on the features and risk-reward characteristics of a new complex investment product before being allowed to sell the product.

Q24: MAS seeks views on the proposal to introduce a new CMFAS examination module for product knowledge on complex investment products.

We agree with the proposal to have adequate training and a new CMFAS module on product knowledge. Several CFA Singapore members have contributed towards development of a financial body of knowledge in Singapore. In addition, the CFA Institute is currently working with the Institute of Banking and Finance (IBF) to map out the technical skill sets required for basic understanding of complex investment products. This should be supplemented by having an ethics module in the training programs that would include understanding and application of the duties and loyalty to clients' principles and dealing with conflicts of interest. We would also encourage workshops to train sales representatives and advisors to write investment policy statements.

More Effective Disclosure

Q1: MAS seeks views on the proposal to require issuers to prepare a Product Highlights Sheet to accompany an offer of an unlisted investment product where the offer requires a prospectus to be issued.

Q2: MAS seeks views on the proposed form and content of the Product Highlights Sheet.

Q3: MAS invites suggestions on how the Product Highlights Sheet can be made more readable and useful for investors.

Q4: MAS invites suggestions on additional information and specific features that should be disclosed in the Product Highlights Sheet for particular products.

We support the introduction of a Product Highlights Sheet with the contents described in the consultation paper. As suggested in item 5 of the Product Highlights Sheet we recommend that the customer must be presented with an “All-in-Fees” for the investment for him to assess the costs prior to making an investment decision. This is an important point as such fees are often not disclosed.

It is reasonable that an investor know how much of his principal is used to invest, and how much goes into fees and commissions. We are aware of claims that it is difficult to calculate the fees. If the fee amount cannot be estimated, then we would submit that such products should not be offered. Such disclosure would also make it transparent to an investor how much the originator and distributor were earning from his investment transaction, and whether this may unduly influence the sales and advisory process.

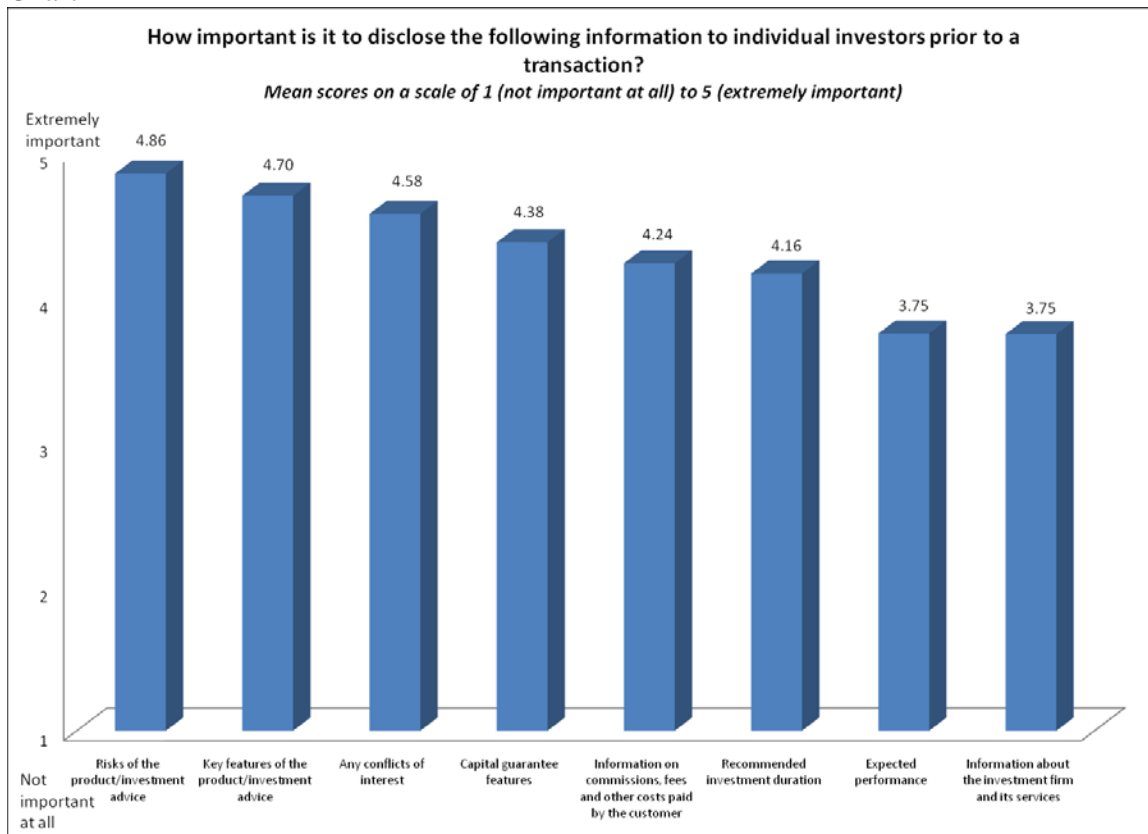
As all the risks of the investments may not be adequately described in the product highlight sheet, additional information have to be provided to the customer on request at point of sale.

In December 2008, CFA Institute Centre conducted an online survey on the topic of investor protection among CFA members in Australia, Hong Kong, Japan and Singapore. The survey received 199 responses. One of the questions in the survey was in relation to information provided or disclosed to customers. The respondents were asked to rate from 1 to 5 (1 being not important at all and 5 being extremely important) a list of key information. (Refer to Chart 1 below.)

The results showed that the most important information to disclose to individual investors prior to a transaction were the risks and key features of the product/investment advice, followed by any conflicts of interest. Of least importance, but nonetheless still important, were expected performance and information about the investment firm and its services. Additional comments from the respondents highlighted that above all else, investors should be made to understand the risks of the investment in an explicit manner. Examples given were:

- worst case scenarios and the probability of such worst case scenarios;
- description of the three biggest expected risks associated with the investment product and not just a listing of all the risks the adviser can think off;
- liquidity and early withdrawal or redemption features; and
- measures that the investor can take to limit losses in the event that the market has an adverse move.

Chart 1



On the matter of disclosure of conflicts, the CFA Institute's *Standard of Practice Handbook* recommends that CFA members disclose special compensation arrangements with the employer that might conflict with client interests, such as bonuses based on short-term performance criteria, commissions, incentive fees, performance fees, and referral fees.

Hence, in the proposed Product Highlights Sheet greater emphasis should be placed on information relating to the risks of the product, the key features and disclosure of conflicts of interest. We agree that the Product Highlights Sheet will to some extent help investors to better digest the information contained in lengthy prospectus and disclosure documents.

Q5: MAS seeks views on the proposal to impose the specific ongoing disclosure requirements described above to issuers of unlisted investment products, where prospectus requirements apply. MAS invite suggestions for additional ongoing disclosure requirements.

Q6: MAS seeks views on the proposal to require issuers to make available, publicly and regularly, bid or redemption prices.

We agree with MAS proposal to require issuers of unlisted investment products to make available semi-annual and annual reports to investors. This will be consistent with the disclosure regime and provide at regular intervals information to investors to assess their investment returns and risk. The usefulness of this information may vary from product to product. For example, the promised yields on a complex investment product may be dependent on holding out the derivative contracts that are entered into at time of inception for the entire duration of the investment product. Some of these derivative contracts may not be liquid and are traded in the over the counter market. They can be marked to market at half yearly intervals with referenced to a benchmark yield curve or mark- to- model in some circumstances.

Similarly bid and redemption prices might be subject to mark-to-model and therefore not as transparent as listed investment products.

Closing Remarks

The CFA Institute Centre for Financial Market Integrity and CFA Singapore appreciate the opportunity to comment on MAS's *Review of the Regulatory Regime Governing the Sale and Marketing of Unlisted Products*.

If you have questions or seek clarification of our views, and feel that CFA Institute Centre and CFA Singapore may be able to help in the formulation of the final guidelines, please feel free to contact Lee Kha Loon, CFA, at +852-3103-9303 or khaloon.lee@cfainstitute.org, or Sharon Craggs at sharon.craggs@cfainsingapore.org.

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