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MIS-SELLING OF FINANCIAL PRODUCTS:
How are investors protected in today's marketplace?
A discussion paper and call for feedback from CFA Institute members

by the Asia Pacific Office of the CFA Institute Centre for Financial Market Integrity

The objective of this discussion paper is to solicit feedback from members on regulation and practices relating to selling of structured financial products to retail investors. Recent events of reported mis-selling of structured products have highlighted the need for increasing awareness of ethical issues relating to protecting investors. Regulators in Hong Kong and Singapore in particular have released reports in the first quarter of 2009 on this matter and are looking for feedback from the industry. This discussion paper focuses on the events in Hong Kong and Singapore and provides a brief background of the issues involved and some suggestions of how we can improve the current system. Please provide your feedback on suggestions identified under Section 4 of this paper by sending an e-mail to cfacentre@cfainstitute.org by 1 July 2009.

1. BACKGROUND – REASONS FOR GROWING DEMAND OF STRUCTURED PRODUCTS

The investment landscape for investors in Asia Pacific has witnessed significant changes over recent years. Social, economic and regulatory developments in the region have given rise to greater interests by individuals to invest in innovative financial products, rather than having their savings in time deposits and stocks.

Several factors have caused this shift:

1. Rising levels of middle-class wealth have positioned the region as the largest growing market for the wealth management industry. The *Financial Times*[1] reported that over 2007, the number of millionaires in Asia Pacific increased by 8.7 percent to 2.8 million and personal wealth expanded by 12.5 percent to USD 9,500 billion. Furthermore, despite the weakening global conditions in 2008, the wealth of the region's millionaires is projected to grow at 7.9 percent pa to USD 13,900 billion by 2012.

2. Individuals in many regional economies are facing increasing pressures to assume greater financial responsibility for their own retirement funding. Social security programmes by the state can no longer be relied upon as the primary provider of

[1] "Distribution of wealth: Rich and becoming more important", *Financial Times*, December 3, 2008.

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retirement benefits, and savings schemes[2] are being implemented that will eventually move the burden of retirement benefit provision from the state to the individual. Coupled with the current low interest rate environment in almost all the developed economies, investors are looking at structured products for higher yields to meet their retirement needs.

3. Greater liberalisation in the marketplace has opened up prospects for cross-border selling of financial products and services by financial institutions. Complex financial products with underlying assets in securities, credit linked notes, credit default swaps and home mortgages in one country can be packaged and sold in other markets around the world through financial institutions after filing prospectuses and disclosure statements that meet local regulatory requirements.

There are a variety of structured products sold to investors in Hong Kong and Singapore. For regulatory purposes investors are classified into two categories. The first are "professional" investors. These investors have a net worth of USD 1 million of assets in Hong Kong[3] and SG2 million in Singapore[4] and they have to also meet income and other means tests. Some products such as accumulators are sold to this group of professional investors through the private banking divisions of financial institutions. The second group are the retail investors.

Structured products are sold to both professional and retail investors by banks and securities firms. If sold to retail investors, there are regulations that require these funds to be registered and authorized by the respective regulators. If these are sold by banks, the management is required to ensure that suitability tests are applied before customers purchase them. Stockbrokerage firms can also sell structured products to retail investors as "execution only" orders and they are not required to give investment advice.

This discussion paper is focused only on selling of structured products to retail investors with emphasis on the example of Lehman mini-bonds. We believe this case is a good representation of the issues relating to mis-selling in Hong Kong and Singapore, and possibly other countries in the region.

Lehman mini-bonds are credit linked notes sold under a Secured Note Programme. The Base Prospectus was registered with the Monetary Authority of Singapore (MAS) by the arranger (Lehman Brothers Singapore Pte Limited) explaining the structure, risk factors, master terms and conditions of the notes. This prospectus was followed by a series of notes called mini-bond series and a separate pricing statement accompanied each mini-bond series for the investors to read and understand before they decided to invest. The main attraction of the mini-bond was the yield.

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[2] Examples are the Mandatory Provident Fund (MPF) in Hong Kong, Employees Provident Fund (EPF) in Malaysia and Central Provident Fund (CFP) in Singapore, which are defined contribution schemes.
[3] Securities and Futures (Professional Investor) Rules (Cap571D) s 3, Persons prescribed as professional investors.
[4] Securities and Futures Act (Cap 289) s 4A.

Mini-bond series 3, for example, offers an interest rate of 5 percent to be paid every quarter for 5 years from 2007 to 2012. The notes are backed by underlying securities and swap arrangements. The underlying securities of mini-bond series 3 notes are credit linked to six financial institutions which are rated AA at the time of issue. This type of structure is also known as synthetic collateralized debt obligation securities or synthetic CDOs. There are similar filing procedures in Hong Kong to sell these Lehman mini-bonds.

2. INVESTOR PROTECTION REGULATION

2.1. Disclosure and conduct rules.

Disclosure-based regulation

One of the objectives of financial sector regulation is to provide adequate protection to consumers of financial services[5]. While the free market approach frowns on government intervention, the general consensus is that rules and laws are necessary to maintain investor confidence and to enable the market to function efficiently and effectively.

Under this regulatory approach, the issuer or seller is required to provide full and accurate information regarding the product offering in a timely manner. This includes disclosure of any adverse information and risks regarding the issuer or the offering, as well as providing updates of relevant information or material changes to information already disclosed. The effectiveness of disclosure-based regulation hinges on the ability of its recipients to process and understand the information available to them. Investors today are overwhelmed with information from prospectuses, product disclosure statements, financial reports and analysis via the news media, including advice from professionals or friends and family.

Few individual investors have the capability or time to carefully analyse the information available to make an informed decision. Information that is too detailed or too technical might prove to be counterproductive if it confuses investors and discourages them from using disclosure documents. In a nutshell, it is the quality rather than the quantity that is important. Regulators have sought to make disclosures easier to understand with guidelines on the form and format of disclosures. For example, recent regulations require that disclosure documents be written in ‘plain English’ as well as issuance of a short-form prospectus that summarises the key information in the statutory prospectus

Conduct rules are designed to bring about fair and open dealing conduct by financial firms and their representatives with clients or potential clients. It requires financial advisers and dealers to be licensed based on their competencies and/or qualifications, and compliance with ongoing professional development obligations, so that investors who seek advice about financial products

[5] The other objectives of financial sector regulation are to ensure systemic stability, institutional safety and soundness, and market integrity.

are assured that these intermediaries are capable of providing that advice. The rules also require market institutions and financial firms to have a complaints process in place, where investors can seek redress against product providers or financial advisers who fail to meet investors' expectations regarding the product or advice.

One of the most important conduct rules in investor protection is the 'suitability rule'. In Hong Kong[6] and Singapore[7] the 'suitability rule' is a regulatory requirement for financial advisers to have a reasonable basis for any recommendations made. It has traditionally been linked to the 'know your client' rule because only through a thorough understanding of the clients' specific circumstances can any suitable recommendation for any particular purchase or sale be made. This typically requires making inquiries into the client's financial situation, risk tolerance, investment knowledge and investment needs and objectives.

Compliance with the suitability rule has been enhanced to include the 'know your product' rule, where a thorough understanding of investment products is necessary to sufficiently explain the product and product risks to the client. The recommended product due diligence process includes not only an understanding of all the salient features of the product but also assigning a risk ranking to the product.

In May 2007, the Hong Kong Securities and Futures Commission (SFC) issued guidance in the form of questions and answers[8] (FAQ) to help investment advisers comply with suitability obligations under the Code of Conduct. The FAQ follows from two thematic inspections carried out on licensed investment advisers by the SFC in 2004 and 2006. The inspections identified recurring issues and deficiencies that relate to conduct by the licensed investment advisers. The SFC made it clear in the FAQ that over and above the 'know your client' and 'know your product' rules, investment advisers are expected to:

- provide reasonably suitable recommendations by matching the risk return profile of each investment product with the personal circumstances of each client to whom it is recommended;
- provide all relevant information to clients to help them make informed investment decisions;
- employ competent staff and provide appropriate training; and
- document and retain the reasons for each product recommendation made to each client.

[6] Paragraph 5.2 of the Code of Conduct for Persons Licensed by or Registered with the SFC states that "Having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for the client is reasonable in all the circumstances."

[7] Financial Advisers Act (Cap 110) s 27(1) – No licensee shall make a recommendation with respect to any investment product to a person who may reasonably be expected to rely on the recommendation if the licensee does not have a reasonable basis for making the recommendation to the person.

[8] The document "Questions and Answers on Suitability Obligations" can be accessed via this link: http://www.sfc.hk/sfcRegulatoryHandbook/EN/displayFileServlet?docno=H457

Despite these detailed regulations on 'suitability' it is very difficult for an investor to prove in court that he has been mis-sold a financial product if he has signed all the risk disclosure documents, and was provided with the product disclosure documents by his investment advisor. Mis-selling however, can also occur if there was misrepresentation of information and risk features of the investment product to the investor by the financial advisor.

2.2. Treating investors fairly – Role of the Board and Senior Management

A new approach being taken is to require the Board and senior management of a financial services firm to have adequate processes in place to ensure that customers are treated fairly in every aspect of the firm's business activities. It essentially involves a culture change within the firm from the top down.

The Financial Services Authority's (FSA) in the United Kingdom started a programme called Treating Customers Fairly (TCF) initiative a few years ago which focused on giving greater attention to the need to treat retail customers fairly. It disclosed in its 2004/05 Business Plan that commitment from the board and senior management of financial firms is key in the implementation of the initiative, where the aim is to embed the "customer first concept" throughout the firm's operations and ultimately within its culture. This means incorporating the TCF framework into what the FSA terms as the product life-cycle, i.e. from product design and governance, identification of target markets, product marketing and promotion activities, sales and advice process, after-sales information to complaints handling.

In February 2008, Singapore decided to pursue an approach similar to that undertaken in the United Kingdom and issued a consultation paper to seek the industry's views on their proposed guidelines on fair dealing. Like the FSA, the Monetary Authority of Singapore (MAS) will be looking to the board and senior management of financial institutions to instil high standards of fair dealing for consumers in their firm's policies, practices and processes.

A listing of the desired consumer outcomes from these two initiatives is shown below.

Desired consumer outcomes of FSA's 'treating customer fairly' initiative[9]	Desired consumer outcomes of MAS's 'fair dealing' initiative[10]
1. Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate	1. Consumers have confidence that financial institutions put consumers' interests first in the

[9] The document titled "Treating customers fairly – towards fair outcomes for consumers" can be accessed via this link: http://www.fsa.gov.uk/pubs/other/tcf_towards.pdf

[10] The consultation paper titled "Proposed Guidelines on Fair Dealing – Board and Senior Management Responsibility for Delivering Fair Dealing Outcomes to Consumers" can be access via this link: http://www.mas.gov.sg/resource/publications/consult_papers/2008/Proposed percent20MAS percent20Guidelines percent20on percent20Fair percent20Dealing.pdf

culture. 2. Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly. 3. Consumers are provided with clear information and kept appropriately informed before, during and after the point of sale. 4. Where consumers receive advice, the advice is suitable and takes account of their circumstances. 5. Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect. 6. Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.	conduct of their business. 2. Financial institutions offer products and services that are suitable for the consumer segments they target. 3. Financial institutions appoint competent representatives who provide consumers with advice that meet their financial objectives and suit their personal circumstances. 4. Consumers receive clear, relevant and timely information to make informed financial decisions. 5. Financial institutions handle consumer complaints promptly and in a consistent manner.

While Singapore is studying how best to implement its fair dealing initiative, the FSA's TCF framework is already in its fourth year of operation. The implementation of the TCF initiative was carried out in three stages and financial firms are required to report to the FSA on progress made.

The TCF initiative is the FSA's attempt to introduce a more principles-based approach to regulation. Financial firms are given the flexibility to deliver the desired consumer outcomes in a way that best suits their particular business activities and customers they deal with. In order to assist financial firms in their efforts to comply with the TCF framework, the FSA used a range of methods to illustrate what TCF means in practice. Tools included case studies, examples of good and poor practice and a statement on the respective responsibilities of providers and distributors.

3. Regulatory Responses to Allegations of Mis-Selling – The Case of the Structured Products Linked to Lehman Brothers

Investor protection rules were put to the test when Lehman Brothers filed for bankruptcy in September 2008. Thousands of investors in Hong Kong and Singapore staged street protests to pressure the authorities to compensate them for their losses in the mini-bond series. These

investors complained of poor advice and aggressive sales techniques[11] from banks who sold them the structured products linked to the collapsed investment bank, and alleged that they were mislead into believing that these investments carried low risk but were in fact high-risk credit derivatives.

According to the MAS, Lehman-related structured products worth close to SGD500 million were sold to about 10,000 retail investors in Singapore. In Hong Kong, the Monetary Authority (HKMA) said that more than 40,000 investors in the territory bought Lehman-related investment products mainly through banks with a total outstanding value estimated at USD3.7 billion. By December 2008, the MAS and HKMA announced that they had received approximately 5,000 and 20,000 complaints respectively relating to investments in these and similar products such as Merrill Lynch Jubilee Series 3 LinkEarner notes and DBS High Notes 5. The financial regulators in both countries announced that they will be conducting investigations into the allegations of misconduct in the sale of these Lehman-related investment products.

3.1. Actions taken by MAS

In order to maintain investor confidence in the marketplace, the MAS consulted with the relevant financial institutions to set up a communications process where investors could obtain clear and timely responses to their queries. It created a dedicated section on its website that contained information on how to lodge complaints regarding the affected structured notes, hotlines for the relevant financial institutions and frequently asked questions in both English and Chinese.

The 3-step complaint process involved first lodging a complaint with the financial institution that sold the product; assessment and decision of the case by the financial institution; and subsequent appeal to the Financial Industry Disputes Resolution Centre (FIDReC) if the investor remained unsatisfied. In order to ensure that the complaints handling and resolution process was independent, fair and transparent, three independent persons were appointed by the financial institutions involved to oversee this process. The MAS also set very clear timelines for the financial institutions to resolve the complaints.

In October 2008, the DBS group announced that it would offer compensation to clients in Singapore and Hong Kong totalling between SGD70-80 million.[12] Maybank and Hong Leong Finance also announced that they would be working to ensure that all deserving investors get their money back. An update from the MAS revealed that as of 14 January 2009, 58 percent of the complainants would be receiving a full or partial settlement, and almost all elderly investors

[11] Examples cited were the use of deposit-related information by banks to target and channel retail customers into investment activities, and the use of gifts as marketing tools to encourage retail investors to subscribe more than they otherwise would have in order to reach the required level of subscription for the gift.
[12] "DBS begins compensation process", The Straits Times, October 26, 2008.

with little income, little formal education and little investment experience had been offered full or partial settlement.[13]

As part of its formal investigations, the MAS will be looking into the selling practices and policies of each financial institution; such as the due diligence process regarding structured notes, procedures used at the point of sale to ensure that the notes were sold to clients whose investment objectives and risk tolerance matched the risk profile of the notes, and the training and supervision of relationship managers. The MAS will be paying particular attention to selling to 'vulnerable' customers. While there is no fixed definition of a vulnerable customer, the MAS will be looking at indicators like low level of education, a lack of proficiency in English, being retired or unemployed and whether the investment amount constitutes a large part of total savings.

3.2. Actions taken by HKMA and SFC

While the activities of dealing in securities and futures contracts and providing investment advice come under the oversight of the SFC, most of the financial firms involved in the Lehman mini-bonds saga were banks regulated by the HKMA[14]. The HKMA moved quickly to quell investors' fears by requesting that the relevant banks set up dedicated telephone lines to respond to questions from the public on the Lehman-related investment products sold to them. The banks were also requested to write to the affected customers to clearly explain the latest situation regarding the Lehman-related products, as well as arrange briefings for them. For its part, the HKMA set up a dedicated hotline to handle individual investor complaints on this matter, and arranged for the Hong Kong International Arbitration Centre (HKIAC) to provide mediation and arbitration services to resolve compensation issues between investors of Lehman-related products and the distributing banks.

Both the HKMA and SFC reviewed complaints in relation to the sale of the Lehman-related products to see whether there had been any misconduct by the financial firms concerned. Of the 20,000 complaints received by the HKMA, 207 cases had been referred to the SFC for further review. If financial firms were found guilty of misconduct potential SFC sanctions include suspension or revocation of registration/licence, reprimands, fines or prohibition orders.

So far, the Hong Kong government has put forward a buy-back proposal that had been agreed upon and accepted by the Hong Kong Association of Banks on behalf of the distributors of the Lehman-related products. However, the buy-back proposal has been halted due to the 'automatic stay' imposed by Lehman's US bankruptcy filings. In December, it was reported that a number

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[13] Press release "MAS Provides Updates on Complaints Resolution" can be accessed via this link: http://www.mas.gov.sg/news_room/press_releases/2009/MAS_Provides_Updates_on_Complaints_Resolution.html

[14] Banks that conduct securities and futures business must be registered with the SFC as Registered Institutions. However, the HKMA oversees their compliance with the SFO through a Memorandum of Understanding (MOU) with the SFC. The MOU sets out how the SFC and HKMA shares responsibilities in respect of regulated activities conducted by Registered Institutions.

of banks had reached settlement agreements with some of the investors who received approximately USD3.8 million in compensation.[15] And, in January 2009, Sun Hung Kai Investment Services agreed to repurchase all outstanding Lehman Brothers mini-bonds from its clients at their original value, estimated at USD7.7 million.[16]

On 31 December 2008, the HKMA[17] and SFC[18] submitted their reports to the Financial Secretary on their observations, lessons learnt and issues identified in the Lehman mini-bonds saga. Some of the key recommendations from both reports were:

- review whether the current institutional regulatory structure is still relevant given the convergence in activities by the banking, securities and insurance sectors;
- enhance disclosure requirements and presentation formats for investment products;
- review whether the definition of professional investor remains appropriate;
- tighten point of sale practices, and segregate banking activities from retail investment activities in banks;
- introduce a cooling off period following the sale of investment products;
- review the need for a dispute resolution mechanism such as a financial ombudsman for aggrieved investors; and
- improve financial literacy for the public through an Investor Education Council.

The situation in Hong Kong took on an added dimension when the Legislative Council decided to assume a more hands-on approach on this issue. It set up a subcommittee to examine how the HKMA and SFC regulate activities involving the issuance and sale of structured products, and the outcome of their on-going investigations and subsequent actions taken. It also invoked its powers to conduct a public probe of Hong Kong banks that had been accused of mis-selling. The Legislative Council subcommittee handling the inquiry was expected to start its inquiry in late January 2009.

Two priorities stood out from the actions taken by the authorities in Singapore and Hong Kong. The first is the need to restore confidence and trust in the financial system and market intermediaries. The second is to have a transparent process in place to address complaints from aggrieved investors. This was one of the recommendations in the SFC report to the Financial Secretary.

Since there was no existing formal dispute resolution process, the MAS was quick in coming out with their 3-step complaints resolution process, which was supported by the relevant consumer and industry associations. In Hong Kong, the Hong Kong International Arbitration Centre (HKIAC) was engaged by the HKMA to help resolve compensation issues for investors who

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[15] "Hong Kong Banks Repay HKD30 Million in Mini-Bond Scandal", Dow Jones Newswires, December 10, 2008.
[16] "Sun Hung Kai to buy back HK$85 million Lehman mini-bonds", Asian Investor, January 23, 2009.
[17] The report titled "Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group of Companies" can be accessed via this link: http://www.info.gov.hk/hkma/eng/new/lehman/lehman_report.pdf
[18] The report titled "Issues raised by the Lehmans Mini-bonds crisis – Report to the Financial Secretary" can be accessed via this link: http://www.sfc.hk/sfc/html/EN/whatsnew/review_lehman.html

were eligible for this scheme[19]. The arbitration fees will be borne by the HKMA and relevant banks.

In February 2009 there were further developments as some investors who did not fall into the "vulnerable investor" category decided to seek redress through potential class action suits. Separate groups were formed in Hong Kong and Singapore to take legal action against the trustees and the distributors of the Lehman mini-bond series notes. On 12 March 2009, a group of Hong Kong investors filed suit in the United States against Lehman (and HSBC), seeking class-action status for more than 30,000 mini-bond investors hoping to recoup some portion of their losses.[20]

4. THE WAY FORWARD – WHAT NEEDS TO BE DONE

The Lehman mini-bonds saga has taught us an important lesson: Keeping up with the complexity of financial innovation and risk management is very important. The regulator, senior management, supervisors, investment advisors and sales personnel could have each played a more effective role in mitigating the widespread effects of the losses suffered by investors. There is also an ethical dimension to the situation, and it is a good time to find ways to address the ethical issues relating to selling of investment products to retail investors.

4.1. Consistency of regulation in the sale of financial products

In today's complex financial services industry investors are offered a vast array of products and service providers to meet their financial needs. As the market evolves, products and providers no longer fit into their neat little boxes. Nonetheless, investors should get the same basic regulatory safeguards and protections whether the product is insurance, securities, banking or investment advisory. The issue, therefore, is the assurance of consistency in the regulation and supervision of products that look and behave in a similar manner, regardless of their origination.

Possible approaches to improve consistency in regulations include a change in the design of the regulatory system (i.e. an integrated or twin-peaks approach) or closer multilateral ties between sectoral regulators (i.e. a council-style arrangement).

[19] The scheme is open to investors who have made complaints to the HKMA and whose complaints have been referred to the SFC for it to decide whether to take any further action or where a finding against a relevant individual or an executive officer of a bank has been made. The HKMA will inform the investors who are eligible for the scheme in writing.

[20] "Hong Kong investors sue Lehman over mini-bonds", *International Herald Tribune*, 13 March 2009. (www.iht.com/articles/ap/2009/03/13/business/AS-Hong-Kong-US-Lehman-Bankruptcy.php)

The **integrated approach** is a single universal regulator which conducts both safety and soundness oversight and conduct-of-business regulation for all sectors of financial services business. The MAS is an example of the integrated approach.

The **twin-peaks approach** is a separation of regulatory functions between two regulators: one that performs the safety and soundness supervision function and the other that focuses on conduct-of-business regulation. The Australian Prudential Regulation Authority (APRA) and Australian Securities and Investment Commission (ASIC) are examples of the twin-peaks approach.

The **council-style arrangement** aims to promote regular consultations among the various regulatory agencies, identify important issues and trends in the financial system, and enhance the overall quality of supervision by avoiding unnecessary overlaps, inconsistencies and gaps in the regulatory framework. This is quick to set up but would entail cooperation and a commitment to high standards among the agencies.

Whichever approach is preferred, there has to be consistency in ensuring there are no regulatory gaps between the banking, securities and insurance divisions and entities.

4.2. Enhancing disclosure rules

It has been expressed time and again that the philosophy behind disclosure-based regulation is to ensure that investors have ready and timely access to enough information to make an informed decision, and thereafter take responsibility for this decision. However, the SFC's report to the Financial Secretary in Hong Kong on the Lehman mini-bonds crisis noted that some investors viewed the authorisation by the regulator as an endorsement of the merit and safety of the product.

In efforts to enhance disclosure rules, it should be remembered that it is the quality and not the quantity that matters. Besides increasing the level of financial literacy through investor education, disclosures will be more effective if they are clear, concise and comprehensible. The format of disclosures is also important, where key details of the nature and risk of the product should be prominently displayed and easily picked up by the investor.

*Information provided or disclosed to investor*s

At the minimum, what information should be made known to investors before or at point of sale? Results from the CFA Institute member survey showed that the respondents ranked information on the risks and key features of the product or investment advice, and conflicts of interest as most important.

- Risks of the product – The risks of the investment should be explained to the investor in an explicit manner. For example, investors should be warned that they can lose part or the full principal invested, rather than merely listing out the probable investment risks.

- Key features of the product – Investors should be aware of, else seek clarification from their advisers on the nature of the underlying securities in the product, relative performance and liquidity of the product, capital guarantee features, investment duration and lock-in periods, termination conditions, valuation and pricing methodology and custody arrangements. Investors might also enquire about the experience and reputation of the product issuers and service providers.

- Conflicts of interest – Conflicts of interest arises 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.

These disclosures should be captured in a Product Highlights Sheet to supplement the current lengthy prospectus and disclosure documents and presented to a customer prior to making an investment decision. In addition there should be disclosures of 'all–in-fees" for a customer to make an informed decision in making an investment. Currently structured products are sold under a regulatory regime in Hong Kong and Singapore that do not require such fees disclosures.

Continuous disclosures by investment funds

Under the disclosure regime public listed companies are required to make continuous disclosures on their company and financial performance. Investment funds should also be subject to continuous disclosure requirements to help investors to keep track of their investments. At the minimum, such reports should be on a semi-annual basis, i.e. a six-month interim report and an annual report, and should contain the following information:

- management discussion of the fund's activities for the period under review, explaining the nature of and reasons for changes in the fund;
- concise summary of the investment objectives and strategies; and
- a discussion on the relative performance of the investment fund compared to a broad-based market index, and why the investment fund under- or over-performed the index.

However the usefulness of this information may vary from one investment product to another. For example, the promised yields on structured 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 over-

the-counter markets. 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.

4.3. Enhancing conduct rules

Asset Manager Code of Professional Conduct

Conduct rules need to be enhanced to emphasise the requirement to treat customers fairly in every aspect of the financial firm's operations. This would involve a cultural change within the organisation, starting from the board and senior management down to the rest of the staff, where acting in the interest of the customer is part and parcel of their job responsibilities. To date, only the United Kingdom has introduced an approach to investor protection that includes fair dealing principles in the agenda. The four-year initiative is now in its final stage and the FSA would soon be able to evaluate whether or not this approach has been able to improve practices in the industry.

Firms that are seeking to enhance their internal processes can also look to the Asset Manager Code of Professional Conduct (AMC) issued by the CFA Institute Centre for Financial Market Integrity. The AMC outlines the ethical and professional responsibilities of firms that manage assets on behalf of clients, and firms that comply with the AMC signal to their customers a commitment to a base level of ethical standards and conduct. Implementing good practices in the development and marketing of financial products would also go a long way to assist financial firms in meeting regulatory requirements.

Setting remuneration policies

Financial firms have been heavily criticized for the way they remunerate their advisers and sales personnel. It is common practice for staff to receive a minimal basic salary, and with a heavy dependence on sales commission. Hence, we have a potential situation where financial firms could be seen to be motivating their front office to be better 'product-pushers' rather than better 'financial advisers'.

There should be 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 percent of the firms surveyed took into account compliance issues in remuneration policies.

Product due diligence

The CFA Institute *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. The same process should apply when introducing new investment products by a distributor.

- 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.

An independent product review committee should 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.

Standards to provide investment advice

The common practice in Hong Kong and Singapore and in many parts of Asia is to have investment advice and execution bundled together. This is because investors in Asia generally do not want to pay for advice. The practice is different in Australia where investors are required to pay separately for advice. The Australian Corporations Act 2001 requires investment advisors to issue a Statement of Advice (SOA) to be given for personal advice to a retail client with details for the content of the SOA.[21]

(This is an example of an SOA proposed by the Financial Planning Association of Australia that complies with the legal requirements.)

The Front Page of the SOA summarises the function of the document and gives the legal requirements for identifying the providing entity.

[21] Other documents that must be provided to retail clients under the Corporations Act 2001 are:

- Financial Services Guide to ensure that prospective retail clients are able to make an informed decision whether to acquire a financial service that is offered.
- Product Disclosure Statement to provide consumers with sufficient information to compare a range of financial products before making an informed decision about buying the products.

The main body of the SOA contains:

1. The scope of the advice – This clarifies what the advice covers and does not cover.
2. Where are you now – This gives an overview of the client's current circumstances to provide an accurate foundation for the subsequent advice.
3. What do you want to achieve – This section sets out the client's objectives and identifies what the client is seeking to achieve from the advice.
4. How you get there – This identifies the key strategies to achieve the client's objectives and explains how the advice can be implemented.
5. What is recommended and why – This section explains the rationale for adopting the proposed solution.
6. The risks you need to know about – This section sets out the risks of the proposed solution.
7. These are the services I will provide to you – This section summarises where information about the services provided may be obtained.
8. This is what the financial service and advice will cost you – This section sets out the key costs to the client of the initial advice, ongoing advice, implementation costs and other payments. For each cost there is a breakdown of whether it is direct or indirect and the dollar amount is specified
9. This will assist in your decision making – A final section listing other factors that might influence the advice, including benefits, interests and associations.

A major part of the problem and solution is therefore making the customer understand the importance of the advisory process and the benefits of an advisory relationship.

Where suitability tests are required in an advisory relationship, the current standards of applying suitability tests in the Asia Pacific region can also be further improved. The CFA Institute *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
(3) approximate portion of total client assets

Investor objectives
(1) return objectives (income, growth in principal, maintenance of purchasing power)
(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
(8) proxy-voting responsibilities and guidance

Performance measurement benchmarks

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.

4.4 Investor education

Finally, the ultimate decision maker in any investment transaction is still the investor. Investors need to play their part by equipping themselves with the knowledge and skills to evaluate the options presented to them and identify those that best suit their needs and circumstances. Investor education helps investors understand how to avoid becoming involved in transactions that have the potential to be financially destructive. And, it has been argued that better educated investors would demand greater standards of professionalism from intermediaries and would ensure that those who do not perform to the level expected of them would get weeded out of the industry.

Recognising that investor education and financial literacy give investors the tools to protect themselves, most regulators in the region have programmes in place whereby they organise seminars, provide printed materials, and have websites that contain useful information about investing in general and what to look for when selecting financial products and seeking financial advice.

In July 2008, the SFC conducted a survey[22] to assess the profile, investment knowledge and behaviour of retail investors in Hong Kong. Some selected findings from the survey of 1,502 respondents were as follows:

- 66.8 percent of the respondents indicated they knew very little or nothing about at least one of the products they had invested in;
- most the respondents were aware that the financial products they had invested in carried risk;

[22] The document "Key Findings of Retail Investor Survey" can be accessed via this link: http://www.sfc.hk/sfc/doc/EN/speeches/public/surveys/08/retail percent20investor percent20survey_2008.pdf

- about half of the respondents appeared to have unrealistic expectations about the performance of their investment, i.e. by expecting a moderate to high level of profits but being unwilling to bear a low level of potential loss;
- 24.7 percent of the respondents claimed to have always read the investment documents carefully before signing them, 38.1 percent just briefly skimmed through the documents and another 27.3 percent trusted their account executive's verbal explanations and signed documents without reading them; and
- 86.8 percent of the respondents knew who to approach to lodge a complaint.

The SFC intends to use these findings to design future investor education programmes in Hong Kong. Investment professionals and associations should continue to work with regulators to step up investor education efforts.

APPENDIX I

5. OBSERVATIONS FROM THE CFA INSTITUTE MEMBER SURVEY ON INVESTOR PROTECTION

The Asia Pacific office of the CFA Institute Centre for Financial Market Integrity conducted a survey of members in Asia to get their views on the disclosure and conduct rules that discussed in this paper. The web-based survey was conducted from 2-19 December 2008. An e-mail invitation was sent to a sample of CFA Institute members in Australia, Hong Kong, Japan and Singapore. These countries were chosen because of their large membership and local regulations permit both domestic and offshore products to be sold to investors residing in these countries. In order to complete the survey a member has to be a buyer, seller or service provider in investment, private wealth or retail investment product business. The survey was completed by 199 respondents.

We have selected relevant portions of the survey results for our analysis below;

- Fulfilling ‘know your clients’ requirements
- Information provided or disclosed to investors
- Policies and procedures in selling financial products

5.1 Fulfilling ‘Know Your Clients’ requirements.

- What would you do if a customer does not provide the information you request to fulfil the “know your client” requirement?

Fifty percent of the respondents said they would not proceed with the transaction, while 34 percent would complete the transaction as long as the client signs a written acknowledge that the information is missing. The data when analysed by type of work, showed that 60 percent of the respondents who worked as buyers of financial products would not complete the transaction under any circumstances.

- What would you do if a customer insists that you complete a transaction that you know is not suitable given the customer’s financial situation, investment objectives, level of risk tolerance and/or financial need, knowledge and experience?

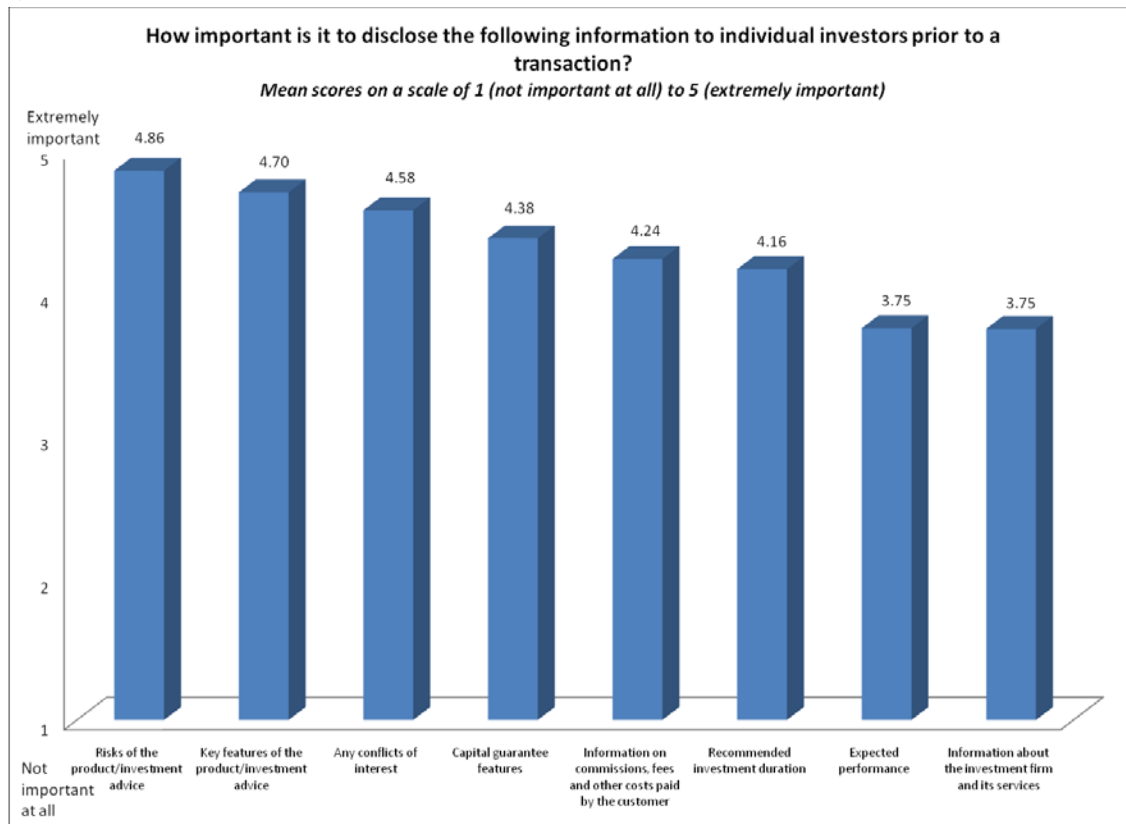
The respondents were split with 45 percent not willing to proceed with the transaction under any circumstances and 43 percent willing to complete the transaction as long as the client signs a written acknowledgement.

5.2 Information provided or disclosed to customers

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:

- giving actual absolute losses in scenario analyses;
- 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 investors can take to limit losses in the event that the market has an adverse move.

Chart 1



5.3. Policies and procedures in selling financial products

The respondents were requested to rate on a scale of 1 (not important at all) to 5 (extremely important), selected policies and procedures adopted by the firm in the introduction of new investment products. While all were rated as highly important, the most important was adequate training and support for sales agents and product distributors.