New Proposals to Regulate Mis-Selling of Investment Funds & Structured Products in Hong Kong: Right or Wrong?

*The recent global financial crisis has resulted in an upswing in regulatory action throughout world markets. In Hong Kong, the Securities and Futures Commission ("**SFC**") has proposed a slew of new requirements, some of which have already been implemented retroactively and without industry consultation. In this article we examine these ongoing developments in SFC policy and their effectiveness in reaching a fair balance between investor protection and costs to the investor and the financial industry.*

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The past few months have seen major developments in the approach taken by the Securities and Futures Commission (**"SFC"**) in regulating the sale of investment products, including mutual funds, unit trusts and structured products. The developments continue to crescendo:

- On October 3, 2008, the SFC issued a circular ("**Retail Products Circular**") to issuers of retail investment products reminding them of various existing regulatory duties;
- On December 5, 2008, the SFC issued a letter ("**CIS Enhanced Disclosure Letter**") to issuers of SFC authorized collective investment schemes providing guidance on marketing materials and, in effect, establishing enhanced disclosure requirements; and
- On December 31, 2008, the SFC co-authored a Report to the Financial Secretary on Issues Raised by the Lehman Minibonds crisis ("**Mis-Selling Report**") setting out recommendations for major regulatory changes.

Regrettably, it seems that some of the proposals have already been implemented retroactively by the

SFC, in particular those relating to product disclosures set out in the CIS Enhanced Disclosure Letter, without industry consultation and without notice to the industry. As a result, the industry has been forced to review all its marketing materials, including those previously authorized by the SFC, with a view to compliance.

The remaining majority of the proposals have not, however, yet been implemented. Some will require legislative amendments, which will take some time. Others may be effected by changes in SFC regulatory requirements and thus, could be implemented on short notice.

Sales Practices

A major focus for the SFC now appears to be (i) to reinforce and supplement the existing duty of issuers of investment products to provide sufficient, balanced and understandable information to describe the product and its risks, (ii) to reinforce the existing duty of intermediaries selling investment products to ensure the products sold by them are suitable for the investors who purchase them, and (iii) to more proactively enforce existing regulatory duties relating to sales practices.

However, going forward the SFC offers a number of possible proposals for consideration, including:

- tightening the definition of a "professional investor",
- requiring disclosure of commissions received by intermediaries,
- introducing a cooling off period, and
- introducing new ongoing disclosure requirements for issuers of investment products.

Product Disclosures – Do Investors Read or Understand Them?

In the Mis-Selling Report, the SFC proposes a requirement for summaries to be prepared for all investment products which are offered to the Hong Kong public. These summaries will be no more than 4 pages of plain, concise, easily understood language augmented by charts and diagrams, will include all key information and will facilitate comparison with other products.

These proposals are consistent with regulatory developments in the U.S., the U.K. and Australia and are in fact reflected in the SFC's new authorization and enforcement practices.

In relation to SFC authorized investment funds, the SFC already appears to be implementing the proposal, with the CIS Enhanced Disclosure Letter requiring marketing materials to contain a summary of key product features and risks upfront, prominently and in a few key bullet points. It requires the summary:

- to state what the product is and what it does, what the key risks are and what the worst case scenario is for an investor, and
- to remind investors not to invest in the product unless they have been advised by the selling intermediary that the product is suitable.

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Content of Product Summaries

Preliminary feedback from the asset management industry suggests confusion as to what is to be included in the summary as opposed to the formal offering document and, consequently, a desire within the industry to standardize the summaries for particular product classes. The industry appears to be experiencing difficulties in describing a product accurately in abbreviated form.

As liability may follow on the occurrence of a risk which was described in the offering document but was not described in the summary because it was considered to be a low risk, there is a concern that issuers of investment products will aim to over-disclose risks in the summary but, because of length constraints, will be forced to generalize risk disclosures to the point where they are all encompassing but meaningless.

Effect of Product Summaries on Investor Behaviour

It is not clear to what extent enhanced product disclosures will benefit investors and whether any such benefit justifies the additional costs of compliance.

In the case of the Lehman Minibonds, whilst a product summary may have highlighted that these products were not traditional fixed income instruments, it is doubtful that such a product summary would have highlighted the bankruptcy of Lehman as a key risk. It is uncertain whether a product summary disclosure highlighting a possible complete loss of principal would have deterred investors as such a loss is possible for virtually every investment product and is likely to be disclosed in all product summaries.

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At the same time, investors may not be inclined to read or to take the time and make the effort to understand product disclosures. They may discount written risk disclosures as standardized disclosures without more considered thought.

In this regard, it is possible that at some point, there may be a point of diminishing returns beyond which further risk disclosures may incrementally decrease the effectiveness of individual disclosures. It is not uncommon for investors who have lost money investing to complain that they did not understand a product even after having signed a written declaration that they understood the product.

In any event, it is unclear whether investors are in a position to assess the probability and consequences of disclosed risks materializing. Indeed, many hedge fund managers, regarded as sophisticated investors, failed to successfully assess the counterparty risk of dealing with Lehman Brothers.

The Case Against Product Summaries

It is difficult for product regulations to protect investors in these circumstances. Investment losses, including severe investment losses, are a natural part of investing. In the absence of evidence that investors would modify behaviour appropriately (*i.e.* to a degree commensurate to the disclosed risks) in light of disclosures contained in marketing materials, there is a danger of over-regulating product disclosures with little investor protection benefits.

Ongoing Disclosure Obligations

In the Mis-Selling Report, the SFC recommends the introduction of statutory requirements for product issuers to provide relevant information to investors including changes in circumstances that may have a significant effect on the value of the investment and for intermediaries to take appropriate steps to ensure that such information is brought to the attention of investors.

The SFC suggests that the SFC website become a central repository for such information in respect of SFC authorized investment products much like the website of the Stock Exchange of Hong Kong is a central repository for such information in respect of listed companies.

The recommendation raises significant potential compliance burdens. Take for example the case of a structured product linked to an underlying listed company and for which the issuing bank serves as counterparty.

- The bank may issue press releases regularly to disclose material developments which affect its share price and which may be material to the creditworthiness of the bank.
- The underlying listed company may issue press releases regularly to disclose material developments which affect its share price or creditworthiness.
- Third parties may produce research which may materially affect the perceived value or creditworthiness of the bank or listed company.

Would the bank now be required to collate, summarize and disseminate information from these press releases and from such research to all intermediaries selling the product?

Alternatively, take for example a mutual fund with a wide ranging portfolio of securities.

- Is the fund company required to disseminate all public information which may reasonably be available to it in respect of each significant portfolio company as it becomes publicized?
- Is the fund company required to monitor the custodian bank's creditworthiness on an ongoing basis and disseminate all public information which may reasonably be available to it in respect of the custodian bank which may affect the creditworthiness of the custodian bank as it becomes publicized?

At the same time, would selling intermediaries be required to disseminate such information to clients who purchased the product? Would investors welcome the receipt of such information on a regular basis and would they appreciate the significance of this information?

Suitability – Can Investors Expect Objective Advice For Free?

Many investors rely upon their banker or financial adviser to recommend investment products to them. Consequently, it has been a long standing regulatory requirement that intermediaries must ensure that the advice they provide is

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suitable for their clients given the clients' individual circumstances.

In the Mis-Selling Report, the SFC proposes to supplement existing suitability obligations by requiring intermediaries:

- to adopt suitable criteria for characterizing investors with a view to assisting in ensuring that investment advice and products offered are suitable for investors;
- to ensure products are only sold by staff who have demonstrated a sufficient understanding of the particular product;
- to document and provide a copy to each client of the rationale underlying the recommendations or solicitations made to the client; and
- to conduct product due diligence on a continuous basis at appropriate intervals having regard to the nature, features and risks of investment products.

At the same time, the SFC proposes to use undercover enforcement officials as part of a programme to enforce compliance with suitability obligations.

In like vein, in the CIS Enhanced Disclosure Letter, the SFC requires product issuers to place a reminder in the front of their marketing materials that they should not invest in the product unless the intermediary who sells it to them has advised them that the product is suitable and has explained how it is consistent with their investment objectives.

Commercial Realities

At base, any discussion on regulation of sales practices should recognize that selling intermediaries are generally in the business of selling investment products rather than advising clients. This is because clients generally do not pay intermediaries for advice. Rather, product issuers pay intermediaries to distribute products.

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Unless the economic interests of selling intermediaries are more closely aligned with the economic interests of their clients, a requirement for selling intermediaries to ensure that product recommendations are suitable may simply encourage intermediaries to justify recommendations in their own economic interests as being suitable for clients rather than to encourage intermediaries to make recommendations based on the economic interests of clients. Reinforcing regulations for selling intermediaries to ensure product recommendations are suitable does not align the economic interests of intermediaries and their clients.

Disclosure of Commissions

Recognizing the possible misalignment of economic interests, in the Mis-Selling Report, the SFC also proposes a requirement for selling intermediaries to disclose at the pre-sale stage commissions payable to and other benefits receivable by them. Such a requirement benefits investors as it places them on notice that the advice which they receive may not be impartial advice. Indeed, the SFC notes that such disclosure is required in Australia, the U.K and Singapore.

Nevertheless, a requirement for disclosure of commissions and benefits does not align the economic interests of selling intermediaries and their clients. Its purpose therefore cannot lie in improving

the suitability of advice given but rather with reducing the degree of reliance placed by an investor on advice.

The Extent to Which Disclosures Protect Investors

However, if a misalignment of economic interests persists, it is not difficult to conceive of intermediaries selling products with higher commissions which, whilst not unsuitable, may be less suitable for clients, rather than selling products with lower commissions which may be more suitable for clients.

To take a simplistic example, assume the universe of investment products may be divided into 2 classes, "A" and "B". Intermediaries receive a $5 commission on each unit of "A" sold but only $1 on each unit of "B" sold. In the short term, an intermediary may wish to offer its clients a selection of "A" products, recommending one of them in particular but without offering any "B" products. In this case, a client would not be aware of the "B" products and may consider the commission disclosed to him as not affecting the recommendation given to him to purchase the particular "A" product.

Investor Responsibility

In light of the foregoing, whilst it is clearly beneficial for investors to receive advice that is suitable for them, it is possible that it is counterproductive for the SFC to reinforce suitability obligations on intermediaries as such obligations may perpetuate perceptions amongst investors that advice they receive from intermediaries is premised on their own best economic interests. Instead, it may be more productive for the SFC to encourage investors to pay for financial advice if they wish to obtain investment recommendations which are premised on their own best economic interests. Unfortunately, investors have traditionally shown reluctance to pay for financial advice and it may therefore be desirable for the SFC to consider moving towards a regulatory framework biased towards such an arrangement.

Professional Investors

Broadly, in the Mis-Selling Report, the SFC suggests that there is no general dissatisfaction with the current definition of a "professional investor" under the regulatory framework and thus, by implication, no general dissatisfaction with the circumstances in which investment products may be sold without SFC authorization or without appropriate advice as to suitability. However, the SFC does propose further consultation on the matter as to the necessity of raising the threshold for a person to qualify as a professional investor.

Cooling Off Period

In the Mis-Selling Report, the SFC proposes the introduction of a cooling off period on sale of investment products. It is not clear whether the SFC proposals are limited to products sold to retail investors but presumably this is the case.

Under a cooling off period, investors would have the right to cancel an investment product purchase within a fixed period of time following the purchase. The SFC notes that a cooling off period al-

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ready exists for Hong Kong insurance contracts, for unlisted unit trusts in Singapore and for certain investment products in the United Kingdom.

The SFC recognizes that in respect of investment products where the value of the investment may fluctuate during the cooling off period, the price refunded on cancellation should be adjusted to reflect any fluctuations.

To the extent that investors are already free to close out any purchase made at any time after the purchase, the proposal does not represent a significant change in current practices and it appears unlikely that such a cooling off period would have been of any assistance to the majority of investors who purchased Lehman Minibonds, as those investors were presumably satisfied with their investment until the collapse of Lehman Brothers.

However, to the extent that investment products are fixed term in nature, the proposal marks a significant change in practice. It effectively eliminates the possibility of an investment product which is premised on a short fixed term, as a product issuer will not be able to effectively hedge the risk it bears on such products if the investor has the right to withdraw their investment before the fixed term expires. For products with a longer fixed term, it effectively limits a product issuer from relying upon the initial portion of the fixed term, which may, in turn, affect product structure.

Notably, the SFC does suggest that selling costs associated with cancellation should not be reflected in any adjustment, opening up the possibility (which product issuers must take appropriate steps to guard against) of selling intermediaries defrauding product issuers with fake investment purchases which are cancelled immediately upon receipt of commissions.

Conclusion

Ultimately, investors must assume responsibility for the losses they incur on their investments. Regulation of sales practices, both on product issuers and selling intermediaries, is clearly desirable but at the macro level, the costs, including compliance burdens on issuers and intermediaries and restrictions on product options for investors, must be weighed carefully against investor protection benefits.

The limits of regulation should also be realistically appraised. To some degree, the SFC must allow investors to suffer the consequences of their own action where they have failed to use the regulatory protections and financial product information which is already available to facilitate their investment-making decisions. In this regard, the SFC should be wary of allowing a climate of heightened regulation to lure investors into the mistaken belief that it and other regulatory authorities exist primarily as a means to insure them against the results of their own folly. ■

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