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Legco Report – Impact on Providers and Distributors of Structured Financial Products.

On 6 June 2012, the Hong Kong Legislative Council Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products (the "Subcommittee") published its long-expected Report[1]. The Subcommittee report reaches a number of conclusions about the legislative framework and regulatory arrangements governing the offering of Lehman Brothers ("LB") structured products by banks to retail investors and makes several recommendations about the offering of investment products generally, which, if implemented, could have a significant impact on how both bank and non-bank financial intermediaries operate in Hong Kong.

Regulatory oversight of financial intermediaries offering investment products

The Subcommittee was critical of the overall regulatory arrangements governing banks offering investment products and concluded that they were not "conducive to early detection of mis-selling of structured financial products" by banks. In particular, the Subcommittee concluded that the division of regulatory oversight between the Hong Kong Monetary Authority ("HKMA") and the Securities and Futures Commission ("SFC") was an "ineffective" arrangement. The Subcommittee was also concerned that, unlike the SFC which regulates employees engaged in securities business through its licensing regime, the HKMA does not directly regulate relevant employees in their conduct of regulated activities but relies on the management of individual banks to ensure compliance.

The Subcommittee recommended that the government consider ***placing the securities business conducted by banks under the direct supervision of the SFC***. Whilst consistent regulation would provide a more level playing field in the conduct of regulated activities by banks and securities brokers, if this recommendation is implemented[2], it is likely to increase the compliance

[1] Three members of the Subcommittee also produced a report which generally supported the findings and recommendations made in the main Report but rather than attributing responsibility for investor losses to ineffective supervision of the regulators, these members gave greater recognition to the role of the global financial crisis and the unexpected collapse of LB for investor losses, and emphasized the efforts of regulators and banks in resolving investor complaints as well as the responsibility of investors to protect themselves.

[2] It may be interesting to note that the UK has also moved towards dual regulation of banks where prudential regulation and supervision of conduct are split between two regulators.

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burden of banks which would be subject to direct supervision by the HKMA of their traditional banking business and by the SFC of their securities business. Employees engaged in regulated activities in respect of the banks' securities business would also be directly subject to SFC regulation.

Regulation of the sales process

In its investigation into the issues arising from the distribution of LB structured products, the Subcommittee identified a number of compliance deficiencies in product due diligence, the provision of staff training and guidance, know-your-client ("KYC") and customer suitability assessments, the conduct of sales processes, monitoring and internal controls and complaint handling.

The Subcommittee recommended that the following measures be taken to strengthen the conduct requirements applicable to securities businesses:

- ***Auditing, examination and surveillance should be increased***

  The Subcommittee recommended that both on-site examinations and off-site surveillance should be stepped up to focus on intermediaries' management controls and systems to ensure adequacy of staff performance in terms of product understanding, an appropriate remuneration and incentive structure that gives sufficient recognition to compliance, proper conduct of product due diligence, KYC and suitability assessments, effective monitoring of sales process, and a fair and expeditious complaint handling process.

- ***Front line staff dealing in and advising on investment products should be subject to more rigorous competency requirements***

  In particular, the Subcommittee recommended raising the minimum academic qualifications (e.g. university degree and/or professional training in specified fields such as finance or accounting) to better ensure front line staff can understand the financial products that may be sold to customers and discharge their duties to clients effectively.

- ***To ensure uniformity of practice, regulators should set benchmarks on key requirements, such as product due diligence, risk-rating of investment products, training for sales staff, customer risk profiling, basic information on investment products that must be explained to customers before completion of a transaction, handling of risk-mismatched transactions and complaint handling procedures***

  Whilst the setting of these benchmarks would be conducive to ensuring basic consistency in market practice and promoting fair competition between market participants, it would in practice be difficult to set useful benchmarks especially in relation to risk-rating, risk profiling and the handling of risk-mismatched transactions.

  One example the Subcommittee gave is for non-principal-protected structured financial products to be given a uniform risk rating. Principal protection is but one of many features (others include counterparties, reference entities and events and collateral arrangements) that could affect product risk. Given the myriad features that structured financial products can adopt, the use of simple benchmarks based on a single or a few product features to determine the risk-rating of a structured financial product may not be practicable or useful.

Similarly, the risk profile of a customer is likely to be derived from an analysis of numerous factors (such as investment experience, age, net worth, education level, amounts and types of other assets held and risk appetite), none of which would be viewed consistently by the market to be absolutely determinative. Whilst it may be helpful to give a non-exhaustive list of factors that should be considered in conducting customer risk profiling and provide guidance as to how such factors are to be taken into account, it may be challenging to prescribe assessment methodologies which are both useful and widely acceptable to the market.

The Subcommittee also gave an example of permitting risk-mismatched transactions only where certain thresholds are met. For the reasons explained above, it may be difficult to develop industry accepted benchmarks in determining the level of risk mismatch and to set workable thresholds.

Quite apart from the difficulty in setting useful "one-size-fits-all" benchmarks, benchmarking would involve the regulators going further into micro-managing securities business than Hong Kong regulators have historically done and raises issues as to the substitution of the regulator's opinion for business judgment.

- ***An intermediary should be presumed to act in an advisory capacity (having the associated compliance obligations of a person providing investment advice) when providing investment information to their customers unless the intermediary proves to the contrary and, so long as the investor remains a customer by holding valid account(s), the advisory duty of the intermediary should continue throughout the product tenor.***

The presumption that intermediaries are providing advice when giving investment information to their customers (with the result that compliance requirements such as suitability assessments and the duty to act with due skill, care and diligence would apply) would in practice mean intermediaries should not provide investment information to their customers on an execution only basis. Although under the Code of Conduct, the obligation to ensure suitability generally arises where a recommendation to or solicitation of the client is made, in the context of structured financial products, even if the transaction is on an unsolicited basis, intermediaries are already required to assure themselves that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products. In addition, in relation to clients without derivative knowledge, intermediaries are currently obliged to explain product risks to the client and (for unlisted derivative products) to advise on suitability of the derivative transaction. This recommendation, if implemented, could potentially require the intermediaries to take on the full range of advisory duties even when transacting with clients who have derivative knowledge on a non-solicited basis.

The recommendation to extend the intermediary's advisory duties to the customer throughout the life of the product so long as the investor remains a customer by holding valid accounts could, if implemented, potentially be very onerous to the intermediary. At present, issuers of unlisted structured investment products have post-sale continuous disclosure obligations (in relation to events such as those having a material adverse effect on the issuer, guarantor or key product counterparties or an event of default in respect of collateral) to keep investors up-to-date on certain developments that affect the risk/return profile of the products and distributors are contractually obliged to pass such information onto the investors, but there is no regulatory duty to continually make suitability assessments and provide on-going investment advice in relation to products that are held by a client. The scope of this proposed duty cries out for a more precise and restricted definition (e.g. the contemplated duties and the frequency at which any reviews are to be conducted should be spelt out and such duties should only apply so long as the investor continues to hold a position in the investment through the intermediary and the intermediary is retained in an advisory capacity). However, as formulated by the Subcommittee, this recommendation could potentially require an intermediary not only to track the risks and returns associated with each of its investment products and to continually assess and apprise the investor of any change in the risk/return profile of his or her investments throughout the products' lives, but also to measure that against the customer's risk profile and to advise the investor of any change in the suitability of his or her investments.

- ***Intermediaries should tighten up supervision of the sales process***

  The Subcommittee recommended that intermediaries should provide their employees with a checklist setting out the requisite steps in the sales process, employees should inform the customers of these steps and seek their acknowledgement upon completion of each step, and intermediaries should audio record each step of the process. The implementation of this recommendation is likely to facilitate monitoring by intermediaries of the sales process and improve transparency for the customers but at a cost of time and convenience in completing the sales process.

- ***HKMA should review and publish its findings on the effectiveness of measures taken to differentiate between the deposit taking business and the retail securities business of banks***

Recommendations on product offering requirements

The Subcommittee also expressed concern that disclosure requirements under the Companies Ordinance for offers of securities did not provide sufficient investor protection, particularly in the context of structured products offered to individual investors. The Subcommittee noted that many of the LB structured product offers were made pursuant to the private placement exemption of the Companies Ordinance, which it viewed as "undermining the usefulness" of the disclosure regime. Further, the report contended that the product offering documentation for the LB structured products was "often copious and not easy to understand" and that the marketing materials did not adequately disclose the material risks associated with the products. The report did, however, affirm the importance for investors to take responsibility for their investment decisions, acknowledging the limits of regulatory protections.

The report commented that last year's structured products amendments to the SFO were an "improvement" to the previous requirements, and the Subcommittee recommended against replacing the current disclosure regime with an across-the-board product approval requirement. However, due to concerns that products were being sold to persons who cannot protect themselves against mis-selling (such as by reason of age or illiteracy), the Subcommittee suggested that the regulators develop ***non-discretionary standards (such as past or current investment activity of the investor) so that only those investors meeting such qualifications may purchase the specified categories of investment products.*** We note that the SFC Code of Conduct already requires consideration of investment experience of an investor in the determination of its professional investor status and, if an investor is not a professional investor, of the investor's knowledge of derivatives if the investor wishes to invest in derivatives. This recommendation, if implemented, could potentially involve setting additional qualifications for an investor (whether or not the investor is a professional investor) depending on the type of investment product that he or she proposes to invest in. As discussed above, given that a number of factors contribute to determine the risk profile of a customer and there are potentially limitless combinations of features that affect the complexity and risk/return profile of a product, it could be challenging to set any tangible or objective criteria[3] by reference to which investor suitability in respect of structured products can be determined. Imposition of these standards would reinforce the effect of other recommendations, such as those relating to benchmarking

[3] The Subcommittee referred to the guidance issued by the National Association of Securities Dealers in US in September 2005 which asks member firms to consider whether purchases of some or all structured products should be limited to investors that have accounts that have been approved for options trading. Firms are allowed to develop other comparable procedures designed to ensure structured products are only sold to appropriate investors. The notice stresses that using an approved account to trade structured products is not a substitute for a thorough suitability analysis.

of customer risk profiling and product risk rating, to ensure that investment products are sold only to suitable investors.

In Hong Kong, the product approval process can already be used as a means to control the types of products to be offered to the public. The SFC already imposes requirements relating to the eligibility of issuers, guarantors and other counterparties and product structure. The SFC also has the power to withdraw authorisation once granted. It remains to be seen how these non-discretionary standards would be implemented, particularly in relation to professional investors (offers to whom need not be authorised by the SFC). This recommendation is consistent with overseas developments where the trend has been to extend the powers of the regulator in controlling the types of products offered to the market to address the perceived failings by intermediaries to ensure that only suitable products are made available to appropriate segments of the market.

Importantly, the Subcommittee also recommended that the ***current disclosure requirements should be "beefed up" along the lines of the "Treating Customers Fairly" initiative (the "TCF Initiative") of the UK Financial Services Authority,*** which imposes more comprehensive obligations[4] on product providers and distributors who target retail investors to ensure the "fair treatment" of customers throughout the product life-cycle. There are already general obligations under the SFC Code of Conduct to treat customers fairly and, in relation to unlisted structured products, specific fairness obligations imposed on intermediaries in terms of product design, terms and disclosure. If implemented, these recommendations could have a significant impact on the compliance obligations at each stage of the product life-cycle including product design and governance, identification of target markets, marketing and promoting the product, sales and advice processes, after-sales information and complaint handling.

The Subcommittee also recommended that ***the product issuer should be required to disclose the types of customers for whom the product is likely to be suitable, and how the product characteristics are suitable for that particular group of target customers*** and that it should be ***mandatory for disclosure of information on structured financial products for sale to retail investors to be written in plain language***. We note that the SFC in practice already requires these measures to be taken in relation to disclosure for authorised structured products.

The Subcommittee also called for the SFC to ***review the effectiveness of the Advertising Guidelines and the Product Key Fact Statement***.

Resolution of investor complaints

Although acknowledging that the majority of LB related complaints submitted to the HKMA have been resolved, the Subcommittee criticised the exclusion of certain "experienced investors" from repurchase offers, implying that the exclusion was "arbitrary" in nature. The report included a recommendation that the ***HKMA re-open unsubstantiated cases if more information***

[4] See text box on the "TCF Initiative – what does it involve?" below for more detail.

becomes available, which may mean that banks will be required to re-visit some cases they had previously thought were closed (possibly including cases involving those investors who are excluded from existing settlement agreements such as "experienced investors").

The Subcommittee called for the ***investigatory and disciplinary powers against registered institutions and their staff to rest with a single regulator*** instead of being shared by the SFC and the HKMA and recommended that ***the regulator be given the power to order the payment of compensation to aggrieved investors in addition to disciplinary sanctions***. Although the grant of the power to order compensation to investors would be novel in Hong Kong, in the UK, the FSA already has the power to make restitution orders against firms in individual cases (e.g. firms may be required to give up the profits made or to compensate an investor for his or her losses) as well as the power to order firms to set up a scheme for investigating and compensating a class of investors.

Beyond the Report : what should we expect?

The Subcommittee's recommendations, if and when implemented, are likely to result in a higher compliance burden and staffing costs for banks' retail structured products business. Whether or not the regulatory framework will be changed remains to be seen, but the HKMA and SFC could be expected to collaborate more closely in ensuring greater consistency in regulation of securities businesses. We would also expect heightened regulatory scrutiny of intermediaries' conduct throughout the sales process, greater emphasis on ensuring product suitability for customers and a more consistent standard of conduct to be adopted by market participants, and, possibly, a tougher regulatory stance in pursuing the resolution of the outstanding LB disputes. Firms should seize the opportunity to revisit their operations to ensure that the regulators' expectations are met. Although the Subcommittee did not make any recommendations in relation to the use of the professional investor exemption for distribution of structured products, we understand that this exemption is scheduled for review later this year in response to a push to tighten up the scope of the professional investor exemption.

If you would like any further information or would like to discuss this further, please contact Andrew Malcolm, Chin-Chong Liew, Victor Wan, Stephen Fletcher, Umesh Kumar, Marc Harvey, Melvin Sng, Jelita Pandjaitan or a member of the Structured Finance and Derivatives, Financial Regulations or Litigation groups.

TCF Initiative – what does it involve?

Treating Customers Fairly is a principles-based initiative of the Financial Services Authority in the UK which focuses on the delivery of fair outcomes for retail clients. It therefore applies to firms who design, market or are involved in the operation of retail products or services, those that distribute retail products, and those that have a contractual or other relationship with retail customers (including as a result of producing or distributing a product) such that they provide an on-going service of some kind. In the context of structured products, both providers and distributors of retail structured products and related services would come within its scope. Firms (or business lines within firms) that are never involved directly with end retail clients are outside the usual scope of the TCF initiative where their actions do not have a material impact on the outcome for those clients. For example, an investment bank contributing a component part to a structured product devised by a retail bank (where the investment bank does not end up with a contract with a retail customer as a part of the transaction and does not have a significant influence over the design of the product) would be outside the scope of the TCF Initiative (although the retail bank would have TCF provider responsibilities). However, where the investment bank designs or significantly influences the design of the product, then it would come within the scope of the TCF Initiative.

The TCF Initiative defines six consumer outcomes which firms under the supervision of FSA are expected to deliver. They are:

(a) consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture;

(b) products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly;

(c) consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale;

(d) where consumers receive advice, the advice is suitable and takes account of their circumstances;

(e) consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect; and

(f) consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

Fair treatment of customers is required throughout the product cycle in respect of product design and governance, identification of target markets, marketing and promoting the product, sales and advice processes, after-sales information and complaint handling.

Under the TCF Initiative, the product provider takes on primary responsibilities to ensure products are soundly designed for the target market (which includes considering which systems and controls it will need to employ to manage the risks posed by a particular product design, stress testing the product and evaluating its impact on the customer). In addition, it must ensure that information it produces for consumers is clear, fair and not misleading and that it applies due skill, care and diligence in preparing information for distributor use, and that products are sold through appropriate distribution channels and perform as the provider promised. The distributor takes primary responsibility to ensure that the customer has the information it needs, that (for an advised sale) the product is suitable for the customer, that post-sale service meets any expectations created and to review performance of products against expectations. The requirement to ensure that there are no unreasonable post-sale barriers (e.g. the level of exit penalties and the effectiveness and efficiency of the complaint handling process) imposed to change a product, switch a provider, submit a claim or make a complaint would be applicable to both providers and distributors.

TCF should be an integral part of a firm's business culture and should be reflected in business leadership, strategy, decision making, controls, recruitment, training and competence and the reward framework. Senior management are expected to ensure that the firm and staff at all levels deliver the consumer outcomes relevant to their business through instilling an appropriate culture, and be committed to and accountable for identifying and addressing customer fairness issues. Firms are required to assess business activities to identify risks to consumers that are relevant to each TCF outcome and to determine appropriate measures to be taken and be able to demonstrate delivery of fair outcomes. The FSA expects firms to regularly produce accurate, timely, relevant and consistent management information (including both qualitative insights as well as quantitative data) and actively monitor and make use of information collected to ensure delivery of each of the outcomes. Such information forms part of the evidence that firms are expected to have to demonstrate to themselves and the FSA that they are treating customers fairly. FSA will also use such information to supplement its own supervisory work.

Those firms that demonstrate delivery of the TCF outcomes can expect less intrusive supervisory testing by the FSA. The FSA has a number of enforcement powers (for example, the powers to impose regulatory fines and make prohibition orders) and has in the past taken enforcement actions as a result of TCF failings.

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