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Responding to the Global Financial Crisis – Implications on Financial Reform and Impact on the Regulatory Regime

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Introduction

It has been over two years since the sub-prime crisis started in the summer of 2007, and Lehman's collapse in September last year sent the global economies into a synchronised recession. Asia was not as badly affected as the developed economies, which faced a market meltdown.

Asia had its own crisis in 1997, and emerged much stronger after taking the necessary reforms to restructure its economy and strengthen its financial system. Asia's relatively less developed capital markets was a blessing, as it was spared the problems of securitisation (the "originate-to-distribute" business model) and the credit default swap (CDS) market.

The global policy response to the crisis was mainly to stabilise markets and restore market functioning, stimulate the economy to avoid a deep recession, and to strengthen the global financial architecture and resilience through coordinated financial reforms. The worst of the crisis is now behind us: it appears that financial markets have stabilised, and the world is on the path of recovery.

What I will focus on today is the global challenge facing markets and regulators today in rebuilding trust and in strengthening investor protection. I will also touch on the SFC's consultation proposals to enhance investor protection.

Rebuilding trust

Financial markets function as long as there is confidence. Fear of the unknown (who holds what risk, and how much) and uncertainty (of the future scenario) breeds panic. As the recent crisis demonstrates, confidence can evaporate very quickly: depositors, investors and lenders retreated from markets and hoarded cash, leading to a credit crunch and drying up of liquidity that led markets to seize up in major economies.

Financial markets have stabilised, but they have not, I believe, fully returned to normal market functioning. One of the keys to achieving this is to rebuild the trust of investors, and until financial intermediaries have fully restored this trust, markets would not be functioning at the full potential.

It is also important for financial intermediaries to realise that there is no going back to "business as normal". The popular view is that market discipline has failed, and the days of

self regulation and unfettered capitalism are over. At the same time, many have cautioned against killing markets with too much regulation.

There is agreement on the vital need for reform, but the challenge is to find the right balance of reform so that markets can continue to function efficiently without undermining financial stability (and economic stability). This does not mean no failures, or an absence of crises. Healthy markets can absorb such shocks without destabilising financial markets.

As recovery takes hold and memory of the crisis fades, there is the danger of a loss of momentum for reform. It is therefore important for both policy makers and market participants to work together for a more resilient financial system. This may mean adjusting to a "new normal".

Strengthening investor protection

For many years before the crisis, the financial sector had grown rapidly and profitably. The crisis has given rise to a call in major markets for the financial system to "go back to basics", that is to grow in tandem with, and not overtake, the real economy. What this means is that financial innovation is fine, but remember that it is a means to an end and not an end in itself. Innovation for innovation's sake is costly at best and useless at worst. Financial intermediaries ought to design products that investors need, and give investors the assurance that "what you get is what you see". It is okay to be plain vanilla and better if it is simple to understand. Complexity does not necessarily make a product better, but might confuse or mislead.

The proposals of the United States and the United Kingdom on investment advice may be of interest to you:

- In the US, there is a proposal to hold broker-dealers to a fiduciary standard, as broker-dealers have become more actively involved in providing investment advice, and in being actively involved in the management of client assets. I am given to understand that under a fiduciary standard, the investment is required to be not just suitable, but it must be in the client's best interest. This proposal will have a significant impact on how broker-dealers in the US deliver the relevant services.
- The UK Financial Services Authority (FSA) has just recently published a number of documents setting out the standards firms need to meet when providing advice on, marketing and designing structured products. It includes a template and accompanying guidance for firms to assess the suitability of structured investment product advice.

In Hong Kong, investors suffered losses when Lehman Brothers failed. The SFC's report to the Financial Secretary in December 2008 found that the common generic complaints of investors were:

- Misrepresentation – that the products were wrongly presented as a low risk alternative to deposits and that the risks and complexity were not properly explained;
- Complexity – the products were too complex and risks disclosures were ineffective in alerting investors; and

- Suitability – that as a result of the above, and the failure of brokers and banks to do proper customer due diligence, inexperienced retail investors were left holding products not suitable to their investment profile.

The SFC's consultation papers on enhancing investor protection

The proposals follow from the SFC's Report to the Financial Secretary, and are aimed at strengthening our regulatory regime regarding the sale of investment products to retail investors and better protect the interests of investors. The proposals are a result of extensive research, experience-sharing and soft-consultation with other major jurisdictions and local stakeholders. It can be broadly divided into three parts:

- the first part is in relation to the way in which disclosure on product risks and features should be enhanced and the obligations that the product issuer or arranger should bear;
- the second part is in relation to revisions to be made to the Code of Conduct which, as we all know, governs intermediary conduct and selling practices;
- the last part involves a newly introduced cooling-off concept for long term illiquid products.

Product

The most prominent feature about the product proposal is the convergence of rules and standards for all products that we authorise, whether they are under the Companies Ordinance or the Securities and Futures Ordinance (SFO) with the Codes governing disclosures of various product types such as unit trusts, investment-linked assurance schemes (ILASs) and unlisted structured products by merging them into one (Handbook) on products, or a Consolidated Code. This will allow for consistent standards and principles to be applied across all products that we regulate.

The Unlisted Structured Products Code is new and a first for a major jurisdiction. Due to its unique structure, we are proposing to impose eligibility requirements on issuers and guarantors of unlisted structured products and to introduce the concept of a product arranger for issuers that are not immediately within our regulatory handle, such as SPVs.

In addition, the SFC subsequently released another consultation on 30 October on proposals to rationalise the regulatory requirements for public offers of structured products. To align the regimes for public offers of structured products presently governed by the Companies Ordinance (where it takes the form of a debenture) or the SFO (where it is not in the form of a debenture), it is proposed to bring all structured products under the SFO by transferring the regulation of public offers of structured products in the form of debentures from the Companies Ordinance prospectus regime to the regulatory regime for investment offers under Part IV of the SFO.

Our primary role in relation to product authorisation is to ensure that the features and risks of the products are adequately disclosed in the offering documents, and the documentation is free from inaccurate or misleading information, so that investors relying on these offering documents can form an informed judgment.

In the past year, one of the messages we have obtained from the market is that not all investors read the product offering documents before making their investment decisions, because the documents are often too long and it is difficult to identify the important parts. Instead they rely on marketing materials which have the sole purpose of attracting investor attention to the products being featured and may not contain all the relevant risks associated with the product, simply because they are much briefer.

To cater for most investors' practice we have developed a Key Facts Statement, which is intended to be user friendly, standardised to the extent possible (to facilitate comparison between products), and be kept concise. In principle, this Key Facts Statement will comprise part of the offering documents of the product and have equal force as the prospectus – yet it will be limited to only a few pages in length so as to highlight and facilitate investors' appreciation of the key features and risks of the product.

Conduct

The Code of Conduct (Code) sets the benchmark for intermediary conduct and core requirements such as the need to ensure suitability. The existing framework is sound, and the proposals are not substantive but would usefully provide further guidance to the industry to cater for market developments. The proposals would strengthen investor protection, as I will explain.

Enhancing disclosure

We propose imposing requirements on pre-sale disclosure by intermediaries to their client regarding potential conflicts of interest (such as commission rebates) and providing each customer with a Sales Disclosure Document that contains useful information, including the disclosure of any benefits received by the intermediary. With a Sales Disclosure Document in hand, the customer would now have the information to make a better informed decision on whether or not to invest in a particular product, as compared to another product not recommended by the intermediary.

Ensuring investors have appropriate knowledge regarding their investments

The second way to protect investors is to make sure that they are armed with the knowledge to understand what they are investing in. There is a general concern that the average investor is often unable to understand the complex nature and features of certain unlisted structured products, especially those with derivative elements. There is evidence of this as an SFC investor survey that was carried out in December 2008 revealed that a good two-thirds of investors surveyed knew very little of at least one of the products they had invested in, such as unlisted equity linked products. It almost begs the question – why did they buy them? Was it the investor's own decision to invest in something that he did not understand but believed might generate handsome returns, or was it the intermediary who recommended an overly risky or complex product that was outright unsuitable for that investor?

We have always had a "Know Your Client" process requirement under the Code. We are now proposing that, as part of that process, intermediaries should seek information from clients in relation to their knowledge of derivatives. Intermediaries would then characterise those clients (other than professional investors) who have derivative knowledge as "clients with derivative knowledge".

If a client is not characterised as a "client with derivative knowledge", the intermediary should not promote any unlisted derivative products to that client.
It follows that those clients that are assessed as being "clients with derivative knowledge" can be sold any kind of derivative product. But I must emphasise that intermediaries still need to comply with the suitability requirement whenever they make a recommendation or solicitation.

Although this appears to be an extra step, it is in fact not a new requirement. Intermediaries are already expected to know such details under the long established "know-your-client" procedures. However, we are trying to make this criterion more explicit by codifying it to help intermediaries determine whether a product is suitable for a client.

Professional investors

This emphasis on investor knowledge and experience applies also to professional investors. Many have put the sole focus of the professional investor definition on the portfolio threshold, which is currently set at US$1 million. Indeed, in the current consultation we are seeking comments on the monetary threshold. However, it is not only about the threshold, it is also about having sufficient knowledge, expertise and investment experience in the relevant financial products under consideration. It is a whole package. High-net-worth investors should be qualified to understand what they are investing in before being treated as professional investors.

Reducing distractions

We also recognise that gifts, when used as a marketing tool to promote investment products, may distract investors from focussing on the features and risks involved and determining whether the product is actually suitable for them. Gifts should not constitute the basis of any recommendation made to the investor. As such we propose to restrict distributors from offering gifts to investors when promoting a specific investment product to investors.

Cooling off

Many of you will know that the concept of cooling off is already applicable in the insurance industry, including for ILAS products – and one rationale for that is because insurance plans and products tend to be long termed and their exits can be difficult and costly. In the consultation we explore the idea of whether cooling off can also be applied to long term, illiquid products – mostly unlisted structured products.

Exercising the cooling off right will come at a price. To account for fair market movement and administrative costs incurred, an investor will typically not be able to recover his entire principal investment amount or all of the commission paid. Either that or part of the costs would likely have been priced into the product in anticipation of the exercise of the right. How the arrangement is determined will likely depend on the product type and the ease of which a product or its position can be unwound.

The concept of cooling off is meant to bring liquidity to products that are otherwise illiquid and not for speculation purposes. Therefore it is possible that we will cap the recovery of investment to the principal amount, but not more.

It is therefore crucial for everyone to think carefully whether cooling off is a suitable option for financial products, in general and for each individual case. If we receive broad support for the concept, we will then consider implementation details, and one of the issues that we would expect and rely on feedback is the length of the cooling off.

Conclusion

The global financial crisis has triggered the most comprehensive financial reforms since the Great Depression. The G20 Leaders have set the roadmap for wide ranging reforms. One aspect is to bring unregulated entities such as credit rating agencies (CRAs), private equity and hedge funds under the regulatory net. Another proposal, which is progressing quite fast in the US and Europe, is to require OTC products that can be standardised to be cleared through a Central Clearing Counterparty. The SFC is closely following these developments, as Hong Kong also has to consider the appropriate regulatory approach for CRAs and OTC products that best suits Hong Kong.

The SFC has put forward proposals to strengthen our regulatory regime. They are, however, not meant to be a be-all-and-end-all solution to the concerns many have regarding our regulatory structure, but we believe the proposals should be able to adequately tackle most of the problems that have surfaced. Equally important are the proposals on the establishment of the Investor Education Council and Financial Services Ombudsman. On the international front, the SFC would continue to benchmark its regulation to international standards or higher, if it better suits Hong Kong.

For any proposal or financial reform to work, the efforts of the SFC alone are not sufficient. We need the participation and cooperation of industry to make it work. Our intention is to put in place a regulatory system that strikes a good balance (it will never be perfect or please everyone) that provides enough flexibility for market players and sufficient investor protection. I would encourage you, as market practitioners in the frontline of your organisations, to make your views heard in your respective organisations. Your feedback would be invaluable to the SFC: on enhancing the financial regime and investor protection, your views count.

To ensure the continued success of any financial market, there needs to be a partnership among regulators, market practitioners and investors in exercising regulatory discipline, market discipline and self-discipline. You have an important role to play, and your professional conduct in the marketplace would contribute greatly to the objective of protecting the interest of investors.

In this regard, I am heartened to note that all CFP certificants agree to be bound by various professional, technical and ethical standards set out in the Code of Ethics and Professional Responsibility, through the promotion of the principles of integrity, objectivity, competence, fairness, confidentiality, professionalism and diligence.

On this note, I wish IFPHK and its members every success in promoting and upholding high standards of professional conduct in the delivery of financial planning and wealth management services.