
INFORMATION NOTE

Regulation of the sale of retail structured financial products in selected places

1. Background

1.1 The purpose of this information note is to provide the Panel on Financial Affairs with information on the regulation of the sale of retail structured financial products in Singapore, the United Kingdom (UK) and the United States (US). The information note will examine the regulatory regime of these selected places in terms of the major regulatory authorities, the principal laws and regulations, the applicable conduct of business requirements, the enforcement mechanism, and the regulatory measures recently proposed or implemented to enhance the regulation of the sale of retail structured financial products.

1.2 In contrast to Singapore and the UK, the US has not put in place a single regulator for monitoring the sale of retail structured financial products. The primary regulator for a certain type of structured financial products offered to retail investors would depend on the nature of the structured financial products. For example, some retail structured financial products are offered as registered investment products, which are regulated primarily by the Securities and Exchange Commission (SEC) and self-regulatory organizations¹. There are other retail structured financial products offered by banks as certificates of deposit with returns linked to the performance of a reference asset or index. These products are treated as bank deposits, which are exempted from the SEC registration and regulated primarily by relevant bank regulators. This information note will only study the regulatory regime governing the sale of the SEC-registered retail structured financial products in the US.

¹ The *Securities Exchange Act of 1934* prescribes a co-operative regulatory effort by SEC and membership self-regulatory organizations. In particular, the Act provides for SEC to devolve various regulatory powers to the self-regulatory organizations to enforce the industry standards and requirements related to securities trading and brokerage. In the US, self-regulatory organizations comprise securities and commodities exchanges, clearing agencies, the Municipal Securities Rulemaking Board and the Financial Industry Regulatory Authority.

Table 1 – Regulatory authorities

	Singapore	The United Kingdom	The United States
Major regulatory authorities	<ul style="list-style-type: none"> Monetary Authority of Singapore (MAS). 	<ul style="list-style-type: none"> Financial Services Authority (FSA). 	<ul style="list-style-type: none"> SEC and the Financial Industry Regulatory Authority (FINRA)².
Responsibilities	<ul style="list-style-type: none"> MAS serves as Singapore's single statutory regulator for the administration and supervision of the financial system. It performs the functions of a central bank, oversees the securities and futures industry, and regulates the insurance industry. MAS is also the licensing authority for conducting regulated investment activities in Singapore. 	<ul style="list-style-type: none"> FSA, being the single statutory regulator of the UK's financial industry, is responsible for the authorization and regulation of investment firms, banks, building societies, mortgage firms and insurance companies. FSA is also the competent authority for listing of securities in the UK. 	<ul style="list-style-type: none"> SEC is the regulator for securities activities of financial institutions including banks in the US. SEC performs the primary functions of enforcing federal securities laws, regulating the national securities markets, and registering and regulating brokers (effecting transactions on behalf of others), dealers (effecting transactions for their own accounts) and investment advisers. FINRA, being a self-regulatory organization, develops rules governing the business conduct of the securities industry, examines securities firms and their registered representatives for compliance with FINRA rules, and disciplines those who fail to do so.
Explicit mandate on consumer/investor protection	<ul style="list-style-type: none"> Information not available. 	<ul style="list-style-type: none"> Yes. The <i>Financial Services and Markets Act 2000</i> (the FSM Act) sets out the securing of an appropriate degree of protection for consumers as one of the objectives of establishing FSA³. 	<ul style="list-style-type: none"> Yes. As stated on the SEC website, the mission of SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation⁴.

² FINRA was established in 2007 with the merger of the National Association of Securities Dealers and the regulatory and enforcement units of the New York Stock Exchange. Currently, it is the largest non-governmental regulator for securities firms operating in the US.

³ FSA has committed £90 million (around HK\$1 billion) to implement the National Strategy for Financial Capability which links the UK government, the financial services industry, the voluntary sector and consumer and education groups to improve the financial capability of at least 10 million people in five years from 2006. According to FSA, financial capability means (a) the ability to make informed decisions about financial products, (b) being able to manage money, (c) keeping track of finances, and (d) staying up to date about financial matters.

⁴ In 2003, Congress established a statutory organization – the Financial Literacy and Education Commission – to undertake the national strategy of improving the basic financial literacy and education for the people in the US. The Commission, which is made up of 20 federal agencies (including SEC and the federal bank regulators), has established a website and a toll-free telephone number to provide the general public with the educational materials disseminated from across the spectrum of federal agencies that deal with financial issues and markets.

Table 2 – Principal laws and regulations

	Singapore	The United Kingdom	The United States
Principal governing legislation	<ul style="list-style-type: none"> The securities market is governed by the <i>Securities and Futures Act</i> (the SF Act) and its accompanying regulations, orders and notifications. The SF Act creates the legislative framework for the regulation and licensing of activities and institutions in the securities and futures industry. The SF Act also defines the scope of regulated investment activities, and the inspection and investigative powers of MAS. 	<ul style="list-style-type: none"> The securities market is governed by the FSM Act and its subordinate legislation. The FSM Act prescribes the establishment of FSA and its powers and functions with respect to the authorization and oversight of firms and individuals participating in regulated investment activities. 	<ul style="list-style-type: none"> Key pieces of legislation include: <ul style="list-style-type: none"> (a) <i>Securities Act of 1933</i> – requiring companies issuing securities for sale to the public to register and file registration statements (prospectuses and other documents) with SEC; (b) <i>Securities Exchange Act of 1934</i> – stipulating the establishment of SEC and its broad authority to regulate various aspects of the securities industry (including the registration and regulation of broker-dealers, and the filing of periodic reports by companies with publicly-traded securities); and (c) <i>Investment Advisers Act of 1940</i> – establishing a scheme of registration and regulation of investment advisers by SEC.

Table 2 – Principal laws and regulations (cont'd)

	Singapore	The United Kingdom	The United States
Conduct of business requirements	<ul style="list-style-type: none"> The securities industry is governed by the <i>Financial Advisers Act (FAA)</i> which contains legal provisions prescribing business conduct requirements for financial advisers with respect to their integrity, objectivity, confidentiality, competence, and due care and diligence. 	<ul style="list-style-type: none"> The securities industry is governed by the <i>FSA Handbook</i>, which comprises a number of themed sourcebooks covering various areas of the financial services industry. The sourcebooks – <i>Principles for Businesses</i> and <i>New Code of Business Sourcebook</i> – set out the fundamental obligations and conduct requirements for investment firms and their registered representatives when carrying out regulated investment activities with their clients. 	<ul style="list-style-type: none"> Securities firms are governed by the rules and regulations of relevant self-regulatory organizations. Rule 204A-1 promulgated under the <i>Investment Advisers Act of 1940</i> requires investment advisers registered with SEC to adopt codes of ethics that set forth standards of conduct expected of advisory personnel (e.g. fulfilment of fiduciary obligations) and address conflicts of interest that arise from personal trading by advisory personnel.
Adoption of disclosure-based approach for regulating the offer of securities to the public	<ul style="list-style-type: none"> Yes. The SF Act requires issuers to include in prospectuses all information that investors would reasonably need to make an informed assessment of the securities being offered. 	<ul style="list-style-type: none"> Yes. The FSM Act requires the provision of sufficient information to potential investors in the form of prospectuses before the issue of securities. 	<ul style="list-style-type: none"> Yes. The <i>Securities Act of 1933</i> requires issuers to disclose fully all relevant information in the registration statements filed with SEC.
Specific rules for the sale of structured financial products	<ul style="list-style-type: none"> Nil. 	<ul style="list-style-type: none"> Nil. 	<ul style="list-style-type: none"> Yes. In 2005, FINRA issued the <i>Notice to Members 05-59</i> to provide guidance to its members concerning their obligations when selling structured financial products⁵.

⁵ These obligations include (a) providing balanced disclosure in promotional efforts, (b) ascertaining accounts eligible to purchase structured financial products, (c) dealing fairly with customers with regard to derivative financial products, (d) performing a reasonable-basis suitability determination, (e) conducting a customer-specific suitability analysis, (f) maintaining a product-related supervisory control system, and (g) training persons associated with selling structured financial products to investors.

Table 3 – Applicable conduct of business requirements

	Singapore	The United Kingdom	The United States
Suitability and appropriateness assessment	<ul style="list-style-type: none"> Financial institutions and their registered representatives must have a reasonable basis when recommending investments. In doing so, they must consider the investment objectives, financial situation and the needs of their customers before making any recommendations on suitable investment products. 	<ul style="list-style-type: none"> An investment firm must take reasonable steps to ensure that any recommendation or decision to trade is suitable for its clients. To fulfil such suitability requirement, the investment firm must gather information regarding the clients': <ul style="list-style-type: none"> (a) knowledge and experience in the relevant investment field; (b) financial situation; and (c) investment objectives. For execution-only transactions, an investment firm must determine whether the clients concerned possess the necessary experience and knowledge to understand the products or services involved (i.e. appropriateness test). An investment firm must warn the clients if it considers the products or services are not appropriate for them. 	<ul style="list-style-type: none"> Securities firms and their registered representatives are required to: <ul style="list-style-type: none"> (a) understand the features of structured financial products and their potential risks and benefits before recommending the products to investors (i.e. reasonable-basis suitability analysis); (b) perform customer-specific suitability analysis to ensure that the recommendation to purchase a particular structured financial product is suitable for the customer concerned⁶; and (c) before launching a new product, consider whether the product is intended for limited or general distribution and to whom the product should not be offered.

⁶ In conducting the analysis, FINRA requires its member firms to examine a customer's financial and tax status, investment objectives, and other considerations necessary for making the recommendations. For example, while some retail structured financial products may pay interest like debt securities, they may not meet the suitability requirements for investors seeking alternatives to debt securities. In particular, the derivative component and the potential loss of the principal for many retail structured financial products may make them more akin to an option contract than to a debt security. See Financial Industry Regulatory Authority (2005b).

Table 3 – Applicable conduct of business requirements (cont'd)

	Singapore	The United Kingdom	The United States
Financial promotion	<ul style="list-style-type: none"> • A financial adviser should disclose to the clients: <ul style="list-style-type: none"> (a) relevant product information such as the terms and conditions, and the associated benefits and risks; and (b) general information (e.g. conflict of interest and any commission, fee or other benefits received from making the recommendation). • A financial adviser should also ensure that all marketing materials are: <ul style="list-style-type: none"> (a) clear – information disclosed to clients in any advertisements or publicity materials in any media should be presented in plain language, and in a manner that is easy for the clients to understand; (b) adequate – warnings and other important information should be prominently presented and clearly explained; and (c) not false or misleading⁷. 	<ul style="list-style-type: none"> • An investment firm must provide its clients with appropriate and comprehensible information about the firm and its services, products, investment strategies, execution venues and costs, and charges. • All communications with clients, including financial promotions, must be fair, clear and not misleading. Information must be accurate and balanced (in terms of potential benefits and relevant risks), sufficient and presented in a way that is likely to be understood by an average reader. It must not hide, diminish or obscure important statements or warnings. • Investment firms are responsible for ensuring their promotions meet the clear, fair and not misleading standard. They are not required to have their advertisements approved by FSA before they are published. 	<ul style="list-style-type: none"> • FINRA prohibits exaggerated statements and the omission of any material fact or qualification that would cause a communication to be misleading⁸. • FINRA also requires all sales materials and oral presentations regarding structured financial products to present a fair and balanced picture regarding both the risks and benefits⁹. • FINRA members must submit their advertisements to FINRA for review prior to their first use or publication.

⁷ As of the date of the publication of this information note, MAS has not provided any information on whether financial institutions are required to submit their advertisements to the relevant authorities for approval.

⁸ Sales materials and oral presentations that omit a description of the derivative component of the products and present such products as ordinary debt securities would constitute a violation of FINRA rules.

⁹ For example, marketing materials should not portray structured financial products as "conservative" or a source of "predictable current income" unless such statements are accurate, fair and balanced.

Table 3 – Applicable conduct of business requirements (cont'd)

	Singapore	The United Kingdom	The United States
General anti-fraud provision	<ul style="list-style-type: none"> The SF Act prohibits any person in connection with the purchase or sale of any securities to employ any device or scheme or to engage in any act to defraud other persons, or to make any untrue statement or misleading omission of material facts. 	<ul style="list-style-type: none"> The FSM Act creates an offence of knowingly or recklessly making a statement which is misleading, false or deceptive where the purpose is to induce an investor to enter into an investment agreement. 	<ul style="list-style-type: none"> Federal securities laws prohibit the use of any manipulative or deceptive device or contrivance in connection with the purchase or sale of any security.
Competency requirement	<ul style="list-style-type: none"> MAS sets out the minimum training and competency requirements for individuals applying for a licence to provide financial advisory services or carry on regulated investment activities in Singapore. Financial advisers are required to design and implement a comprehensive training and competency plan to ensure that their registered representatives have the skills and competence to provide good quality advice to clients. 	<ul style="list-style-type: none"> FSA sets out the training and competence requirements for individuals applying for a licence to carry on regulated investment activities in the UK. FSA requires, among other things, individuals providing advisory services on structured financial products to pass the relevant examinations. 	<ul style="list-style-type: none"> FINRA requires its member firms to train their registered representatives on the characteristics, risks, and rewards of each structured financial product and the factors that would make such products either suitable or unsuitable for certain investors, before allowing them to sell the products to investors¹⁰.
Other requirements	<ul style="list-style-type: none"> Information not available. 	<ul style="list-style-type: none"> Information not available. 	<ul style="list-style-type: none"> Given the similar risk profile of many structured financial products and options, FINRA calls for its member firms to limit the sale of such products to investors that have accounts already pre-approved for options trading.

¹⁰ FINRA considers that it is crucial for registered representatives to have a full and balanced understanding regarding both the risks and rewards of structured financial products, as investors may turn to these products as an alternative to traditional equity and fixed-income investments.

Table 4 – Enforcement mechanism

	Singapore	The United Kingdom	The United States
Supervisory approach	<ul style="list-style-type: none"> MAS conducts on-site inspections of financial institutions in Singapore. It normally notifies them of planned inspections, although unannounced inspections may be carried out when necessary. "Mystery shopping"¹¹ techniques have also been used by MAS for its thematic reviews of the financial services. 	<ul style="list-style-type: none"> FSA conducts on-site inspections and transaction testing in its thematic work of surveying industry practices (such as reviewing financial promotions). "Mystery shopping" techniques have been employed as part of its thematic sampling work¹². 	<ul style="list-style-type: none"> Self-regulatory organizations conduct routine and unannounced on-site inspections of their member firms. SEC performs oversight examination to evaluate the quality of the inspections of the self-regulatory organizations.
Enforcement powers of the regulatory authorities	<ul style="list-style-type: none"> MAS's regulatory actions include public reprimand, fines, civil penalty actions against market misconduct, prohibition orders, revocation of licence, and referral of the case to the Commercial Affairs Department of the Singapore Police Force for criminal investigations and prosecution. 	<ul style="list-style-type: none"> FSA has a range of disciplinary, civil and criminal powers including financial penalty, public censure, withdrawal of a firm's authorization, seeking injunctions, requiring firms to compensate consumers, and even criminal prosecution for market misconduct. 	<ul style="list-style-type: none"> SEC has the authority to impose administrative sanctions including cease and desist orders, suspension or revocation of any broker-dealer or investment adviser registration, public censure and fines. SEC can also bring the case to court for civil penalty action or refer it to the Department of Justice for criminal prosecution. Self-regulatory organizations are empowered to discipline its members for violations of the relevant securities laws/rules and subject them to incur fine, suspension or expulsion from the securities industry, or the penalty to pay compensation.
Financial dispute resolution mechanism	<ul style="list-style-type: none"> Investors who have financial disputes that cannot be resolved with the financial institutions concerned can file a complaint with the Financial Industry Disputes Resolution Centre. 	<ul style="list-style-type: none"> FSA puts the primary onus on investment firms to resolve financial disputes internally wherever possible, but it allows for the referral of the case to the Financial Ombudsman Service if the internal mechanisms fail to satisfy the complainant. 	<ul style="list-style-type: none"> Self-regulatory organizations require broker-dealers to accept arbitration of disputes at the demand of the customer. FINRA operates the largest dispute resolution forum in the securities industry to assist in the resolution of financial disputes.

¹¹ Mystery shopping is a research tool used to measure quality of retail service or gather specific information about products and services. Mystery shoppers posing as normal customers perform specific tasks – such as purchasing a product, asking questions, registering complaints or behaving in a certain way – and then provide detailed reports or feedback about their experiences. See Wikipedia (2009).

¹² According to Hong Kong Monetary Authority (2008), it appears that FSA does not conduct unannounced on-site inspections (apart from mystery shopping).

Table 5 – Recently proposed/implemented regulatory measures

	Singapore	The United Kingdom	The United States
Measures proposed or implemented	<ul style="list-style-type: none"> • MAS is undertaking a review of the marketing and sale of structured financial products, which covers: <ol style="list-style-type: none"> (a) stronger suitability requirements for certain types of products; (b) clearer product labelling and risk rating; (c) simpler descriptions of the features and risks of the products so that they can be more readily understood; and (d) clearer separation between a bank's traditional deposit-taking business and its investment product sales and marketing activities¹³. 	<ul style="list-style-type: none"> • FSA has recently implemented the "Treating Customers Fairly (TCF)" initiative to stipulate the respective roles of the product providers and distributors in the fair treatment of their customers^{14, 15}. • FSA has defined six customer outcomes which firms are expected to deliver under the TCF initiative, particularly with respect to ensuring product suitability for and appropriate disclosure of product information to the customers¹⁶. 	<ul style="list-style-type: none"> • In March 2008, the Department of the Treasury released its "Blueprint for a Modernized Financial Regulatory Structure" proposing a major restructuring of the US financial regulatory framework¹⁷. • The Blueprint proposes, among other things, the establishment of an optimal regulatory structure comprising: <ol style="list-style-type: none"> (a) a market stability regulator to address the overall conditions of financial market stability; (b) a prudential financial regulator to oversee firms with explicit government guarantees; and (c) a business conduct regulator to monitor business conduct regulation across all types of financial institutions, thereby providing effective consumer and investor protection¹⁸.

¹³ Following the review, MAS will conduct a public consultation by mid-March 2009 to solicit public views on, among other things, enhancing the regulatory regime for advertising and marketing materials and introducing product summary documents.

¹⁴ For example, the product providers should identify the target investor market for which the product is likely to be most suitable. They should also consider whether the information given to the product distributors is sufficient, appropriate and comprehensible and whether it will enable the product distributors to provide suitable advice (if relevant) to the end investors.

¹⁵ For example, the product distributors must put in place systems and controls to manage the risks that financial promotion poses. They must also act with due skill, care and diligence in passing on promotional materials. When passing provider materials to customers, the product distributors should consider whether they understand the information provided. They should not distribute the product if they do not sufficiently understand such information.

¹⁶ Please refer to the Appendix for details of these six TCF outcomes.

¹⁷ The Department of the Treasury considers the current system of functional regulation, which maintains separate regulatory agencies across segregated functional lines of banking, insurance, futures, and securities, is largely incompatible with today's financial markets. Of particular relevance is the lack of a single regulator to monitor systemic risk under the functional regulation approach. See Department of the Treasury (2008).

¹⁸ The optimal regulatory structure proposed in the Blueprint is similar to the "twin peaks" approach discussed in the report published by the Group of Thirty in October 2008. The "twin peaks" approach is one in which there is a separation of regulatory functions between two regulators: one that performs the safety and soundness supervision function and the other that focuses on the conduct of business regulation.

Table 5 – Recently proposed/implemented regulatory measures (cont'd)

	Singapore	The United Kingdom	The United States
Measures proposed or implemented (cont'd)	<ul style="list-style-type: none"> MAS is studying how best to implement the Guidelines on Fair Dealing to help financial institutions achieve better standards of fair dealing outcomes for consumers¹⁹. 	<ul style="list-style-type: none"> FSA has published a consultation paper proposing to introduce a new framework for regulating the retail banking business, including the sale of structured financial products. FSA is conducting the "Retail Distribution Review" which outlines proposals aiming at giving more consumer confidence and trust in the retail investment market. These proposals include: <ul style="list-style-type: none"> (a) providing greater clarity for consumers about advisory services by distinguishing independent advice from sales advice²⁰; (b) raising professional standards of advisers by setting minimum qualifications for different types of financial advice and establishing a Professional Standards Board; and (c) requiring independent advisers to agree the cost of financial advice with customers up-front, removing the possibility of commission-bias where product providers could potentially influence the advice given if they pay the advisers on business generated. 	<ul style="list-style-type: none"> The Blueprint should serve as an input for the report to be submitted by the Department of the Treasury to Congress by 30 April 2009. The report is required to contain recommendations on the current state of the financial market and the regulatory system²¹.

¹⁹ According to Monetary Authority of Singapore (2008e), financial institutions should strive to achieve the following five fair dealing outcomes: (a) prioritising consumers' interests in the conduct of business, (b) offering suitable products and services, (c) appointing competent representatives who could provide consumers with suitable advice, (d) ensuring consumers to receive clear, relevant and timely information to make informed financial decisions, and (e) handling consumer complaints promptly and in a consistent manner.

²⁰ Independent advice refers to recommendations made by adviser firms that are unrestricted and unbiased, and the firms have considered all investments and product providers from across the market to meet a customer's needs. On the other hand, sales advice is where adviser firms recommend the products of one of a more limited range of providers.

²¹ The *Emergency Economic Stabilization Act of 2008* sets out, among other things, a key reporting requirement that by 30 April 2009, the Department of the Treasury must report to Congress on the current state of the financial regulatory system and its effectiveness at overseeing the participants in the financial market. The Treasury must also make recommendations for improvements. The *Emergency Economic Stabilization Act of 2008*, commonly referred to as a bailout of the US financial system, is a law enacted in response to the global financial crisis of 2008 authorizing the Secretary of the Treasury to spend up to US\$700 billion (around HK\$5,450 billion) to purchase distressed assets, especially mortgage-backed securities, and make capital injections into banks.

Appendix

Six customer outcomes to be achieved under the "Treating Customers Fairly" initiative

- A.1 FSA has defined the following six consumer outcomes which firms are expected to deliver under the TCF initiative:
- (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 targeted accordingly;
 - (c) consumers are provided with clear information and 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 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.
- A.2 The delivery of TCF has been assessed as part of FSA's usual supervision of firms from January 2009 onwards. The assessment involves a review of the achievement of the above six TCF outcomes with reference to:
- (a) a firm's management information system capable of measuring fairness of consumer outcomes;
 - (b) direct testing of the consumer experience (for example, through call listening, mystery shopping, file reviews and reviews of consumer communications); and
 - (c) examination of any other relevant, up-to-date evidence (such as the results of recent thematic work).

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Singapore

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