

Investor Protection

Emerging trends in Investor Protection

After the Global Financial Crisis

Anthony Neoh, SC

27 February 2013, Hong Kong

The Challenges

- Ascent of financial regulation to the top of the political agenda.
- Convergence of financial regulatory concepts.
- Convergence of accounting/financial reporting concepts with regulatory concepts.

Setting the Scene

“To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes. (emphasis added)”

(The Preamble to the Wall Street Reform and Consumer Protection Act
– Dodd Frank Act)

Systemic Issues

- Expanded Presidential Council (Financial Services Oversight Council).
 - enhance the integrity, efficiency, competitiveness, and stability of United States financial markets (powers to require reporting of financial institutions with over \$50 Billion to make reports and designate institutions systematically important)
 - promote market discipline
 - maintain investor confidence
- Powers of the Fed
 - to identify and regulate systemically important financial institutions
 - To identify and regulate significant non-bank financial institutions (designated by FSOC) as if they are bank holding companies.
 - Regulating systemically important clearing and payment systems.
- The Volcker Rule.
- Creation of Federal Insurance Office.
- Creating Liquidation Authority and Liquidation Fund.
- Bringing OTC derivatives into central clearing.

Consumer Protection and Market Conduct issues

- Creation of Consumer Financial Services Protection Bureau.
- Empowering SEC to create Consumer Advocate and tighter rules on Point of Sale Conduct, as well as fiduciary duties of brokers and advisers.
- Reporting requirements of hedge fund advisers.
- Co-ordination between SEC and CFTC on regulation of derivatives.
- Regulation of Credit Rating Agencies.
- Strengthening corporate governance (shareholder vote on executive compensation) and financial reporting.

Other Purposes

- Greater accountability of financial regulators.
- Proscribing predatory lending and imposing disclosure by lenders and minimum underwriting standards.
- Strengthening international co-operation and co-ordination, and disallowing use of overseas markets to evade Act.

Financial Regulatory Reform in the United Kingdom

"In addition to dealing with the operational failings of the system introduced between 1997 and 2000, the Government believes that the reform of the regulatory framework must address a number of fundamental issues. "

"A new approach to financial regulation:
judgment, focus and stability"

Consultation Paper on Financial Regulatory
Reform of the Coalition Government

The UK Financial Services Act 2012

- The Financial Policy Committee under the Bank of England.
- The Prudential Regulation Authority.
- The Financial Conduct Authority.

Universal Template

- Stronger Systemic Co-ordination.
- Deeper Prudential Regulation.
- Stricter Business and Market Conduct Regulation.

International Agenda

- Basle Committee – Basle III.
- European Community – Solvency II and MiFid Review.
- Convergence of Regulatory Concepts – with use of “three pillar approach” – capital and liquidity –effective internal governance- market discipline – 360° supervision.
- Convergence of regulatory (capturing dynamics of change) and accounting concepts (from static to dynamic concepts).
- Convergence of accounting concepts into one set of global concepts - IASB and FASB convergence project.

Three focal areas in financial regulation

- Stable financial systems and institutions.
- Efficient and transparent markets.
- Effective consumer protection.

Impact on financial institutions (3 - Pillar approach)

- Capital Adequacy.
- Good internal controls (inclusive of good COB procedures) and corporate, particularly risk governance.
- Good disclosures.

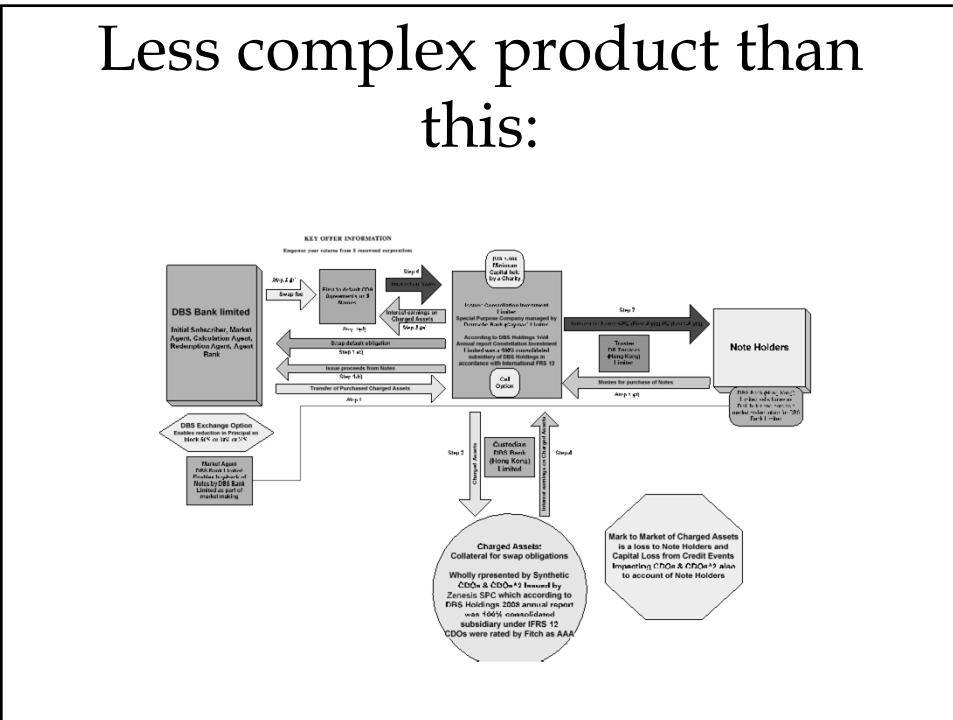
Impact on Markets and Corporate Governance

- Exchange trading of derivatives (clearing issues).
- Transparency in large off exchange trades.
- Reporting by systemically important institutions – international co-operation.
- Greater detail in reporting by corporates, particularly risk reporting, in part driven by new financial reporting standards.
- Greater director participation in oversight, particularly risk oversight.
- Need for deeper reflection by boards on performance measurement and management remuneration.

Impact on regulation of Asset Management and Investment Advice

- Asset Managers may be sufficiently big to become systemically important.
- More reporting requirements.
- Product regulation will most probably come in.
- Tighter Asset allocation and product regulation for insurance and pensions industry, including Provident Fund Regulation.
- More transparency for product disclosure and marketing.
- More stringent requirements and stricter definitions for risk assessment (including test of client financial literacy and means) and disclosure for professional and consumer clients.
- Clearer definition of duties, including what represents fiduciary duties, including conflicts rules.

Less complex product than
this:



Improving Consumer Protection

- New FINRA Rules (Regulatory Notice 11-02).
 - MiFid Review (MiFid II and MiFiR)
 - HKSFC, HKMA, CBRC, CSRC, CIRC Efforts.
 - IOSCO: Suitability Requirements with respect to the Distribution of Complex Financial Products (Consultation Report 2012)

The new FINRA Rules –

(May 2012)

- KYC (Rule 2009) separate from Suitability. (Rule 2111)
- KYC – reasonable diligence as to "essential facts", to know service needs and legal compliance, particularly AML
- Duty to ensure reasonable basis for believing that a recommended transaction or strategy is suitable to client investment profile.
- 3 dimensions of suitability– reasonable basis (product or strategy suitability), client specific (financial ability and objectives), quantitative (not excessive) suitability.
- Investment profile includes age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information disclosed by client in connection with recommendation.
- "Suitability Rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct"
- No contractual opting out of Rules.
- Institutional investor exemption – reasonable basis assessment that institution can exercise independent judgment and institution so affirms.

MiFid Consultation (evolving to MiFiD II and MiFiR)

A set of 18 questions on investor protection, asking:

- Whether providing basis of including reasons for advice to clients and standards for adequacy of advice.
- Whether providing prior to transaction, risk/gain analysis valuation profile of investment in different market conditions,
- Whether clients should have on going disclosure of changes of position of investments, quarterly valuations of complex products, assurance of independence and integrity of such valuations, keeping suitability under review.
- Whether inducements should be disclosed and third party inducements banned.
- Whether the three level category of protection (retail, professional and ECP) should persist, and whether to exclude complex products from ECP and introduce principle of fair dealing to all ECPs.
- Removing municipalities from professionals per se.
- Whether presumption of suitability and appropriateness should be retained for all types of professional investors

SFC Code of Conduct

- Two categories of professional investors – Rule 15.2A (financial institutions), 15.2B –Part I Schedule 1 of SFO, individuals or corporates having a portfolio of not less than HK\$ 8 million, or corporate with assets of not less than HK\$40 million.
- Rule 15.5 sets out waivers by professional investors – no need to establish financial position or need to ensure suitability of recommendation of investment.
- Rule 15.2B professional investors not deemed to waive unless assessment made in writing that intermediary is reasonably satisfied that person is knowledgeable and has sufficient expertise in *relevant products and markets*, with a separate assessment in relation to a *different product type and market*, or if product or market not traded for 2 years, and explanation given in writing of consequences and ability to opt out of status, plus annual survey.

SFC Over-arching principles for New Product

- GP1 Acting fairly
- GP2 Disclosures
- GP3 Proper protection of assets
- GP4 Avoidance of Conflicts
- GP5 Regulatory Compliance
- GP6 Diligence
- GP7 Marketing

SFC Amendments to Codes

- Code on Unit Trusts
- Code on ILAS
- Code on Unlisted Structured Investment Products

Product Information

- Key Product Summaries (“KPS”)
- Advertising guidelines
- On going disclosures
- Cooling off period (already for ILAS extended to SIPs)
- Definition of SIP

Need for better communications between industry and regulators

- Early consultation on product development.
- Consumer focus groups to help regulators and industry.
- Industry to develop best practice.
- Investor education – financial literacy and understanding of risk by both regulators and intermediaries.

Need for effective dispute resolution machinery

- Need for publicly sponsored mediation, arbitration and adjudication process outside the Court system (class action will need time to implement).
- Frank Dodd Act empowers SEC to mandate pre-action ADR procedures (Hong Kong enacting legislation for watered down version of UK Financial Ombudsman).
- Need for all jurisdictions to find mediators, arbitrators and judges with specialized financial knowledge.

Civil Liability?

- Whether civil liability should attach to breach of the MiFid where loss has been caused: MiFid Consultation.
- Decision of XI Civil Senate of the German Federal Court of Justice published 22 March 2011:
 - Plaintiff mid-sized business in field of restroom hygiene.
 - D sold to P acting by the MD (a Graduate Economist) a CMS Spread Ladder Swap, based on net mutual interest payments, D designated the risk as "theoretically unlimited". But D remains exposed at most to 3% per annum.
 - D has duty to provide "investor appropriate" and "investment appropriate advice".
 - "investor appropriate" means obtaining certainty that prior to investment client understood all aspects of risk in the product - mere advice of "theoretically unlimited risk" not sufficient. Qualifications of client unimportant - actual knowledge of instrument to be ascertained.
 - "investment appropriate" means drawing attention to realistic risk and explaining imbalance of risk reward. In particular, disclosure of negative value at time of trade. The client must have substantially the same level of awareness of the risks and rewards as the bank. This information would have substantial importance in making the investment decision. Subsequent hedging does not affect this initial position.
 - D is liable to compensate P for loss in value of investment at time of closeout.

CMS Ladder Swap

- $P(\text{Obligation to pay D}) = 1.5\% + 3 [1\% - (A_{10} - A_2)] \geq 0$
- $D(\text{Obligation to pay P}) = 3\%$
- $D(\text{net exposure}) \leq 3\%$
- $P(\text{net exposure}) = \infty$

[1% gradually decreases to 0.55%]

D pays P a fixed rate of 3% pa on reference amount of Eu 2 M and P pays D on same reference a fixed of 1.5% in year one and year 2, a variable rate of 1.5% plus a factor of $3 \times (1\% \text{ minus the differential between 10 year and 2 year Eurobor})$. If differential is over 0.5% positive, P gets a positive net interest rate but gains only up to a diff of 1.5%, because that would bring gross interest payable to 0%. Thus, P will get something when the diff is between 0.5% to 1.5% positive, but will never get more than 3% p.a. On the other hand, if diff is 1.5% negative, P pays D 6% net interest to D. If 10% negative, P pays D 31.5% net interest.

Civil Liability in HK

- Two contrasting cases on structured product:
 - *Susan Field v. Barber Asia Limited* HCA 7119/2000 (Advice to unsophisticated investor). See also:
 - *Rubinstein v. HSBC Plc* [2012] EWCA Civ 1184 (commentary on *Springwell v. JP Morgan* [2010] EWCA Civ 221)
 - *Kwok Wai Hing v. HSBC Private Bank* HCCL 2/2010 (Execution only contract for sophisticated investor). See also:
 - *Michael Wilson & PS Trustees v. MF Global UK Ltd* [2011] EWHC 138 (QB)
 - *Casa a di Risparmio v. Barclays Bank* [2011] EWHC 484
 - See: S. 169(4) of the SFO.
 - See: S. 150 of FSMA.

Report on Class Actions 集體訴訟報告書

Law Reform Commission of Hong Kong
Class Actions

香港法律改革委員會

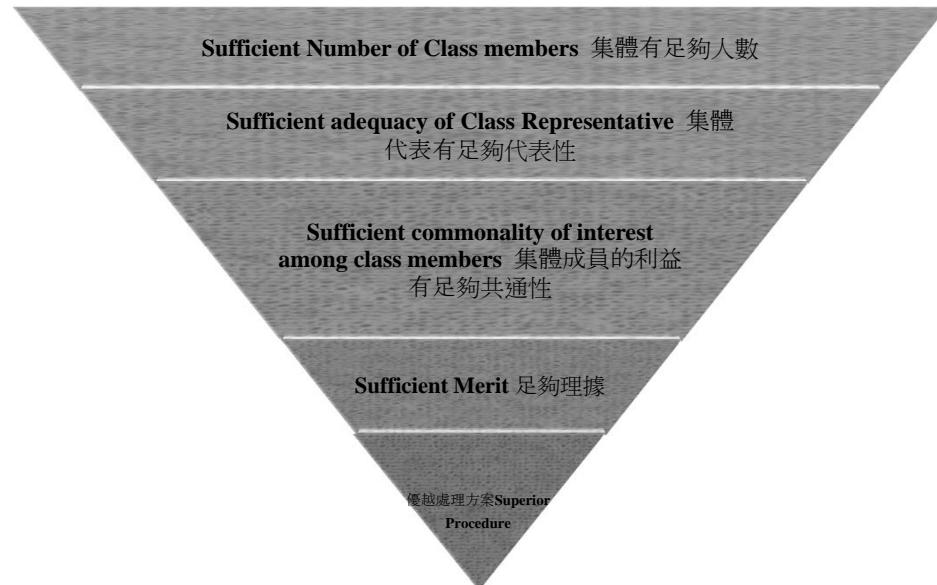
1. Principal Recommendations 主要建議

1. Introducing a class actions regime, starting with consumer cases (引入集體訴訟機制, 先由消費者案件開始)
2. Consumers' tortious and contractual claims in relation to goods, services and immovable property (涵蓋消費者就貨品、服務及不動產而基於合約或侵權所提出的申索)
3. Certified suitable by the court (須先由法庭核證)
4. Compatible with Alternative Dispute Resolution methods (與解決糾紛的另類辦法兼容)

Principal Recommendations

5. Opt-out as default procedure (選擇退出為預設模式)
(foreign plaintiffs (opt-in)) (外地原告人(選擇加入))
6. New regime covers public law cases upon extension (compatible with Order 53) (新機制若擴大適用範圍, 會適用於公法案件, 並與第53號命令兼容)
7. Procedural safeguards to prevent abuses (程序上的保障以防止濫用), such as security for costs (訟費保證) and adequacy of the class representative (集體代表有足夠代表性)
8. Suitable funding mechanism (合適的籌措資金機制)
9. Active case management (案件管理)
10. Legislative changes (立法的配合)

2. Certification by court 由法庭核證



3. Funding Mechanism 筹措資金機制

- 1. Expanding Consumer Council's Consumer Legal Action Fund** (擴大消費者委員會的消費者訴訟基金)
- 2. Establishing a class actions fund for the long term** (長遠而言，設立集體訴訟基金)