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Should Beta Consumers Have Alpha Protection?

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Abstract

This interdisciplinary paper marries behavioural finance and legal regulations in banking. Behavioural studies consider individuals to be never completely rational, which supports legal regulations that have the objective of protecting vulnerable investors. In this paper, I outline a legal framework to evaluate the applicability of future recommendations for banking and finance in Singapore. First, the substance of the recommendation must be in line with micro-level regulations and the macro-level legal approach. Second, the recommendation must be translatable into the language of regulatory obligations, and the appropriateness of prescriptive rules versus outcomes-focused principles should be weighed in balancing certainty and flexibility. Last, recommendations that meet the first two criteria must still be utilized judiciously to avoid over-exposure to legal liability or mere application without fulfilling the intended purpose. I thus recognize and deal with the issues of policymaking in banking and finance, from both a legal and business point of view.

Introduction

At present, the law regarding investor protection in Singapore is founded upon, *inter alia*, a belief in consumer rationality and reasonableness. However, recent developments in the field of behavioural finance recognize that humans can never be completely rational, and thereby challenge this assumption. This paper therefore breaks new ground by applying such behavioural finance developments to the law in Singapore. It shows that law is an integral starting point to understanding the relationship between banks, consumers and regulators. It provides support for the notion that legal regulations should aim to protect the vulnerability of investors, and gives insights on how regulations can be tailored to this purpose. The major contribution that behavioural finance brings to legal regulation, especially in the financial context, gives a deeper understanding of the balance between consumer protection and excessive paternalism.

Behavioural finance is a discipline that can make significant contribution to the development and application of legal regulation. Behavioural finance explores multiple cognitive and emotional ‘behavioural biases’ which demonstrate that humans are never completely rational and do not always make decisions which are in their best interests. The conclusion that pure rationality is artificial reveals the inherent challenge for legal regulations governing human behaviour: while it supports the regulatory objective of protecting vulnerable investors, the psychology of how people make rational and irrational decisions raises the question of how far such protection should go, and what standards should be applied to the concept of a ‘reasonable man’.

This paper demonstrates the existing balance in Singapore, between protecting vulnerable investors and ensuring that they take an appropriate amount of responsibility for their own actions. This is accomplished by treating ‘like’ investors alike, although the criteria for defining classes of ‘like’ investors must be clearly and fairly laid out, so as to prevent future problems in the law and its application. The balance is also found in Singapore’s switch to the disclosure-based approach, which preferred the regulatory facilitation of informed decision-making as opposed to micro-managing the risk level in the market. The disclosure-based approach therefore reflects Singapore’s position that regulators should seek to facilitate informed decision-making, while giving individual investors autonomy to make their own decisions but a corresponding responsibility for these.

One example of how regulators have facilitated informed decision-making is through Singapore’s Product Highlights Sheet system. This finds support in the behavioural finance theory of salience, which recognizes that consumers are affected less by ‘how much’ information is given as compared to ‘how useful’ that information would be. Therefore regulation should prohibit banks from throwing everything including the kitchen sink into their ‘disclosure’ documentation, and instead direct them to synthesize such information into a form that is easily processed and understood by consumers.

This paper also addresses the issue of where the boundaries lie for the application of libertarian paternalism in Singapore. It also identifies the need for regulators to use behavioural

finance judiciously, so as not to ‘over-correct’ and thereby cause more harm than good in regulating the market. Apart from the challenges faced by implementation, another challenge for this interdisciplinary approach is distinguishing between specific intentional and unintentional facets of human irrationality. Even if the law seeks to protect consumers from having their vulnerabilities exploited, it also should not find itself thrust into a position where it creates a moral hazard problem by endorsing and supporting irrational actions.

This paper evaluates both the principles-based and rules-based approaches in regulation to show that while there is no one right or wrong way to regulate a market, the key touchstones of effective regulation are certainty, responsiveness, and the ability to adapt to new innovation. Each country must therefore evaluate its own unique objectives and circumstances, in order to find an appropriate balance between these.

In light of the current behavioural trend towards preserving individual freedom of choice, the law must make an explicit recognition of human irrationality in order to better protect vulnerable investors. However it must do so without going too far towards either extreme of excessive paternalism or almost no protection for vulnerable consumers.

1. Behavioural Finance and Legal Regulation

This first section identifies the insights from behavioural finance, and shows how they can contribute to legal regulation. In comparison to traditional finance, which does not consider the factor of human rationality, the relatively-modern discipline of behavioural finance is one that can make significant contributions to the development, application and understanding of legal regulation. Behavioural finance takes the more realistic view in recognizing that individuals are never completely rational, through its use of prospect theory and identification of behavioural biases. This supports the regulatory objective of protecting vulnerable investors (especially in the financial sector), and also gives insights into improving such regulations. However, it also raises the question of exactly ‘how far’ such protection should go. It also reveals the inherent need to understand human behaviour and the reasons for such, in order to better develop and apply legal regulations that govern ‘rationality’.

1.1. Pure Rationality is Artificial

Traditional finance theories have limited real-world application, due to their abstract nature. In contrast, behavioural finance gives insights that can be applied to real people. Behavioural finance recognizes that pure rationality is artificial, and therefore human behaviour is ‘predictably irrational’². It analyses and explains this irrationality through prospect theory and behavioural biases.

Traditional finance theories represent an attempt to distill predicted market behaviour into neat equations. This mathematical elegance is attractive, especially for academics.

² Reference to Dan Ariely’s work on the subject, aptly titled *Predictably Irrational* (2008, revised 2009), Harper Collins Publishers.

However, many unrealistic assumptions are required in order to reduce the multiple facets of human behaviour into some combination of α , β and ϵ ³. This high level of abstraction severely limits the real-world applicability of traditional finance.

One example of these inaccurate assumptions is a belief in ‘homogeneous expectations’ (that every single market participant has the same needs and wants, and thinks in exactly the same way)⁴. Significant oversimplifications like this have facilitated theoretical calculations and predictions, albeit while giving results that deviate from reality. Therefore, while traditional finance has provided the foundations for a conceptual understanding of how the financial markets work, its models are of very limited application to analysing real-life investors.

In contrast to the idealized theory of traditional finance models, behavioural finance involves empirical observation and an understanding of decision-making. It stems from the fundamental premise that humans can never be perfectly rational, and this is apparent in the decisions they make. Prospect theory, as developed by Kahnemann and Tversky in 1979, provides a sound academic theory which supports the more realistic starting point of non-homogeneous expectations. It illustrates, through a value function, how people view gains and losses as deviations from a reference point, and also experience diminishing marginal utility for these.

Behavioural finance accounts for human irrationality through several cognitive and emotional ‘behavioural biases’, so named for the systematic way that they consistently ‘bias’ an individual towards a certain irrational outcome. One example of such a behavioural bias is regret aversion, which shows that individuals attribute greater weight to losses than gains. This is demonstrated when investors are reluctant to sell securities that are ‘losing’ relative to the market, and when they are willing to take greater risks to avoid losses than to seek gains of the same magnitude.⁵ This sometimes leads to a status quo bias, which is the tendency of inertia to leave things as they are, as individuals would prefer to passively retain a status quo than actively make a decision that could generate regret from a negative outcome.⁶

Another example is availability bias, which illustrates subjective judgment in individuals. People tend to make decisions based on the facts they can more easily recall, from their own personal experience and knowledge, instead of in an objective manner.⁷ This is

³ These are the Greek symbols for *alpha*, *beta* and *epsilon* respectively, which are used in the Fama-French 3-factor model in finance.

⁴ The assumption of homogeneous expectations is demonstrated in the often-used Capital Asset Pricing Model (‘CAPM’), one of the foundational pillars of traditional finance. See Fama, E. F., & French, K. R. (2004), *The Capital Asset Pricing Model: Theory and Evidence*, *The Journal of Economic Perspectives*, 18(3), pp. 25-46. It is surprising that the CAPM is still relied upon by many academics in traditional finance, when its founders have recognized that “most applications of the model are invalid” due to failure in empirical tests (p. 26).

⁵ See Grinblatt, M., & Keloharju, M. (2000), *The Investment Behavior and Performance of Various Investor Types: A Study of Finland’s Unique Data Set*, *Journal of Financial Economics*, 55, pp. 43-67.

⁶ See Thaler, R. H., & Sunstein, C. R. (2008), *Nudge*, New Haven & London: Yale University Press, and Samuelson, W., & Zeckhauser, R. (1988), *Status Quo Bias in Decision Making*, *Journal of Risk and Uncertainty*, 1, pp. 7-59.

⁷ See Tversky, A. & Kahnemann, D. (1974), *Judgment under Uncertainty: Heuristics and Biases*, *Science*, 183, pp. 1124-1131.

affected by the framing bias, which shows that people give different answers to identical questions or scenarios that are ‘framed’ in a different manner.⁸ Both these biases arise from the fact that it would require too much cognitive effort in real life to source for all available information, and to compare every single option to an individual’s own preferences. Therefore individuals making decisions only compare the various options against each other, depending on how they are framed to highlight different distinguishing components.⁹ These two biases therefore create a systemic bias to individuals’ decision-making, which can be addressed through legal regulations on salience in disclosure.

1.2. Behavioural Insights for the Legal Sphere

The law forms a fundamental starting point to analyse the relationship between banks, consumers and regulators. Regulatory objectives reveal the point at which regulators try to strike the balance between protecting consumers and facilitating a dynamic free market; specific regulations show the approach by which regulators achieve these objectives. Any theoretical discourse must therefore begin with an understanding of the present law and the changes it made from the past; it must then go further to see how regulators, consumers and banks each view the purpose and effects of that regulation, so as to propose solutions for further developing laws that move the market towards progress.

Two insights can be distilled from behavioural finance: first, its recognition of human irrationality supports the regulatory objective of protecting vulnerable investors. Second, the specific cognitive and emotional biases identified give suggestions on how to better develop and draft these regulations. However, at the same time, they also reveal the underlying question of the appropriate extent of such protection. There is thus an inherent need for lawyers and regulators to understand human behaviour and the reasons for such, in order to better develop and apply legal regulations that seek to govern human behaviour and its ‘rationality’.

Pure rationality is artificial. Regulators in particular should be aware of the behavioural finance view that humans are irrational and do not always make decisions in their best interests. This therefore supports the objective of financial regulation being the protection of vulnerable investors, especially where financial institutions have engaged in unconscionable behaviour at their expense. While the courts have already recognized that they cannot look at each allegation with the benefit of hindsight, they do utilize a ‘reasonable man’ standard in assessing whether any actions taken were acceptable. A greater understanding of human irrationality would enable the courts to better qualify what defines that ‘reasonable man’ and therefore, what actions would have been logical for him to follow.

In particular, the identification of cognitive and emotional biases also demonstrate the ways in which people make decisions that systematically deviate from a perceived ‘rational’

⁸ See, for example, Benartzi, S., & Thaler, R. (2002), *How Much is Investor Autonomy Worth?* Journal of Finance, 17(4), pp. 1593-1616.

⁹ See Kahneman, D., & Tversky, A. (Mar., 1979), *Prospect Theory: An Analysis of Decision under Risk*, Econometrica, 47(2), pp. 263-292; also Iyengar, S., & Lepper, M. (2000), *When Choice is Demotivating: Can One Desire Too Much of a Good Thing?* Journal of Personality and Social Psychology, 79, pp. 995-1006; Thaler, R. H., & Sunstein, C. R. (2008), *Nudge*, New Haven & London: Yale University Press.

outcome. Recognizing these therefore allows regulators to better tailor financial regulation to address how companies may attempt to use them to take advantage of consumers. One example is the combination of availability and framing biases affecting how a consumer makes a decision regarding financial products. In theory, a financial institution could market a product attractively by being selective in disclosure. In practice, financial regulation would not only have comprehensive disclosure requirements to address the availability issue, but also provide guidelines and a structure to minimize disadvantageous framing. A greater understanding of these biases also reveals that the underlying reason is insufficient cognitive capacity; therefore, disclosure requirements tailored around salience serve to better facilitate consumer decision-making.

While these insights have the potential to contribute to the development and application of legal regulation in protecting individual investors, they also raise the question of exactly ‘how far’ such protection can go. A balance must be struck between protecting investors and imposing overly-onerous restrictions on the other parties involved. To go too far to either extreme would not bode well for Singapore’s future as an international finance hub. Global interconnectedness has resulted in increased competition for investable funds, and overly-onerous restrictions on financial institutions and dealers would stifle Singapore’s growth and attractiveness in the world market. Yet overprotection of individuals would also create a moral hazard problem in removing their responsibility for their own choices.

This paper therefore recognizes that while behavioural finance can explain and enhance the development and application of financial regulation, it also indicates the necessity for an appropriate balance to be struck in these areas: between financial institutions and consumers, between restrictions and protections, between ‘inherent’ irrationality and blatant risk-taking.

2. With Great Autonomy Comes Great Responsibility

The next two sections explore the existing balance between protecting vulnerable investors, while ensuring that they take appropriate responsibility for their own actions. Section 2 looks at tiered responsibility according to ability – distinguishing ‘treating like alike’ from ‘treating all alike’. Section 3 evaluates the disclosure-based approach in Singapore and contrasts it to the previous merit-based approach. They thus demonstrate recognition of the protective rationale of regulation, as well as the need for investors to take responsibility for their own decisions, where appropriate.

The rationale of financial regulation in Singapore has been the protection of the vulnerable investor. At the same time however, courts have been reluctant to impose a general fiduciary duty on banks and financial institutions. This illustrates the balance with protection – that individuals must also have responsibility for their own decisions – and also public policy.

2.1. The Classification of Investors in Singapore

Tiered protection in Singapore recognizes that sophisticated investors should be able to make their own decisions, and therefore should take corresponding responsibility for such. In

the Parliamentary Debates, on the Second Reading of the Securities and Futures Amendment Bill (2009), Nominated Member of Parliament (“NMP”) Mr Siew Kum Hong highlighted the regulatory role of protecting vulnerable investors:

“The role of regulation is not so much to protect people like the Members of this House, whom I am sure are intelligent and sophisticated enough to take care of ourselves, but *to protect the gullible, the unsophisticated, the vulnerable.*” (at col. 1108, emphasis mine.)

In the Parliamentary Debates on the Second Reading of the Securities and Futures Amendment Bill (2009), NMP Mr Siew Kum Hong had also brought up the issue of protection for vulnerable investors:

“So, at one end of the spectrum, we have different treatment for sophisticated investors. *Why should we also not have different treatment at the other end of the spectrum, to protect unsophisticated investors as well?* Indeed, logic dictates that at the margins, a one-size-fits-all approach is likely to be inadequate, and that differentiated treatment is likely to be required.” (col. 1104) [emphasis mine]

It is possible that criteria such as age (‘elderly investors’), literacy (‘illiterate investors’), prior investing experience (‘novice investors’) and total level of wealth (‘lower-income investors’) could be used for such a system. However, classification through such individual categories may result in unjust outcomes, as explained by the Minister of Trade and Industry, Mr Lim Hng Kiang, in Parliament regarding the Update of MAS’ Investigation of Mis-selling of Structured Products (2009):

“While MAS has asked the FIs to pay particular attention to this priority group of complainants based on some general characteristics, such as age, education and investment experience, *a single characteristic such as age or education alone does not determine if an investor will be vulnerable to being mis-sold the products. For instance, someone with little formal education may be a successful businessman.* The person may have prior investment experience or could have invested in structured products jointly with, say, a younger family member.” (at col. 1067-1068) [emphasis mine]

Mr Lim then proposed the idea of a holistic assessment:

“It is the overall combination of, first, what is the risk assessment of products versus the risk profile of the person to make sure that there is matching and therefore, there is no inappropriateness in the products sold to the person. Then, in assessing whether it is inappropriate or not, we have to look at the person's ability to make his investment decisions, his education, his track record and the way he has been investing his funds. So it is a holistic assessment of each case.” (at col. 1077)

As with the classification of wealthy investors, these criteria could appear arbitrary, be over-inclusive or under-inclusive, or not be fully representative of the circumstances in each case. Current legislation and subsidiary regulations do not constitute a ‘one-size-fits-all’ system, and instead attempt to tailor the level of protection accordingly to different classes of

investor. However, this tailoring does not appear to be finely-tuned to the myriad of different investors and circumstances, and at best represents a ‘blunt’ approach towards differentiation between, but not within, the different broad classifications. This classification is significant because financial advisers can be exempted from compliance with certain obligations, depending on the nature of the product, and the level of ‘sophistication’ of the investor.

The table below gives a summary of the criteria for these classifications. They show how the level of protection in financial regulation is tiered between each class of investor, both in terms of the criteria as a basis for that protection, and how the existing regulations carve out exemptions for investors who are deemed to be able to take greater responsibility for their decisions.

Classification	Level of experience, as reflected by business dealings	
“Practicing investors”	SFA s. 4A: “Institutional investor” defined as including any non-individual corporation or body which has its business in finance, financial products or dealing in such products.	SFA s. 4A: “Expert investor” defined as an individual whose business involves acquiring, disposing or holding of capital markets products.
Classification	Level of wealth	
“Wealthy investors”	SFA s. 4A: “Accredited investor” defined as either: <ul style="list-style-type: none"> • An individual with net personal assets over S\$2 million (or such other amount as prescribed); • An individual whose income in the preceding 12 months is not less than S\$300,000 (or such other amount as prescribed); or • A corporation with net assets exceeding \$10 million in value on the balance sheet (or such 	FAA-G07 para. 7: HNWI defined as either having: <ul style="list-style-type: none"> • (a) Minimum of S\$1 million of assets in bank deposits, capital markets products, life policies or other investment products as prescribed; • (b) Total net personal assets exceeding S\$2 million in value; or • (c) Annual income not less than S\$300,000 <p><i>It also includes an individual who is assessed by the financial adviser to have the potential,</i></p>

	other amount as prescribed).	<i>within two years</i> , to become a person described in (a). [emphasis mine]
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2.2. Evaluating the Criteria for Classification

The classification of practicing investors clearly distinguishes between those who have a level of experience (as reflected by business dealings in financial or capital markets products), and those who do not. Its criteria are clear, comprehensible and easily identifiable, with little scope for variation in interpretation.

The distinction between ‘vulnerable’ and ‘practicing’ investors is also a reasonable one. Practicing investors with relevant commercial experience would be expected to be able to obtain independent advice and make their own informed judgments. In particular, institutional investors with in-house legal and financial advice should be allowed the benefit of such when dealing with investment products, and should therefore take corresponding responsibility.

In contrast, the classification of wealthy investors highlights problems in the law and its application. Exempting sophisticated investors assumes that they knowingly invest and should take responsibility for their decisions. However, this is only valid for practicing investors, and reveals a lacuna that there are some wealthy investors who may not be financially-savvy enough to make informed decisions. This classification could thus work to an investor’s disadvantage in excluding him from protection that he may otherwise have needed.

First, the statutory classification implies that wealthy investors are better able to absorb their losses due to their level of wealth. However, this alone does not seem like a justifiable rationale to deny them protection. Moreover, it is unrealistic to assume that all wealthy investors would have a higher level of financial knowledge or experience. Where an individual does not have the financial knowledge on what to do with his wealth, the financial criteria may become more of an arbitrary limit than providing actual safeguards for those who are ‘vulnerable’ i.e. do not have the knowledge to make informed decisions. For example, the statute does not take into account sudden gains, like a lottery windfall or inheritance, which would otherwise have rendered a ‘vulnerable’ investor suddenly a ‘wealthy’ one, even though he still has the same level of knowledge. The actual figures for criteria determining level of wealth can therefore also appear arbitrary.

Second, the statutory use of ‘or’ suggests that an investor would be considered a wealthy investor as long as any one of the criteria is fulfilled. Specifically, the criterion of ‘total net personal assets’ is problematic in this aspect, because by definition it would include illiquid assets such as cars and real estate. Therefore many Singaporeans who own property could be considered ‘millionaires’ in name, though not in substance; considering that the rationale for

such criteria is to ensure that they have income or net personal assets to support their investment patterns¹⁰, it is unreasonable to suggest that illiquid assets be able to ‘support’ these.

Finally, the definition of HNWI includes an investor who may not actually fulfil the criteria at the time of application, but is nevertheless assessed to potentially have at least S\$1 million of assets in bank deposits or capital markets products within two years. This evaluation of potential does not appear to have any penalties for erroneous assessment, or any guidelines for how such assessment is to be carried out. A conflict of interest is thus created: an unscrupulous bank seeking to minimize its risk, or a relationship manager under pressure to achieve business targets, could deliberately assess non-wealthy investors to nevertheless “have the potential to become” such, even if they may not be capable of making their own informed decisions. This would shift such investors into the category of HNWI in order to take advantage of statutory regulations exempting specialised HNWI-serving units from compliance with certain obligations like the duty of disclosure.

The first part of this evaluation therefore shows that clear and fair criteria, such as that of practicing investors, effectively facilitate regulators being able to treat ‘like’ investors alike. They show that greater autonomy and greater experience require greater responsibility on the part of the one exercising that autonomy and experience, in order to prevent a moral hazard problem where investors consider themselves not responsible for their own decisions.

However, the second part of this evaluation reflects that criteria which are not clear or fair have the potential to hinder effective regulation instead of facilitating it. It reveals that classification criteria must be in line with regulatory objectives and be clear enough to prevent potential abuse of the tiered protection given to different classes of investors.

2.3. Treating ‘Like’ Alike

Under the FAA, banks as exempt financial advisers¹¹ must comply with certain core obligations in performing financial advisory services to investor clients. These core obligations are the obligation to disclose all material information relating to the recommended product (s. 25 FAA), the prohibition of making false or misleading statements in providing any financial advisory services (s. 26 FAA), an obligation to have a reasonable basis for making recommendations (s. 27 FAA), and an obligation to disclose interests in securities recommended (s. 36 FAA).

The level of protection is tiered between each class of investor. A financial adviser is also exempted from holding a financial adviser’s licence when giving analysis on bonds to an expert

¹⁰ This is similar to the rationale stated in the MAS Response to Feedback 2007 on Proposed Exemption from Maximum Credit Limit, at para. 2.9: “important that individuals enjoying credit limits in excess of four times their monthly income continue to have income streams or net personal assets that will support their spending patterns”.

¹¹ S. 23(1) lists the categories of ‘exempt financial advisers’ who are not required to apply for and hold a financial adviser’s licence to provide advisory services to the public. S. 23(4) lists the provisions that are still applicable to exempt financial advisers, namely ss. 25-29, 32-34 and 36. In the interests of space and the narrow focus of this paper on protection of vulnerable investors, the core obligations focused on are ss. 25-27 and 36 on disclosure of relevant information, false statements, reasonable basis for recommendations and disclosure of interests in securities recommended, respectively.

or accredited investor (FAR reg. 28). In advising institutional investors or related corporations, an exempt financial adviser is exempted under FAR reg. 32B from the core obligations of, *inter alia*, disclosure, not providing false or misleading statements, and having a reasonable basis for recommendation¹².

Moreover, the Guidelines on Exemption for Specialised Units Serving HNWI under s. 100(2) FAA (FAA-G07) recognize that a separate and distinct unit set up to cater to HNWI can apply for general exemption from any or all provisions or written directions, where the MAS considers it appropriate to do so¹³. These Guidelines therefore allow application for exemption from s. 25, 27 and 36, which deal with the obligation to disclose information, to have reasonable basis for recommendations, and to disclose interests in securities recommended, respectively. All these exemptions reiterate the current system of tiered protection in Singapore.

FAR regulations 33, 34 and 35, which deal with exemption from s. 25, 27 and 36 of the FAA respectively, provide that where an investor is an accredited or expert investor, a financial adviser must disclose such exemptions in providing any financial advisory services. However, where the investor is an institutional investor or related corporation, the financial adviser does not even have to provide a disclosure of such exemption from its statutory obligations. This appears to reflect a legislative view that institutional investors should take more responsibility for their own research and decision-making than accredited or expert investors, possibly due to the resources that they have.

Thus, while having a tiered system demonstrates greater fairness in treating ‘like’ investors alike (as opposed to treating ‘all’ investors alike), there still remains the risk that it could operate contrary to the legislative intent and end up excluding otherwise-deserving individuals from protection. The ‘blunt’ approach through classification is justified on the basis of an individual’s level of experience, but could be problematic as an investor’s level of wealth does not necessarily reflect his understanding of investments. Therefore the rationale of protecting vulnerable investors may be better advanced in ensuring that regulation is geared towards a holistic assessment of appropriateness, on the basis of risk assessment of products versus the risk profile of the investor.

3. Disclosure of (not just) Merits and the Merits of Disclosure

A comparison of Singapore’s regulatory switch from the merit-based approach to the disclosure-based approach shows that the current regulatory preference is towards the facilitation of informed decision-making as opposed to micro-managing the risk level in the market.

¹² The exemption is from the duties and obligations under s. 25-29, 32, 34 and 36 of the FAA. These comprise all the provisions that are applicable to exempt financial advisers under the FAA.

¹³ The general exemption in s. 100(2) FAA provides that upon application, the MAS may allow exemption from all or any of the provisions of the FAA or the requirements specified in any written direction, where the MAS considers it appropriate to do so. Notably, s. 100(3) states that an exemption under s. 100(2) need not be published as public information, and may be withdrawn at any time by the MAS.

The merit-based approach uses regulatory approval to restrict the investment products allowed into the market, while the disclosure-based approach accepts all products, regardless of their merits (or demerits). The merit-based approach seeks to protect the market, but suffers from the potential problems of conflict of interest, lack of a uniform standard, moral hazard, and inability to keep up with the pace of market developments. The disclosure-based approach facilitates informed decision-making by giving investors both autonomy and responsibility, but as the playing field can never be truly made level, it exposes the market (and especially vulnerable investors) to potentially-harmful products.

3.1.1. The Merit-Based Approach

George Shenoy (1999) concisely defines the merit-based approach:

“A merit-based regime is one where the securities regulator decides on whether transactions should be allowed to proceed on the basis of their perceived merits and on whether adequate disclosure has been made before the disclosure is allowed to be released.” (at p. 55)

The regulator takes a more paternalistic role by only allowing approved investment products in the market. Approval generally depends on considerations of public interest, interest of the investing public, and interest of the product issuer. However, the ultimate decision is still made by the investing individual, as the regulator cannot and does not guarantee returns on approved investments. The merit-based approach assumes that the regulator has no conflicts of interest in giving approval, and is better informed than the investing public. The regulator would thus be in a better position to decide the merits of approving certain investment products for market transaction.

However, one man’s soup may be another man’s poison: one regulator alone may not be able to create a uniform standard that takes into account all the interests across a wide spectrum of public investors, especially as different investment products are suitable for different segments of investors. If the regulator approves all products that risk-seeking investors would want, the idea of regulation is defeated as this would result in almost every single product being admitted to the market. Conversely, if the regulator only approves what conservative investors would want, the market would be protected from high risk investments but this would also severely stifle innovation and choice that risk-seeking investors want.

The merit-based approach also suffers from a moral hazard problem, as some investors may erroneously perceive the approval process to mean that all investment products in the market have been approved and are thus ‘safe’. This over-weighting of the value of approval (irrational behaviour in financial markets) could lead to an investor putting less of his own effort into researching and choosing his portfolio.

Moreover, given the rapid pace of investment product creation, the regulator may not be able to approve products as soon as they are created, without compromising the quality of assessment. This would lead to delayed market releases, which would greatly hinder international competitiveness as the financial market would lag behind its rivals. It would also

stifle financial innovation and development: where a corporation believes that its product might not even make it into the market, it may not want to spend resources to innovate and create that product, or alternatively may opt to do it overseas. Both of these consequences also have negative implications for the international competitiveness of a financial market.

3.1.2. The Disclosure-Based Approach

Contrary to the merit-based approach, the regulator under a disclosure-based approach does not assess the merits of any investment products and thus does not restrict any from the market. The regulator's role is to ensure that all relevant information is disclosed to the investing public in an accurate and timely manner, and that no false or misleading information is promulgated. Therefore the disclosure-based approach "acknowledges that the market is better able to decide on the merits of transactions rather than the securities regulator" (Shenoy, 1999, p. 55).

Shenoy (1999) observes that this "high standard of disclosure levels the playing field between companies and investors" (p. 58). The lack of a market 'gatekeeper' largely eradicates the moral hazard problem of complacency that was present under the merit-based approach, as investors cannot rely on approval and have to take responsibility for their decisions. However, it raises questions on whether levelling the playing field is the right thing to do. Levelling the playing field may not always be a good thing, especially in a market dominated by unsophisticated investors. Where these investors may not have the financial knowledge to make informed decisions and take responsibility for such, regulation to level the playing field through mandatory disclosure may only serve to confuse such investors further. This is because they may not be able to understand the disclosures and remain at risk of purchasing products that are inappropriate for them.

Moreover, natural and tactical information asymmetries in the market, like the "shrouded attributes" analysed by Gabaix and Laibson (2004), also inevitably beg the question of whether the playing field can ever be truly 'level'. Natural information asymmetries between corporations and investors refer to the latter being unable to entirely understand mandatory disclosure, due to differences in experience, resources, or level of knowledge. Tactical information asymmetries reflect deliberate attempts by corporations to capture more profit by concealing information or being strategic in price determination. The former is usually unavoidable; the latter may constitute a statutory offence. Thus, while the law can seek to educate consumers and regulate the level and standard of disclosure, there will always be some degree of informational asymmetry (especially between corporations and vulnerable investors). Therefore a regulator can never fully level the playing field, although it still remains a commendable ideal to strive towards in promoting a responsible free market.

Ultimately, markets derive more benefit where investors take responsibility for their own decisions and do not rely on regulators to act as the 'gatekeeper' of financial markets. Shenoy (1999) observed that the more-level playing field in the disclosure-based approach leads to greater variety of investment choice and draws in more investors, thus facilitating more liquidity in markets, which in turn attracts more companies and products. The disclosure-based

approach also creates a more transparent and informed system, as third party analysts have access to more information and therefore can supply the public with better analysis and evaluation. Companies have incentives to ensure that their balance sheets and accounting statements are an accurate reflection of the company finances, and that they remain in a healthy state. Shenoy (1999) thus predicts that markets would experience greater efficiency and innovation from the more laissez-faire disclosure-based approach.

3.1.3. Singapore's Position

Before 1997, Singapore's approach was considered "somewhere between merit-based and disclosure, but with a tendency towards the merit" (Shenoy, 1999, p. 55). However much has changed since then – DPM BG Lee Hsien Loong stated in the Second Reading of the Securities and Futures Bill (2001) that Singapore has moved towards a disclosure-based regime which gives investors both the autonomy and responsibility for making their own decisions. This view was supported by Member of Parliament for Marine Parade, Mrs Lim Hwee Hua, who believed the shift "may be a departure from the previous mindset that an approved public offer equals a good investment opportunity ... [but] will cause investors to be more discriminating and savvy over time" (col. 2146).

The current regulatory regime in Singapore is a purely disclosure-based one. This was explained by Minister for Trade and Industry, Mr Lim Hng Kiang (speaking for the Senior Minister), in the Parliamentary Debates on Structured Notes (MAS' Supervision of Financial Institutions) (2009):

"Under [Singapore's] disclosure-based regime, MAS' role is "not to judge the merits of the product being offered. Rather, MAS checks that the issuer discloses the features and risks of the product, and that there are no false or misleading statements. This approach provides investors with investment choices, in recognition that they have different needs and risk appetites ... MAS does not, and cannot, micro-manage financial institutions in their operations." (col. 801-802.)
[emphasis mine]

The MAS, in its 2001/2002 Annual Report, stated that this shift from judging suitability to supervising disclosure was done with the objective "to allow market participants greater choice and freedom to take calculated risks so as to promote a more vibrant market". This is in line with the observations by Shenoy (1999) on the disclosure-based approach facilitating greater investor autonomy, market innovation and development.

In the Parliamentary Debates on the Liberalisation of the Singapore Stock Exchange (2000), DPM BG Lee underscored the necessity of the shift as "finally, investors have to make their own decisions and to take responsibility for them. No merit-based regulator can guarantee that only successful companies will be listed and that investors will definitely make a profit." (at col. 933) He also illustrated that:

"while we can print a good prospectus, this will only help if people actually read the prospectuses, and do not just blindly subscribe to IPO shares confident that they will make a profit on the first day. And in fact, it is known in some markets, you go

to the stockbroker's office, you get the application form with the prospectus, you go out, *you throw away the prospectus in the dustbin and you just take the form and hope that the shares are worth some money.* Sometimes, even the form is worth some money. But that is not the way.” (at col. 933-934) [emphasis mine]

DPM BG Lee thus recognized that the shift to the disclosure-based approach would potentially have negative implications on the investors who would not be bothered with doing their own research. However, he stated unequivocally at the Second Reading of the Securities and Futures Bill (2001) that:

“The public will be reminded time and again that the primary responsibility for making investment decisions lies with themselves and, over time, they will be able to learn to be able to look out for their own interest. There is no alternative. We have to shift. We cannot go on the basis that the regulator, or MAS, or the Exchange will make sure that every investment is safe and sure to make money. If you want to invest, you have to make your own judgement, find out your own information and make your own decisions.” (col. 2162) [emphasis mine]

Singapore has, having experienced the merit-based approach, chosen to adopt the disclosure-based approach in regulation of investment products in financial markets. The nature of Singapore’s economy, with a focus on trade and the financial sector, supports the shift as a more flexible financial system would allow Singapore to keep up in competitiveness with other global financial markets such as London, Tokyo and Hong Kong. Yet the Parliamentary excerpts reveal the perils of the disclosure-based system: if investors simply are not bothered to take responsibility for their own decisions, they could end up making significant personal losses that could eventually take down the entire system.

In the Parliamentary Debates on the Liberalisation of the Singapore Stock Exchange (2000), DPM BG Lee recognized the limits of regulatory intervention in a free market, especially where risk and returns were integral to the transaction:

“I think overall, our new rules and philosophy are correct. The Government cannot stop companies from being listed on SGX because we think that their business is too risky, or because we think their shares are priced too high. Risk taking is the essence of business and particularly in the new economy. But we will educate the public on the risks so that people know what they are doing and go in with their eyes open. Whether they are actually looking or not, that is another matter.” (col. 931)

He also noted that investors would seek risk wherever they could, and there was only so much that regulation could do within one financial market:

“Anyway it is difficult to prevent people from taking risks, by keeping what we think are risky companies off the Stock Exchange. *People who want risky investments find many ways to make them. They can invest overseas.* In the old days, when the Malaysian stocks were listed on CLOB, they invested on CLOB, which is a different environment from the Singapore stock market. *Or sometimes, if they cannot invest on the stock market, they put money on horses or many other things,*

or football, or even watch two raindrops on the windscreen and see which goes faster. That is their instinct.” (col. 932) [emphasis mine]

A regulator should not aim to make markets entirely risk-free, or expect a hands-off approach to result in ‘free market efficiency’. Both of these are unrealistic ways of thinking. Instead, a regulator should aim to ensure appropriateness of product recommendations to individual investors’ risk profiles, and allow a free market to develop within its regulatory framework of rules and principles. Risk is an integral part of the market for investment products, and the regulatory challenge is not to exclude or minimize it altogether. Instead, a regulator should focus on the *appropriateness* of the risk to the investor (disclosure-based approach), rather than seek to change the market (merit-based approach). In so doing, a regulator conveys the clear signal that its role is to facilitate informed decision-making, and will protect investors who have been taken advantage of – but it remains the investor’s own responsibility to do his research and take responsibility for the decisions that he makes.

4. Saliency

This section first explains the behavioural recognition of ‘libertarian paternalism’ to caution that no matter how appealing behavioural finance recommendations are in theory, they must be used judiciously to avoid ‘over-correction’. While Singapore has implemented several policies that are more paternalistic in nature, these have been in several integral areas of society and therefore do not automatically support the use of libertarian paternalism in the financial sector.

This section then introduces the behavioural finance theory of saliency, which aims to facilitate more informed decision-making by reducing the individual’s availability and framing biases. It gives theoretical support for the existing Product Highlights Sheet system in Singapore, which seeks to regulate the market through meaningful disclosure.

4.1. Libertarian Paternalism

The phrase ‘libertarian paternalism’ was coined by Thaler and Sunstein (2008); it is not an oxymoron, but rather, reflects the fact that a regulator could seek to protect investors (essentially ‘paternalistic’) while preserving individual freedom of choice (‘libertarian’ in nature). This is done through the concept of ‘choice architecture’, which is the structure of choices facing individuals. The core principle is that a regulator can never aim to be entirely objective, as regardless of how a choice is structured, it would nudge decision-making in some way. Thaler and Sunstein (2008) explain the concept of the ‘nudge’:

“A nudge, as we will use the term, is any aspect of the choice architecture that alters people’s behaviour in a predictable way without forbidding any options or significantly changing their economic incentives. To count as a mere nudge, the intervention must be easy and cheap to avoid. Nudges are not mandates.” (at p. 6).

Thaler and Sunstein (2008) thus believed that regulators should use this to provide a more ideal starting point, i.e. to paternalistically nudge an individual towards a certain recommended option. However they simultaneously preserve the libertarian stance in allowing the individual the choice to reject the nudge, at minimal cost. Therefore the application of libertarian paternalism to the financial markets proposes an interesting development for the law. Legal regulation generally seeks to prescribe steps that must be complied with, or else form a framework within which individuals have freedom to act. However the behavioural finance theory of nudging goes beyond such a mandate, in seeking to ‘nudge’ individuals towards the option that is in their best interests, while preserving their freedom to choose otherwise.

Singapore appears to take a more paternalistic approach towards certain societal aspects that it deems essential, such as compulsory retirement savings through the Central Provident Fund (“CPF”). It has also reflected ideas of libertarian paternalism in other areas, such as the Human Organ Transplant Act (“HOTA”), where it used the concept of a ‘default option’ effectively. By making consent to organ donation the default, significantly fewer people opt out, as the presence of the default represents a status quo which they believe to be the prevailing attitude towards organ donation. As a reference point, it also serves to convince those who are undecided, and operates for society’s benefit regarding individuals who would otherwise have been apathetic towards actively exercising an option. This is an example of libertarian paternalism as the costs to rejecting the ‘nudge’ are very low.

However, the presence of paternalistic regulation, as well as the existing use of libertarian paternalism ideas in regulation, does not automatically support the use of libertarian paternalism in the financial advisory and investment market. These Singapore examples could very well imply ‘thus far and no further’, drawing the boundaries for the scope of application of libertarian paternalism.

Another problem is that of overcorrection: “we do not want to make pessimists out of the market”. Where nudges are directed towards the wrong outcome, or go beyond their ‘suggestive power’, there is a significant risk that the market could suffer for it. What is ‘socially optimal’ is a difficult question to answer in specific circumstances, and regulators must be careful to avoid fencing the entire market in with multiple nudges, to the extent that freedom of choice – and what can be chosen – is compromised.

The key question is whether the libertarian paternalism approach is consistent with the current regulatory rationale of protecting vulnerable investors. As libertarian paternalism seeks to nudge individuals towards socially optimal choices, and where vulnerable investors may not have the knowledge to make that choice independently, a nudge can go a long way in helping them to make good decisions. One possible application of this could be a regulatory recognition that banks could be providing countervailing nudges in making an investor feel rich and wealthy, and therefore issue guidelines to place limits on such behaviour.

4.2. Product Highlights Sheet (Singapore)

The rationale of salience is to facilitate understanding of mandated disclosure. One method of doing so is by translating complicated or abstract statements into concepts that are easy to understand (Thaler & Sunstein, 2008). Salience is a behavioural finance recommendation that is consistent with both the micro-level and macro-level regulatory approaches, as it complements the rationale of Singapore’s disclosure-based approach: regulators facilitate informed decision-making by requiring that disclosure be made, and that this disclosure should be easily understandable.

Singapore currently utilizes additional disclosure requirements for different types of financial products. The figure below, taken from the National Financial Education Programme website, highlights the use of different documents for improved disclosure of different products. One example is the Product Highlights Sheet which aims to summarise key information in clear, objective and simple language (DPM and Minister for Finance Mr Tharman Shanmugaratnam, at the Second Reading of the Securities and Futures (Amendment) Bill (2012)).

Product information

Financial institutions are required to disclose the features, risks and costs of investment products to you. Here are the key documents you must receive depending on the product you buy:

Product	Product Summary & Benefit Illustration	Product Highlights Sheet	Prospectus	Key Terms Sheet
Life insurance (non-investment-linked plan)	Yes	No	No	No
Investment-linked plan	Yes	Yes	No	No
Unit trust	No	Yes	Yes	No
Structured notes	No	Yes	Yes	No
Exchange traded funds	No	Yes	Yes	No
Structured warrants	No	No	No	Yes
Bonds	No	No	Yes	Yes

Please note that the requirement to provide a prospectus, product summary and benefit illustration and product highlights sheet only applies to financial advisers when providing a recommendation on a collective investment scheme (e.g. fund, unit trust or ETF), debentures or investment linked plans. While issuers are required to issue Key Terms Sheet, MAS does not require brokers or financial advisers to provide these when dealing with or advising consumer on structured warrants or bonds.

Figure 2: Disclosure documents for different products (MoneySENSE Singapore)

The SFA Guidelines (SFA 13-G10) on the Product Highlights Sheet state that it should be prepared by issuers for new offerings of debentures, structured notes, unlisted collective investment schemes and exchange-traded funds. It further prescribes that the PHS should not exceed four pages (or eight pages maximum, including diagrams and a glossary), should use clear and simple terms for investors to understand, and that information should be in a font size of at least 10-points Times New Roman. These pre-empt, respectively, a deluge of information on investors, jargon that undermines the rationale of comprehensibility, and using small print to hide certain facts ‘in plain sight’.

The Singapore approach of using principles and rules together, where each is tailored to an appropriate intention, represent a good balance between principles and rules. For example, the Guidelines give issuers the discretionary flexibility on what to include, while

ensuring that they comply with a standard framework of product suitability, key features, key risks, fees and charges, and valuation.

Singapore also pre-empts the problem of creating a uniform standard – Figure 2 demonstrates how it has one type of salience document for life insurance and investment plans, another type for structured warrants and bonds, and so on. This allows each framework to cater to the unique traits of the type of investment products (life insurance and investment plans are more long-term, while structured warrants and bonds are of medium-term).

In prescribing a framework for the issuer to follow, it significantly increases certainty and lays down a minimum standard that should be expected of the improved disclosure. Yet while leaving it open on the details of the information to be included, issuers are able to interpret the framework flexibly to different products which may be structured differently. This is facilitated by its approach of issuing guiding principles under specific rules, instead of the reverse: it can use the rules to restrict the applicable scope of each guideline, and therefore create a structure that benefits both from certainty and uniformity, as well as flexibility and adaptability.

5. Principles and Rules in Market Regulation

This section considers the drafting of recommendations and their enforcement in practice. While behavioural finance theory can contribute significantly to financial regulation, it remains but only ‘theory’ if it cannot be transcribed in an applicable way. An evaluation of the principles-based and rules-based approaches demonstrates that while there is no one right or wrong way to regulate a market, the key touchstones of effective regulation are certainty, responsiveness, and the ability to adapt to new innovation. Each country therefore must find its own appropriate balance between these, in order to better develop its financial system.

5.1. Comparing the Principles-Based and Rules-Based Approaches

General principles are more flexible and can adapt to changing circumstances, but this inherent uncertainty creates problems in enforcement. In contrast, the specificity of detailed rules makes compliance and enforcement easier, but potentially leads to banks complying with the letter but not the spirit of the law. A comparison between these approaches show that both ‘principles’ and ‘rules’ lie at opposite ends of a spectrum of specificity, with no clear defining line between them. Therefore drawing a distinction between principles and rules may be, at times, purely academic. Regulators should not view the drafting tools of principles and rules as the ends in themselves; but rather, that principles and rules are the means to attaining the ends of three regulatory touchstones – certainty, responsiveness, and the ability to adapt to new innovation in the market.

Principles-based regulation involves general overarching principles that represent a purposive expression of regulatory rationale, with the goal of facilitating compliance with the spirit of the law. These principles are worded in general qualitative terms, such as to “observe

proper standards of market conduct”¹⁴; they thus have a broad application to many circumstances. The defining aim of principles-based regulation is to ensure flexibility in interpreting the principles, so as to give firms some level of discretion in determining their own methodology to achieve the intended regulatory outcomes.¹⁵ This makes principles-based regulation inherently responsive to future market developments, as ideals such as “due skill, care and diligence”¹⁶ are less likely to change over time.

In contrast, rules-based regulation involves more specific rules that prescribe the specific procedures to be complied with. It therefore seeks to ensure certainty and a more uniform approach across the regulated industry.¹⁷ Due to the importance of certainty, rules-based regulation is often quantitative and detailed; for example, in specifying a criteria of “\$300,000 income”¹⁸. This facilitates ease of compliance as the requirements are usually clear and straightforward. However, prescriptive rules may end up being not entirely in line with the regulatory outcomes envisioned, especially if firms adopt a ‘tick-the-boxes’ mentality towards following the letter but not the spirit of the law. Specificity in rules also involves a trade-off against room for adaptability and future development, and this is of critical importance given the dynamism of the financial industry.

5.2. A Spectrum of Specificity

Despite a distinction between them, the difference between principles and rules may be purely academic due to the lack of a clear defining line between them. In theory, a principle appears to be more broad (and therefore more uncertain) than a rule, which is narrower but has more certainty due to its specificity. The comparison between principles-based and rules-based approaches thus appears to be purely academic at the margin: in adding greater detail and certainty, when does a principle cease to be a ‘principle’ and start to become a ‘rule’? There is no clear defining line between these two concepts, both of which fall at opposite ends of a spectrum of specificity.

A principle that is too broad may effectively convey nothing at all. In New Zealand, financial advisers’ response to principles-based regulation had highlighted the necessity of certainty, as the dominant sentiment was “where are the rules, how do we know we’re doing that?”¹⁹ However, the regulatory advantage of principles is that these represent ideals that the market should always strive towards, and thus naturally adapt to any future changes.

In contrast, a rule that is too prescriptive involves a high degree of certainty as to what constitutes compliance, but also runs the risk of over-inclusion or under-inclusion due to its

¹⁴ The UK FCA Principles, Principle 5: A firm must observe proper standards of market conduct.

¹⁵ Black, J., Hopper, M., & Band, C. (2007), *Making A Success of Principles-Based Regulation*, Law and Financial Markets Review, pp. 191-207.

¹⁶ The UK FCA Principles, Principle 5: A firm must observe proper standards of market conduct.

¹⁷ Black, J., Hopper, M., & Band, C. (2007), *Making A Success of Principles-Based Regulation*, Law and Financial Markets Review, pp. 191-207.

¹⁸ Singapore’s definition of a High Net Worth Individual (“HNWI”) in FAA-G07, at para. 7, involves clear numerical values stated as criteria for determining whether an investor is a HNWI.

¹⁹ “Advisers Struggling with Principles-Based Approach” (2013), <http://www.goodreturns.co.nz/article/976501228/brown-advisers-struggling-with-principles-based-approach.html>.

narrow specificity. In 2000, the then-Deputy Prime Minister Brigadier-General Lee Hsien Loong had recognized the limited usefulness of explicit rules in Singapore's financial regulation, as it is impossible to draft comprehensive rules that would predict all possible products and circumstances.²⁰ Drafting, parliamentary readings and debates also create a 'lag-time' where obsolete rules could still remain in the market. Rules that cannot keep up with developments are unable to fulfil their purpose of regulating the market, especially if they had not pre-empted a particular investment product or scenario.

5.3. Compliance

Compliance under rules-based regulation is generally more uniform across the industry, due to clear and comprehensive specifications of the elements necessary for compliance. In contrast, it has been argued that as principles provide the objectives of regulation, they facilitate better substantive compliance with the objectives rather than making banks focus on the specifics of individual rules.²¹ However, the inherent discretionary flexibility in principles-based regulation leads to different interpretations (and scope for argument) between the various financial institutions, the regulator, and the courts or other enforcement tribunals. While principles convey the intended regulatory outcomes, variance in interpretation could undermine the efficiency of its application. This is especially so because the inherent uncertainty could lead to a "chilling effect" where banks end up being more conservative in interpretation and application, thereby eroding the value of the flexibility in the principles-based approach. Financial institutions would be overly cautious where standards are unclear, the regulatory stance is unpredictable, or the expected cost of non-compliance is high.²²

Another argument in favour of principles-based regulation has been the idea that individual banks are better placed than the regulator to determine the appropriate procedures required to achieve a given regulatory objective.²³ Regulation has therefore been proposed to be more effective when it states the intended outcomes and then gives management the flexibility and responsibility to create an appropriate methodology to achieve those outcomes.

However, this raises the question of conflict of interest that could arise between banks and the regulator, or between banks and their clients. Where a bank's self-interest conflicts with regulatory ideals or customers' interests, giving banks the discretion to work out their own solutions could do more harm than good in the financial markets. The regulator thus may be better placed to implement standards that would be interpreted and applied consistently across the industry. Especially where the regulatory rationale is the protection of vulnerable investors, it seems more appropriate that the regulator, instead of those who may have a conflict of

²⁰ Parliamentary Debates on Minimum Disclosure Standards for Initial Public Offerings (2000), at col. 687.

²¹ Black, J., Hopper, M., & Band, C. (2007), *Making A Success of Principles-Based Regulation*, Law and Financial Markets Review, pp. 191-207.

²² Black, J., Hopper, M., & Band, C. (2007), *Making A Success of Principles-Based Regulation*, Law and Financial Markets Review, pp. 191-207.

²³ Black, J., Hopper, M., & Band, C. (2007), *Making A Success of Principles-Based Regulation*, Law and Financial Markets Review, pp. 191-207.

interest, should be the one to implement regulatory procedures or minimum standards that fulfil such a rationale.

5.4. Enforcement

The issue of enforcement is linked to that of certainty: laws must be certain in order to be enforced. There arise several potential problems in enforcing uncertain principles and the uncertainty in their applicable scope. Moreover, there are significant consequences of making principles non-binding and non-enforceable: if a bank has the discretionary flexibility to figure out its own methods of compliance, the regulator must clearly state its expectations beforehand and respect that flexibility when making decisions regarding enforcement.

Enforcement of uncertain principles is dangerous as it may not be foreseeable by banks that they have acted in contravention of such. In the UK, the Financial Services Authority (“FSA”) has stated that it can and will take enforcement action on the basis of principles alone where appropriate,²⁴ which has led to controversial decisions such as the *Citigroup* case in 2005 and *Deutsche Bank* case in 2006.

In 2005, the FSA had ordered Citigroup Global Markets to relinquish profits and pay a penalty for using a bond trading strategy that had led to a short term drop in bond prices. Even though the FSA had not considered this strategy as ‘market abuse’, it still penalized Citigroup for breach of FSA Principles 2 and 3, which generally required Citigroup to conduct its business with due skill, care and diligence, and take reasonable care to organize and control its affairs reasonably and effectively. The decision was controversial “because it casts doubt generally on the legitimacy of market impact trades that do not result in any contravention of specific FSA rules or FSA principles which directly concern market confidence or fair treatment to investors”²⁵.

Black, Hopper & Band (2007) recognized that “there is a risk that [firms’ own rules] become a stick with which to beat them”²⁶. In support of this, they cited the 2006 Deutsche Bank case, where the FSA had imposed a penalty for breach of stabilization rules. These rules would not have ordinarily applied in the circumstances, but the bank had adopted an internal policy that it would comply with them. Thus the FSA had effectively held the bank to a standard which it had voluntarily adopted but which had not been necessary for compliance.

The converse approach of making principles non-enforceable appears to be equally fraught with problems. Where enforcement is not an option, one is forced to question the purpose of the guidelines. If there is no penalty for non-compliance, banks would have little incentive to take the guidelines seriously. Unscrupulous banks could even deliberately ignore or act in contravention of the outcomes reflected in the guidelines, while ensuring compliance with the letter of the specific rules.

²⁴ FSA Enforcement Conference, 2006.

²⁵ Morgan Lewis, (2006), *A Summary of the Financial Services Authority’s Market Abuse Regime in the United Kingdom*, p. 10.

²⁶ Black, J., Hopper, M., & Band, C. (2007), *Making A Success of Principles-Based Regulation*, Law and Financial Markets Review, pp. 191-207, at p. 198.

5.4. Balancing the Three Regulatory Touchstones

Regardless of whether principles or rules are utilized, the main objective of regulators is to find a balance between certainty, responsiveness and flexibility in the market. The subsections above have illustrated that principles are generally more flexible and can adapt to innovation and change in the market, but have an inherent uncertainty that creates problems in interpretation and enforcement. Rules can be detailed and specific, thereby facilitating compliance through high levels of certainty; however, they cannot comprehensively anticipate every single possible scenario, and may lag behind the market due to drafting and review time. Moreover, rules could encourage a ‘tick-the-box’ approach, where compliance is made with the letter but not the spirit of the law. Therefore some combination of principles and rules is optimal to balance certainty, responsiveness and flexibility in regulation.

However, the expansion of subsidiary explanation and guidance could increase uncertainty instead of decreasing it, if the elaboration of the principle eventually crystallizes into a view that deviates from that expressed in the principle itself. Ultimately the flexibility of the principles-based approach necessarily declines over time, as some form of explanatory note, guidance, or applicable enforcement decision would inevitably create an inroad into discretionary flexibility.

A comparison of the Singapore approach to the UK approach demonstrates two different ways of utilizing both principles and rules in market regulation. This reflects that there is no single ‘right’ method, but instead, regulators must take into account all facets of their particular market in order to draft effective regulation. This effective regulation must therefore, regardless of method, strike a balance between certainty, responsiveness, and the ability to adapt to new innovation.

Singapore has acknowledged that the Financial Services Authority (“FSA”) in the UK was “widely recognized as the foremost practitioner in the world of the principle-based approach”²⁷. The general hierarchy in the United Kingdom (“UK”), as identified by Black, Hopper & Band (2007), is that principles are overarching and that rules serve to outline examples for compliance. In contrast, the approach in Singapore is one that is predominantly rules-based, where principles are issued as supplementary guidelines to existing rules.

The supplementary nature of principles in Singapore is evident from the Monetary Authority of Singapore (“MAS”) Guidelines on Standards of Conduct (FAA-G04), which explain that these “provide general guidance and are not intended to replace or override any legislative provisions or written directions” (at para. 2). Paragraph 5 also states that the Guidelines should be read in conjunction with the legislative provisions and other issuances, and that the MAS would use them to consider whether requirements in the rules have been satisfied. In the Frequently Asked Questions (FAQ) on the Financial Advisers Act (“FAA”) and Financial Advisers Regulations (“FAR”), the MAS has stated that the Guidelines “do not

²⁷ Second Reading of Securities and Futures Amendment Bill (2009), Nominated Member of Parliament (“NMP”) Mr Siew Kum Hong, at col. 1116.

have the force of law” but it nevertheless expects adherence, “so as to foster professional standards and maintain confidence in the industry” (at para. 12 of Section V).

MAS has also recognized some degree of discretionary flexibility in these principles, as it prescribes that “each financial adviser may need to adapt these Guidelines to its particular circumstances” (at para. 4). The Guidelines on Conduct of Business for Execution-Related Advice (FAA-G08) similarly provide for that discretion as the MAS has “adopted a principle-based approach rather than a detailed prescriptive approach ... [and] expects dealers to adhere to these standards and *introduce other practices, processes and procedures, where appropriate*, to safeguard the interests of their clients” (para. 3) [emphasis mine].

In the Second Reading of the Securities and Futures Amendment Bill (2012), Deputy Prime Minister and Minister for Finance Mr Tharman Shanmugaratnam recognized the need for a balance between prescriptive rules and broad principles:

“MAS’ approach is to avoid moving towards either of two extremes in financial regulation. To avoid relying solely on prescriptive rules for every type of instrument or market participant on the one hand, or solely on issuing broad principles and guidance, which can be then interpreted in different ways by different market participants, and hence introduce uncertainty in markets. Neither of these polar extremes in financial regulation – relying solely on prescriptive rules or solely on principles and guidance – has worked well in international experience. They certainly would not work well in preserving stability or enabling sustained growth in today’s world.”

This highlights that both principles and rules can and should be used by regulators, where each is tailored to a specific purpose. Principles reflect overall intended regulatory outcomes and are useful in areas where the law needs to adapt quickly to market developments. Detailed rules have greater consistency in interpretation and application, and are better in mandating certain procedures which are necessary for the market. These allow for an adequate balance to be drawn among the three key touchstones of certainty, responsiveness, and the ability to adapt to new innovation.

5.5. Singapore’s Regulation

The Singapore example demonstrates that uncertainty as a whole must be minimized to allow for enforcement, and this must be considered in the context of scope, interpretation and application. Certainty in scope can be addressed through clear confinement to particular situations, and a vigilant awareness that ‘regulatory creep’ – the gradual pushing of that boundary – can and does happen in practice. While regulatory guidance aids in interpretation and application, it also erodes the discretionary flexibility present in principles-based regulation. Guidance must therefore be made judiciously and regulatory intention made especially clear, so as to avoid development of principles in a manner which had never been envisioned. Sufficient certainty in regulation allows for enforceability, but regulators must be careful to not interfere too much or to penalize banks for voluntarily adopting standards higher than industry practice. Either, or both, of these actions would stifle innovation and growth in the financial market.

Uncertainty as to the applicable scope of the principles has posed problems for banks' interpretation in the UK. Black, Hopper & Band (2007) use the phrase 'regulatory creep'²⁸ to describe a situation where the broadness and generality of the wording in principles leads to them being used to manage other areas that they had not been intended for in the first place. They cite the example of the 'Treating Customers Fairly' initiative in the UK, where the general wording of overarching principles led to the FSA expanding its scrutiny into areas like product design, even though such areas had not previously been contemplated to be the subject of those regulatory principles. The authors thus conclude that this pushing of jurisdictional boundaries may not be an appropriate way for regulatory policy to develop.

In contrast, the Singapore approach is to supplement rules with principles, not to make rules under principles as in the UK. Most of the guidelines issued by the MAS thus far have been confined to particular situations, thereby ensuring greater certainty in scope. For example, FAA-G01, Guidelines on Criteria for the Grant of a Financial Adviser's Licence, states in para. 1 that these "are intended to provide guidance on the licensing admission criteria for persons applying for a financial adviser's licence under the Act".

Even guidelines that appear very general also have their intended scope set out at the start. For example, para. 5 of the FAA-G04 Guidelines on Standards of Conduct for Financial Advisers and Representatives limits its applicability to "considering whether a financial adviser or any of its representatives satisfy the business conduct requirements that are set out in the Act ... or is a fit and proper person to be engaged in financial advisory services in Singapore". This restriction of applicable scope is necessary to promote certainty in the market.

Moreover, regulatory guidance is necessary to prevent financial advisers from interpreting and applying both principles and rules in a manner contrary to legislative intention. This was recognized in the Second Reading of the Financial Advisers (Amendment) Bill (2012) by Member of Parliament ("MP") for West Coast, Ms Foo Mee Har.²⁹ She noted that rules should not be applied in a way that creates "unnecessary bureaucracy with no value added outcomes":

"I have observed how financial advisers ("FA") in other Asian markets, in their efforts to comply with regulations, end up building safeguards into their client investment processes that are bureaucratic and inconvenient. This ends up becoming a frustrating experience for their clients. One example is the insistence that financial transactions can only take place in person at the FA's branches where interactions with clients are fully recorded. Another example is clients being subjected to lengthy documentation, confirmations, double confirmations and independent checks in order to guarantee that compliance can never be disputed ... To facilitate the implementation of the Bill, I urge MAS to guide FAs in their interpretation of the changes so as to strike the right balance between building appropriate levels of safeguards for the investing public and unnecessary bureaucracy with no value added outcomes for investors." [emphasis mine]

²⁸ Black, J., Hopper, M., & Band, C. (2007), *Making A Success of Principles-Based Regulation*, Law and Financial Markets Review, pp. 191-207.

²⁹ Second Reading of the Financial Advisers Amendment Bill. Sing., Parliamentary Debates, vol. 89 (15 November 2012).

Ultimately, “[t]he question is how to provide both certainty and predictability while giving firms the flexibility and space to innovate that principles can create”.³⁰ Further elaboration to principles clarifies how a regulator would measure compliance and what consequences arise from non-compliance. Yet such elaboration, in reducing the inherent uncertainty of principles, naturally erodes the discretionary flexibility that is the core of the principles-based approach. Additional detail from case law, rules or guidelines also removes that discretionary flexibility, albeit in a less obvious way. There also may be a risk of inconsistent decisions, or that interpretation is done through the “battle of the experts” which could differ from regulatory intention.³¹

While addressing uncertainty in scope, interpretation and application is not without its accompanying problems, Singapore has recognized this and taken steps to ensure that there is sufficient certainty for enforcement of its regulations. Singapore avoids the zero-enforcement problem by prescribing penalties for non-compliance. It supplements its predominantly rules-based approach with additional rules (under s. 58 FAA) and guiding principles (under s. 64 FAA). Non-compliance with the former is an offence³², while guidelines issued under the latter would not suffice to create private independent causes of action, or separate enforcement by MAS apart from breach of other rules. However, the guidelines cannot be entirely disregarded by financial advisers, as they can be used in legal proceedings to establish or negate any liability in question (s. 64(4) FAA). Banks thus retain some element of discretionary flexibility in their interpretation and application of the supplementary guidelines, which is in line with the aim of the principles-based approach.

Singapore is also likely to deviate from the UK enforcement standards in ‘beating a bank with its own stick’ where it voluntarily adopts higher standards than industry practice. It therefore encourages banks’ use of discretionary flexibility under the principles in Singapore, which promotes innovation and constructive development in the financial market. This can be inferred from the judicial reasoning in the recent case of *BNM v. National University of Singapore and anor* [2014] SGHC 5. The plaintiff’s husband had drowned in a swimming pool at the National University of Singapore (“NUS”) and the case therefore involved the question of whether NUS had sufficiently discharged its duty of care at the pool. The court recognized that NUS had voluntarily exceeded the industry standard for pool safety, in being one of the earliest in the country to have an automated external defibrillator (AED). However, one of the court’s holdings was that NUS’ actions were nevertheless sufficient to conform to the industry standard at that time, and thus it should not be ‘beaten with its own stick’. The court recognized that:

“... if a defendant who conforms to the industry standard nonetheless strives to achieve a higher standard, it should not be penalised if it fails to reach that higher

³⁰ Black, J., Hopper, M., & Band, C. (2007), *Making A Success of Principles-Based Regulation*, Law and Financial Markets Review, pp. 191-207.

³¹ Black, J., Hopper, M., & Band, C. (2007), *Making A Success of Principles-Based Regulation*, Law and Financial Markets Review, pp. 191-207.

³² See s. 58(5): an offender shall be liable on conviction to a fine not exceeding \$25,000 and for a continuing offence, a fine up to \$2,500 for every day or part thereof where the offence continues after conviction.

standard. *It would be against public policy to discourage parties from trying to achieve safety or other standards of care that exceed industry or acceptable standards of that time by penalising them if they fail to reach the same.* Moreover, it cannot be right that one defendant who conformed to industry or current standards is held not liable but another who tried to achieve more than industry or current standards but failed to do so is liable for its failure to achieve that higher standard.” (at [81]) [emphasis mine]

Sufficient certainty in scope, interpretation and application of guiding principles, allows Singapore to benefit from the flexibility of the principles-based approach while simultaneously ensuring that essential requirements are followed to the letter. Moreover, banks in Singapore are not likely to be held liable for voluntary ‘overreaching’ beyond the industry standard, as long as it complies with minimum requirements. The Singapore legal position is thus likely to facilitate banks’ exercise of discretionary flexibility in innovating and developing approaches tailored to their specific circumstances, without fear that a higher standard would be used against them. It addresses most of the problems under the principles-based approach, through an infusion of certainty and recognition of value in the discretionary flexibility of the supplementary principles in Singapore. This creates a more dynamic industry practice that complies with principles and strives towards regulatory outcomes.

This discussion also has implications for the drafting of behavioural finance recommendations into regulation: as pure rules, they may encourage compliance with the spirit but not the letter of the law; as pure principles, banks unfamiliar with behavioural finance theory would find themselves floundering as to what the expected standard would be. As always, a balance would need to be struck between the two, in considering the specific circumstances of the recommendations evaluated.

6. ‘Alpha’ Protection versus ‘Over’ Protection

The preceding discussion raises the issue of how much protection should be given to consumers, without compromising the dynamism of a free market or creating a moral hazard problem where consumers gain freedom without corresponding responsibility. Behavioural finance insights also show that a line must be drawn between recognizing and addressing irrationality, versus actively encouraging it. This paper draws the distinction thus between ‘alpha’ protection and ‘over’ protection. Alpha protection does not necessarily mean ‘maximum’ protection – sometimes, having a lot of a good thing can be bad in itself. And especially where there are conflicting rights and interests involved, giving maximum protection to one side would naturally mean that other parties have been compromised. The term ‘alpha’ protection is therefore distinct from ‘over’ protection: while the latter refers to giving as much protection as possible, the former reflects having the best possible level of protection, in light of regulatory objectives, approach and the interests of all other parties involved.

The old adage comes to mind: if you give a man a fish, you feed him for a day; if you teach a man to fish, you feed him forever. These two scenarios reflect the two opposites of an

inward view versus an outward view. The former asks, to what extent must a regulator change the market to make it safer, while the latter asks, to what extent should a regulator facilitate the ability of people to operate within that market independently? And from a behavioural perspective, it also brings the corresponding questions of what a regulator should do if the man cannot learn to fish, has to catch prawns, or simply refuses to do so.

First, the scenario where a man cannot learn to fish is analogous to the need for tiered protection in the market. Regulators must acknowledge and accept that one set of rules may not be precise enough to cater to all the different types of consumer in the market. In particular, regulators must bear in mind that if their regulatory objective is the protection of the individual, then they must also utilize regulation to protect the most vulnerable, without taking away his responsibility for his own 'feeding'.

Second, the scenario where a man has to catch prawns is analogous to the fact that there are many similar systems in the financial market. So while a regulator could, in theory, tranquilize the entire pond of fish, it should also recognize that this would affect individuals' ability to take care of themselves in the shrimping pond. Where individuals internalize a perception that they would be taken care of, their ability to take care of themselves will be subconsciously decreased.

Last, the scenario where a man refuses to catch fish is analogous to how choice is structured in the market, and by regulators. In a progressing world which places increasing emphasis on the value of 'choice', regulators need to draw from libertarian paternalism to understand that the value of choice is less important than what an individual actually does with the choice that is given to him. Where individuals have to choose between one or the other, but erroneously believe that they can make a 'neutral' third choice, regulators should step in to facilitate greater understanding through information. Regulators should not micro-manage the market or impose overly-restrictive nudges that erode the value of choice. However, regulators should also be aware that choice in itself is not of the highest significance, and therefore utilize a regulatory approach that facilitates *informed* choice and encourages individuals to make the right decisions. This is especially significant when the choices made have life-changing consequences for the individuals that make them.