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PRODUCT DUE DILIGENCE AND THE SUITABILITY OF MINIBONDS: TAKING THE BENEFIT OF HINDSIGHT

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This article focuses on some problems arising from applying the product due diligence requirement of the suitability rule to complex financial products. The article draws several conclusions. First, the 'not unsuitable' test should be adopted to reduce legal uncertainty. Second, the comparative risk approach is a better choice in assessing the suitability of investment products. However, there must be further elaboration of the classification of product risk. Third, there must be a balance between risk and return to avoid risk mismatches in product design. Fourth, what have been termed minibonds raise the problem of documentation suitability. Though it is difficult to define suitable documentation, it may be worthwhile for regulators to establish some minimum standards that might have a great influence on product risk. Financial regulators may consider differentiating between financial products in assessing their suitability rather than adopting a one-size-fits-all approach.

I. INTRODUCTION

The purpose of this paper is to examine the construction and application of the suitability rule in Singapore in relation to complex structured financial products, with an emphasis on the product due diligence requirement. The key question is how to define the suitability of a financial instrument for retail investors.

The collapse of Lehman Brothers has had some unexpected victims in Southeast Asia: retail investors in Lehman 'minibonds' and similar products[1] from Singapore and Hong Kong, both of which are markets with high savings rates but low market interest rates.[2] Driven by the demand for a higher return from their cash deposits, retail investors were exposed to highly complex financial products that combine the features of fixed-income debentures and derivatives, offering coupon rates higher than prevailing market interest rates. In Singapore, it was estimated that about 7,800

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[1] This article will focus on structured notes that are called 'minibonds' arranged by Lehman Brothers. There are other retail structured notes issued in Singapore by other financial institutions (*e.g.*, Morgan Stanley Pinnacle notes), which may share similar problems.

[2] In Singapore, market interest rates during a period in which the 12-month fixed deposit rate has been below 1% since May 2003. See online: Singapore Government Securities <https://secure.mas.gov.sg/msb/InterestRatesOfBanksAndFinanceCompanies.aspx>.

investors with a total investment of S$ 508 million suffered as a result of the minibond saga.[3] More than 29,000 investors became victims in Hong Kong.[4]

Among all the regulatory responses raised by the minibond fiasco,[5] one crucial issue is the suitability of retail financial products.[6] The idea of suitability is not new to the field of consumer protection.[7] In the context of financial regulation, the suitability rule has a strong connection with quality of advice.[8] It is also perceived as a tool to reduce mis-selling risks.[9] The rationale is that investors have less access to information and less market sophistication than financial firms.[10] In the UK, it has been found that "[p]eople who had bought an investment had twice the probability of a mis-purchase".[11] The complexity of many investment products, "coupled with the relative infrequency of purchase, means that consumers often need advice on these products to ensure that they fully understand what they are buying and that it is suitable for them."[12] Thus, the suitability rule is seen as a cornerstone allowing retail investors access to riskier investment products.[13] Alongside conflict of interest rules, the suitability rule could "dilute the risk of failures in product regulation and mitigate the limitations of disclosure."[14]

In response to the minibond fiasco, Singapore law now adopts a two-stage approach in the suitability assessment: product due diligence and matching the product to target customer segments.[15] The latter involves more customer-specific analysis of a client's personal information and financial objectives. The former, being the focus of this article, refers to the analysis of a financial product to assess its features and risk-reward characteristics, the sale process, and target customer

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3 In Singapore, it was estimated that the minibond market had a total size of about SGD 508 million and 7,800 investors. See "Investigation Report on the Sale and Marketing of Structured Notes linked to Lehman Brothers" *Monetary Authority of Singapore* (7 July 2009), online: MAS <http://www.mas.gov.sg/resource/news_room/press_releases/2009/INVESTIGATION%20REPORT_7%20JUL%2009.pdf> [*MAS*].

4 Alan Ewins *et al.*, "The Lehman Aftermath: Hong Kong and Singapore Regulatory Reforms in the Structured Product Markets World" (2010) 5:3 CMLJ 301 at 301.

5 See generally *MAS*, *supra* note 3 at 12-18.

6 Ewins, *supra* note 4 at 313, 317.

7 Gail Pearson, "Reading Suitability against Fitness for Purpose—The Evolution of a Rule" [2010] 1 Sing. J.L.S. 129 at 132-139.

8 Niamh Moloney, *How to protect investors: lessons from the EC and the UK* (Cambridge: Cambridge University Press, 2010) at p. 235. "Investment Quality of Advice Processes II" *Financial Services Authority (FSA)* (August 2008) Ch. 4, online: FSA <http://www.fsa.gov.uk/smallfirms/resources/factsheets/pdfs/iqap2.pdf>.

9 Moloney, *ibid.* at p. 236.

10 Peter M. Geckeler, "Municipal Derivatives Use and the Suitability Doctrine" (1996) 49 Wash. U. J. Urb. & Contemp. L. 285 at 303.

11 Andrea Finney and Elaine Kempson, "Consumer Purchasing and Outcomes Survey" *Financial Services Authority (FSA)* Consumer Research 76 (2008), online: FSA <http://www.fsa.gov.uk/pubs/consumer-research/crpr76.pdf> at 122.

12 Strictly Financial, *Accessing Investment Products: Consumer Perceptions of A Simplified Advice Process* (FSA, Consumer Research 73, 2008) at pp. 5, 8.

13 Moloney, *supra* note 8 at 236; Jason D Haines, "The Markets in Financial Instruments Directive (MiFID): Investor Protection Enhanced by Suitability Requirements" (2007) 28:11 Comp. Law 344 at 345; Strictly Financial, *ibid.* at 8.

14 Moloney, *supra* note 8 at p. 236.

15 See *infra* Part III.

segments for which the product is suitable. The same approach is also adopted in Hong Kong.[16]

Then we may ask how product due diligence may be conducted. The product due diligence exercise exposes the difficulty of defining the suitability of investment products, a task which requires a fine balance between risk and return. Even worse, it is convenient to assess suitability in hindsight.[17] It is easy to say that a financial adviser must analyse certain characteristics of a product. Nonetheless, the standard for assessing suitability is never clear.[18] Minibonds offer us a good example for academic investigation.

Therefore, the purpose of this paper is to clarify the interpretation and application of the suitability rule in Singapore to complex retail financial instruments by analysing minibond documentation from a both theoretical and practical point of view. The analysis will be useful not only in understanding the suitability rule in Singapore; it might also help lawmakers in the UK, the US or any other country when revising consumer protection rules in financial regulations.

The following sections first introduce the nature and structure of minibonds, mainly using the Minibond Series 9 as an example. Minibond Series 2 may be analysed for comparison purposes. Part III is a conceptual discussion of suitability, including the choice of standards, classification of risk, and product design. Part IV focuses on documentation and suitability in more detail. Part V concludes the article.

II. Minibonds in a Nutshell

A. *Meaning*

It is a difficult task to describe minibonds accurately in simple words. Yet, retail investors are supposed to understand all the features specified in long legal documents before making an investment decision. This underlines the main challenge in law.

In short, a minibond is a kind of 'synthetic credit-linked portfolio note', which is a debt security with an embedded credit derivative instrument. The redemption value of a minibond is linked to the occurrence of a credit event[19] for one or more debt instruments ("reference obligations") issued by specified institutions ("reference entities") in a specified portfolio (the "underlying portfolio") defined in the documentation for the note. Each element may be explained in turn.

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[16] See Question 2 of the Suitability Obligation of Investment Advisers under the FAQ section of the Hong Kong Securities and Futures Commission (HKSFC) website, online: HKSFC <http://www.sfc.hk/sfc/doc/EN/faqs/super/faq_ia_eng.pdf>.

[17] Finney and Kempson, *supra* note 11 at 124. In *R (Williams) v. Financial Ombudsman Service* [2008] EWHC 2142 (Admin), Irwin J. also observed at para. 44 that "[t]here must be a risk, in circumstances like these, of hindsight by an ombudsman."

[18] Moloney, *supra* note 8 at p. 241. In 1971, Cohen had already noted the substantial difficulty of suggesting 'specific criteria for judging the risk suitability of particular recommendations' (Stephen B. Cohen, "The Suitability Rule and Economic Theory" (1971) 80(8) Yale L.J. 1604 at 1606).

[19] Subject to product documentation, a credit event normally includes bankruptcy, failure to pay, corporate restructuring, repudiation and moratorium. Minibond Series 9 Pricing Statement (Series 9 Pricing Statement) at pp. 39-41.

First, a derivative is "a financial instrument whose value depends on (or derives from) the values of other, more basic underlying variables".[20] In a way, derivatives "allow trading in the return or price fluctuations of other assets *without the necessity of trading in the assets themselves*".[21] As the minibond prospectus stated,

> [i]nvestors gain exposure to the credit risk of the Reference Entities without directly holding the debt obligations of the Reference Entities and without directly involving any Reference Entity in the transaction. This is achieved by linking payment of the principal and interest on the Notes to a Reference Entity's default (defined as a Credit Event).[22]

Second, minibonds are 'synthetic' credit-linked notes because credit losses are transferred via a credit default swap ("CDS").[23] Under a CDS, one party (the protection buyer) pays a price (*i.e.* the premium for the credit protection) to the other party (the protection seller) and receives protection from the protection seller upon the occurrence of a credit event.[24] In the case of minibonds, the CDS is settled in cash.[25] As there is more than one reference entity in the underlying portfolio, it is structured on a 'first-to-default' basis so that minibond issues must be redeemed whenever the 'first' credit event occurs to a reference obligation in the underlying portfolio.[26]

Hence, minibond holders lend money to the issuer to enable it to provide a kind of credit protection to the protection buyer (*i.e.* the swap counterparty). To put it in another way, minibond holders invest in the credit risk of the reference entities. The price of underwriting this credit risk is the periodic interest payments due (*e.g.*, for Minibond Series 9, 4.3% p.a.). If a credit event occurs, the redemption value[27] will be reduced to reflect credit losses, which are transferred from the swap counterparty to the protection seller (*i.e.*, the issuer of minibonds) and then from the issuer to the minibond holders. The noteholder should receive the full redemption value upon maturity if no credit event occurs. Thus, minibond holders are the ultimate bearers

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20 John C. Hull, *Options, Futures, and Other Derivatives*, 6th ed. (New Jersey: Prentice Hall, 2006) at p. 1.

21 Satyajit Das, *Derivative Products & Pricing*, 3rd ed., rev. ed., (Singapore: John Wiley & Sons, 2006) at p. 4.

22 See Base Prospectus and Pricing Statements of Minibond Series 9 & 10 (Base Prospectus) dated 26 June 2008 at p. 27. The base prospectus and relevant pricing statements were retrieved from the MAS Opera database, online: MAS <http://masnet.mas.gov.sg/opera/sdrprosp.nsf/LeftFrame?OpenFrameset&LayerVal=D&Frame=RightPane&SRC=/opera/sdrprosp.nsf/vewPublicAllDebuntures Sort?OpenView>.

23 Satyajit Das, *Structured Products Volume 1: Exotic Options; Interest Rates & Currency*, 3rd ed., rev. ed. (Singapore: John Wiley & Sons, 2006) at p. 117.

24 The operation of a CDS is also explained by Hamblen J. in *Cassa Di Risparmio Della Repubblica Di San Marino SpA v. Barclays Bank Ltd.* [2011] EWHC 484 (Comm) at paras. 22-30. The protection could be in the form of physical delivery (*i.e.*, the protection seller buying the bond at its face value) or cash settlement (*i.e.*, the protection seller paying the difference between the face value and the settlement price of the reference obligation). If no credit event occurs, the protection buyer will receive nothing in return.

25 Series 9 Pricing Statement, *supra* note 22 at p. 19.

26 Series 9 Pricing Statement, *supra* note 22 at p. 2; Condition 7(c) of the Master Terms and Conditions of the Notes ("Ts&Cs") in the Base Prospectus, *supra* note 22 at pp. 46-47.

27 It is called the "credit event redemption amount". See Series 9 Pricing Statement, *supra* note 22 at p. 1.

of credit losses on the reference obligations. The odd part is that minibond holders offer credit protection by paying a lump sum of cash in advance.

B. *Issuance Structure*

The minibonds in Singapore were issued by Minibond Ltd., a special purpose vehicle incorporated in the Cayman Islands with capital of US$50,000 divided into 50,000 shares.[28] The deal was arranged by Lehman Brothers. The issue was based on a multi-issue medium term note programme for which a base prospectus was circulated along with a pricing statement (alternatively called an "offering circular" in some places) for each issue.

For example, the parties involved in Minibond Series 9 are shown in the following table:

Parties	**Name**
Issuer	Minibond Ltd.
Trustee	HSBC Institutional Trust Services (Singapore) Limited
Swap counterparty	Lehman Brothers Special Financing Inc
Guarantor for swap counterparty	Lehman Brothers Holding Inc
Portfolio of reference entities	Aviva plc, HSBC Bank plc, Prudential plc, Malaysia, China (PRC), SingTel[29]
Calculation agent (original)	Lehman Brothers Asia Ltd.
Collateral (if any)	Notes issued by Wachovia[30]
Custodian of collateral	Unknown
Arranger	Lehman Brothers Singapore Pte. Ltd.
Distributors	DMG & Partners Securities; OCBC Securities; Hong Leong Finance; UOB Kay Hian
Others: Payment agent, disposal agent, depositary, etc.	HSBC (as paying agent); Lehman Brothers (International) Europe (as dealer and marketing agent)

It is interesting to note that at least five different entities associated with the Lehman Brothers group were involved in Minibond Series 9, enabling Lehman Brothers to earn various fees.

The involvement of multiple parties in minibonds indicates a need to execute a number of contracts between relevant parties. This contributes to the opacity of minibonds and entails a higher level of legal risk in the documentation. Similar to conventional bonds, there is an issuer and noteholder(s), as well as a trustee and/or depositary or custodian. Apart from the terms and conditions of the notes, there must be other contracts (*e.g.*, a trust deed and agency agreement with other agents) to regulate the powers and obligations of relevant parties (*e.g.*, trustee, calculation agent, paying agent, *etc.*). The inclusion of a CDS adds a 'swap counterparty' to the scene. The documentation of the credit default swap (between the issuer and the swap

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[28] See Base Propectus, *supra* note 22 at p. 84.

[29] Series 9 Pricing Statement, *supra* note 22 at p. 6.

[30] See *MAS*, *supra* note 3 at p. 2 note 6.

counterparty) is usually based on the standard form published by the International Swaps and Derivatives Association ("ISDA").[31]

Moreover, if collateral is required for an issue, the issuer is often obliged by contract to pay the interest from the collateral to the swap counterparty. Thus, it is common to execute a corresponding currency and interest rate swap to accommodate this part of the cash flows.[32]

Returning to the Singapore minibond issue, it could be argued that Lehman Brothers would hardly lose money from the deal. Even though the swap counterparty had to pay premiums for the CDS, the extent of its obligation was reduced by a well-structured interest rate swap between the same parties. As a result, the swap counterparty made a *de facto* indirect investment in the collateral funded by the minibond holders. These features put noteholders in a poor contracting position.

III. Current Suitability Rules in Singapore

Singapore had suitability rules in place even before the minibond crisis. Section 27(1) of the *Financial Advisers Act*[33] requires a financial adviser to have a reasonable basis for making a recommendation to a client. An adviser must consider "the information possessed by him concerning the investment objectives, financial situation and particular needs of the person."[34] Violation of s. 27(1) may lead to civil liability.[35]

Though s. 27 does not specifically use the word 'suitable', the Monetary Authority of Singapore ("MAS") has clarified that "[s]ection 27 … requires a financial adviser to analyse the information provided by the client and identify the product that is *suitable for the client* based on the information obtained from the client".[36] Advisers also have to explain to their clients the basis of their recommendation,[37] and must retain documentation if a client refuses to give information or decides to invest in an unsuitable product.[38]

In response to the minibond saga, the MAS issued the "Guidelines on Fair Dealing—Board and Senior Management Responsibility for Delivering Fair Dealing Outcomes to Consumers"[39] in 2009 to clarify application of the suitability rule for the purpose of fair dealing. In Outcome 2, the MAS requires "[f]inancial institutions [to] offer products and services that are *suitable for their target customer segments*".[40] To reach this goal, a financial institution must "undertake formal product due diligence

[31] Series 9 Pricing Statement, *supra* note 22 at p. 35.

[32] Series 9 Pricing Statement, *supra* note 22 at pp. 19, 20.

[33] Cap. 110, 2007 Rev. Ed. Sing. [*FAA*].

[34] *FAA*, s. 27(2).

[35] *FAA*, s. 27(3).

[36] *Notice on Recommendations on Investment Products*, (Cap. 110, N. FAA-N16, 2011 Ed. Sing.), para. 28 (emphasis added). The MAS further specified three aspects of the "reasonable basis" requirement at para. 10: (1) know your customer; (2) needs analysis; and (3) documentation and record-keeping.

[37] *Ibid.* at para. 31.

[38] *Ibid.* at paras. 24, 25, 32, 33.

[39] FAA-G11 (2009) [*Fair Dealing Guidelines*].

[40] *Ibid.* at 2.1.1 (emphasis added).

on any investment product it intends to distribute" and "tailor its marketing approach to the profiles, financial objectives, and general financial literacy of its target customer segments."[41]

In addition, there is currently a proposal to insert the product due diligence requirement into the Financial Advisers Regulations ("FAR"). Proposed FAR Regulation 18B(1) states that:[42]

> [a] financial adviser shall carry out a due diligence exercise, before offering any new product in Singapore to any client, to ascertain whether the new product is suitable for the targeted clients.

The product due diligence exercise should include assessment of the target client base and investment objectives for a "new product",[43] the "key risks" of the product, costs and fees, the sale process in place, any measure to mitigate any conflict of interest, minimum qualifications for training, *etc.*[44] In addition, according to the Fair Dealing Guidelines, the product due diligence exercise should also include the review of relevant documentation including the prospectus, the pricing statement, product highlights, and other marketing materials.[45]

The key questions then become—how to define a suitable product after the product due diligence exercise, and how should the documentation be reviewed? Before we consider specific problems associated with minibonds, we must address some conceptual difficulties with regard to interpretation of the suitability rule.

IV. Conceptual Difficulties of Product Suitability

A. *Most Suitable or Not Unsuitable*

In theory, the term 'suitable' may be open to two distinct interpretations: first, a product may be considered suitable because it is the 'most suitable' choice; or second, it is suitable as long as it is 'not unsuitable'. This distinction exemplifies the standard for assessing the suitability obligation. The 'not unsuitable' test would provide only a minimum threshold for firms to comply with.

For example, assume there are three products available for the firm to recommend and that all three of them carry the same degree of risk. However, product A offers a 6% return, product B offers a 5% return, and product C offers a 4% return. Assuming that the customer's objective is to earn a return of at least 5%, only A is suitable under the 'most suitable' test. In contrast, both A and B would be suitable if we were to apply the 'not unsuitable' approach.

On the face of it, the 'most suitable' test seems to be an apt conclusion if the suitability rule is used to measure the quality of financial advice. However, there

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[41] *Ibid.* at 2.2.1 and 2.3.1.

[42] MAS, *Consultation Paper on Proposed Amendments to the Financial Advisers Regulations*, P015-2010 Annex 1, proposed Regulation 18B(1).

[43] 'New product' is defined in proposed FAR Regulation 18B(6) as a product which has not been sold by the adviser before that is not a foreign exchange transaction nor exchange-traded futures or securities.

[44] *Ibid.*, proposed FAR Regulation 18B(2). See also *Fair Dealing Guidelines*, *supra* note 39, at 2.2.3.

[45] *Fair Dealing Guidelines*, *supra* note 39 at 2.2.2. However, this part is missing from the newly amended Financial Advisers Regulations.

are a few problems with this interpretation. First, the 'most suitable' test is not supported by statutory wordings. Section 27 of the *FAA* only requires an adviser to have a "reasonable basis" for any recommendation. We might stretch the literal meaning of "reasonable basis" too far if it were construed to mean the 'best possible choice'. The new FAR and the *Fair Dealing Guidelines* also fail to cast any more light on the meaning of the term "suitable".

Second, it is difficult to define what is 'most suitable' for an investment product (as opposed to more standardised products like simple life policies or time deposit accounts), considering the risk and return of different investment vehicles. If we extend the 'most suitable' test to its limit, it may simply mean the adviser has a duty to formulate a plan for the best use of the customer's monetary resources on every occasion. Given that the success of an investment often hinges on future uncertainties, applying the 'most suitable' test from the outset would be meaningless. For this purpose, a 'not unsuitable' test may offer more flexibility and less uncertainty.

On hindsight, the minibonds offered in Singapore could hardly be seen as the 'most suitable' investment product. However, one can equally argue that they were 'not unsuitable'. From a return perspective, the payout offered by the minibonds looked decent in the low interest rate environment of Singapore. From a risk perspective, minibonds are certainly complex, but the risk involved was not necessarily outrageous. After all, the minibond investors suffered from the insolvency of the counterparties rather than a credit event on the underlying portfolio.[46]

In sum, current Singapore law fails to make a distinction between the 'most suitable' and 'not unsuitable' tests. A narrower interpretation of s. 27 of the *FAA* might lead to the conclusion that advisers are not obliged to recommend the most suitable product, though it is clear that they must not recommend an unsuitable product. This article proposes that the 'not unsuitable' test should be adopted for complex products like minibonds. On the one hand, this test provides more certainty to financial advisers and may reduce the danger of reviewing from hindsight. On the other, alongside a minimum standard for product and documentation review (see below), this approach may strike a balance between the responsibility of an investor and a financial adviser. However, whether this must be the case for all other financial products is a question the MAS should clarify in future.

B. *Comparative Risk Approach*

Another conceptual problem is the connection between product due diligence and the credentials of target customers. From a limited number of British judgments, the most common way to find 'unsuitability' is where a product carries higher risk than the level tolerated by a customer ('risk suitability'). This is what this article calls a 'comparative risk approach'. The question then becomes: should Singapore adopt the same approach?

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[46] However, as in the case of DBS High Notes 5 or some Morgan Stanley Pinnacle notes, losses still occurred due to the collapse of a reference entity or the issuer of the collateral. See Hans Tjio, *Principles and Practice of Securities Regulation in Singapore*, 2nd ed., (Singapore: Lexisnexis, 2011) at pp. 72-73.

1. *The Approach in the UK*

In the UK, the courts and financial ombudsmen seem to adopt the comparative risk approach in dealing with the suitability issue. For example, in *R (Williams) v. Financial Ombudsman Service,*[47] the client wanted to have an adequate income during retirement. On Williams' advice, the client transferred his original endowment policy to a new "traded endowment policy" ("TEP") that was then used as security for a loan. The ombudsman found that the TEP could not provide a fixed income and cover the repayments and interest due on the loan, and that it might raise the risk of capital loss. Thus, the advice was found to be unsuitable because the TEP carried a higher level of risk than the client's expectation. The same approach was taken in other judicial review cases regarding a decision issued by an ombudsman.[48]

In *Seymour v. Caroline Ockwell & Co*[49], Seymour wanted to avoid capital gains tax and sought an offshore investment that was easily accessible and low-risk. Ockwell recommended that Seymour invest in an opaque offshore fund that guaranteed investors a 15% p.a. return and made profits by making loans to personal injury victims to enable them to bring legal proceedings. The fund eventually collapsed. Havelock-Allen J. found that the advice to invest in the fund was not suitable because

> [t]he features which clearly placed the [fund] outside the low risk category were: (1) that it was administered from the Bahamas where there was no regulatory system in place and no legislation providing an indemnity or compensation to investors in the event of insolvency; (2) the investment involved the purchase of shares, the value of which could fluctuate and could only be realized by a process of redemption; (3) the safety features advertised as being in place were not ones which, on a careful reading of the prospectus, were likely to avail investors in the event of misconduct by the directors of the Fund.[50]

In *Morgan Stanley UK Group v. Puglisi Cosentino*,[51] the bank sold currency-linked notes to Puglisi for US$10 million. The bank then offered to buy back the notes for US$9 million. As part of the deal, Puglisi agreed to repurchase the notes at a later date. In short, the bank offered leverage through this sale and buyback structure. Facing the bank's action for breach of contract (due to Puglisi's refusal to repurchase the notes), Puglisi counterclaimed that the bank had breached the suitability and risk warning rules of the Securities Association ("TSA"). Longmore J. held that the product was unsuitable for Puglisi because the investment was a lot larger than any

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47 [2008] EWHC 2142 (Admin) [*R* (*Williams*)].

48 *E.g.*, *R (Heather Moore & Edgecombe Ltd.) v. Financial Ombudsman Service* [2008] EWCA Civ 642 (regarding the transfer of a pension to a riskier plan); *R (IMG Financial Services Ltd) v. Financial Ombudsman Service Ltd* [2005] EWHC 1153 (Admin) (regarding a recommendation to invest in a currency and derivatives fund that was too risky to be a medium-risk investment). The applications for judicial review were all rejected. The fact that the investor had retired or was close to retirement could have been a factor. See *R (Young Ridgeway & Associates) v. Financial Ombudsman Services Ltd* [2004] EWHC 3371 (Admin).

49 [2005] EWHC 1137 (Q.B.) [*Seymour*].

50 *Seymour*, *ibid.* at para. 82. The applicable suitability rule was the then FIMBRA rule quoted at para. 77.

51 [1998] C.L.C. 481 (Comm Ct).

previous investment and the structure of the investment posed significant liquidity risk to Puglisi.[52]

While the comparative risk approach taken by British courts seems to reach sensible results, there are still two problems: first, the difficulty in classifying risk; and second, an over-emphasis on risk. These issues are discussed in the next two sections.

2. *Classification of Risk*

The suitability assessment relies heavily on the analysis of risk, resulting in a need to classify risk profile and risk appetite. In relation to product due diligence, the underlying problem is that the riskiness of the investment product may be influenced by a variety of risk factors to differing degrees, yet we often have to classify the overall riskiness of a product with a single description.

An investment product may be exposed to future uncertainties arising from factors ranging from financial risks (such as market, credit, operational, and liquidity risks[53]) to non-financial factors (*e.g.*, a volcanic eruption in Iceland). In the case of minibonds, investors are exposed to several risk factors[54] including the credit risk of the reference entities in the portfolio, fluctuations in the market value of the collateral, the credit risk of counterparties[55] and the issuer of the collateral (if any),[56] liquidity risk,[57] and so on. From this perspective, it is arguable whether a single label of high, medium or low risk is meaningful.

Financial engineers have found a number of ways to measure the relationship between product risk and product performance. Nonetheless, they have so far failed to provide clear normative guidance on how to determine what degree of risk is reflected in the "high risk", "low risk", and "medium risk" categories (or any in between). The nature of minibonds as credit-linked notes suggests that their risk profile depends to a large degree on credit ratings. The relatively high credit ratings awarded to reference entities and the issuer[58] might give the impression that minibonds are relatively safe. However, the term "investment grade" encapsulates such a broad range of ratings[59] that its normative meaning is much diluted. The credibility of credit rating agencies

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[52] *Ibid.* at 497.

[53] Satyajit Das, *Risk Management*, 3rd ed., rev. ed., (Singapore: John Wiley & Sons, 2006) at p. 5.

[54] See *supra* note 22, Series 9 Pricing Statement at pp. 9-13; Base Prospectus at pp. 19-26.

[55] *E.g.*, for Minibond Series 9, the filing for Ch. 11 was made by the swap counterparty on 3 October 2008. The issuer, as a special purpose vehicle, should in theory be structured as insolvency-proof. However, it is not impossible for the issuer to become insolvent. See, *e.g.*, *Re Sigma Finance Corp* [2009] UKSC 2.

[56] Early redemption will take place if a credit event occurs to the collateral issuer. However, the redemption value will be calculated according to the prevailing market value of the collateral and the termination payment for the underlying swap. Thus, minibond holders will bear the losses in the end, even though early redemption is out of their control. Series 9 Pricing Statement, *supra* note 22 at pp. 23-24.

[57] See *infra* Part V.A. for more discussion on liquidity.

[58] For Series 9, the issuer and the reference entities must be rated A or higher. See Series 9 Pricing Statement, *supra* note 22 at iii.

[59] Investment grade refers to credit ratings of BBB or higher for Fitch and Standard & Poor's, or Baa or higher for Moody's. See Philip Wood, *Law and Practice of International Finance*, University ed. (London: Sweet & Maxwell, 2008) at p. 333; *Cassa Di Risparmio Della Repubblica Di San Marino SpA v. Barclays Bank Ltd.* [2011] EWHC 484 (Comm) at para. 46.

is also under heavy scrutiny in the wake of the global financial crisis.[60] Thus, credit ratings should not be the sole basis for assessing suitability.

Moreover, it is not much easier to classify a customer's risk appetite. It is common practice for a bank to categorise a client based on certain standards or computer-generated results from a questionnaire.[61] The task would be simpler if clients were to give a clear account of their risk tolerance.[62] A client's risk appetite can sometimes be inferred from his objectives.[63] However, emphasising what the customer says in the first place heightens the danger of over-reliance on statements made by a client who may be ignorant of his risk appetite or may simply exaggerate his own risk tolerance. This increases the difficulty of the suitability assessment and challenges the effectiveness of the suitability rule, if the comparative risk approach is adopted. This suggests a necessity to conduct further researches on behaviours of investors in order to access the effectiveness of rules regarding retail investor protection.[64]

Given the difficulties involved in risk classification, it still seems sensible to adopt a comparative risk approach. The comparative risk approach might not require a definite label to be attached to a product or a client's risk appetite. However, this approach does not remove the need to classify the level of risk. After all, risk must be classified for the court or an ombudsman as a starting point for comparison purposes. This does not present a problem in extreme situations, but may pose a problem in borderline cases.

3. *Product Design: Risk vs. Return*

A further challenge is whether the suitability assessment overly focuses on the analysis of risk. Risk has been the hallmark of the suitability assessment.[65] However, an over-emphasis on risk may not show a complete picture—the other side being 'return suitability'.

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[60] See generally Tin A. Bunjevac, "Credit Rating Agencies: A Regulatory Challenge for Australia" (2009) 33(1) Melbourne U.L. Rev. 39.

[61] *E.g.*, DBS classified clients into five categories: conservative, moderate, balanced, growth, and aggressive. For instance, the description for "balanced" is "I would like to balance having stable savings and investments with the aim of achieving some capital growth over a longer period. I am able to accept price changes to my investments over 2 to 3 years in exchange for potential returns that are higher than time deposits." MAS, *supra* note 3 at p. 31.

[62] *E.g.*, In *Seymour*, *supra* note 49 at para. 80, the customer indicated clearly that he wanted the kind of risk associated with the deposit-based products of the major banks.

[63] *E.g.*, In *R (Williams)*, *supra* note 47, the client simply wanted to "have adequate income in retirement not putting what little I have in jeopardy" [2008] EWHC 2142 (Admin) at para. 17.

[64] See generally Michael K.H. Law, "Behavioural Risk Disclosure and Retail Investor Protection: Reflections on the Lehman Brothers Minibonds Crisis" (2010) 40 Hong Kong L. J. 15 at 30-39; Ann Morales Olazábal and Howard Marmorstein, "Structured Products for the Retail Market: The Regulatory Implications of Investors Innumeracy and Consumer Information Processing" (2010) 52 Ariz. L. Rev. 623; Lawrence A. Cunningham, "Behavioral Finance and Investor Governance" (2002) 59 Wash. & Lee L. Rev. 767; Donald C. Langevoort, "Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers" (1996) 84 Calif. L. Rev. 627; Emilios Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis* (Oxford: Oxford University Press, 2005) at pp. 56-61.

[65] Cohen, *supra* note 18 at notes 7-9. A review of the key risks of a product is also the main obligation of a financial adviser in Singapore. See FAR Reg 18B(2)(c), *supra* note 42.

One view is that suitability refers to the capacity and willingness of the customer to accept the expected return of a product to compensate for the risk associated with it.[66] Thus, the balance of risk and return is important in determining the suitability of an investment portfolio.[67] From this perspective, the suitability analysis should involve not only risk, but also the return aspect. The question then becomes how to converge the analysis of risk and return. If we accept the common wisdom that a higher return must imply higher risk, the analysis of return seems to be the flipside of risk assessment. However, this is not necessarily true.

First, higher risk does not necessarily mean a higher return. It may be questionable whether the return of a product is adequate in relation to the risk implied. Thus, a product should be considered unsuitable if it combines high risk with a low return—a situation of 'risk mismatch'—even if a client is content with the reward.

This then leads to the problem of the lack of a universal and transparent pricing model. When a product is illiquid as in the case of minibonds, one can hardly use market prices as a reference. The pricing of minibonds often starts with calculation of the credit risk of the underlying portfolio. Eventually, the credit risk will be revealed in terms of probability (*i.e.* the likelihood of default or insolvency), thereby enabling financial institutions to calculate potential losses and a possible rate of return.[68] Some may use historical default rates as the starting point.[69] However, how reliable historical data is as a guide for future defaults is anyone's guess.

Second, another issue regarding product design is whether the principal investment amount is protected. As a matter of fact, minibonds are not capital-protected.[70] Like every financial product, minibonds could never be immune from counterparty risk. However, it could be argued that retail investors are far less capable of withstanding capital losses. This may raise an argument that financial products with no adequate capital protection scheme are unsuitable for retail investors.

Third, one may see a failure to achieve the expected return as a risk, such that the return aspect could be incorporated into the risk analysis of a product. As Irwin J. observed in *R (Williams)*, "the question of future returns was absolutely crucial to the assessment of risk and thus the suitability of the investment for [the customer]."[71] However, Irwin J. also cautioned that

> [it] is nevertheless wrong to treat the question of returns as the only risk and the only relevant question of risk. A risk assessment must involve assessing the consequences for the individual of a poor outcome, as well as the chances of the poor outcome eventuating.[72]

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66 Cohen, *supra* note 18 at 1623; see also "The Regulation of Risky Investments" (1970) 83 Harv. L. Rev. 603 at 608.

67 Cohen, *supra* note 18 at 1607 *et seq*. In contrast, the degree of risk could be lowered with a well-diversified portfolio. Geckeler, *supra* note 10 at 298-299.

68 Satyajit Das, *Credit derivatives: CDOs and structured credit products*, 3rd ed. (Singapore: John Wiley & Sons (Asia), 2005) at pp. 489-492; another popular pricing model is based on a comparison with an asset swap at pp. 461-488.

69 *Ibid.* at pp. 489-492.

70 Series 9 Pricing Statement at p. 14.

71 *R (Williams)*, *supra* note 47 at para. 49.

72 *Ibid.*, at para. 50.

In addition, this argument does not address the issue of whether the design of a product involves mispricing and risk mismatching. Thus, this argument does not remove the need to analyse the return aspect of a product.

Fourth, different financial products may require differing degrees of balance between risk and return. For example, a simple life policy would generate more issues of return suitability than of risk suitability. In other words, if an adviser recommends a life plan with features that do not meet the customer's needs, the recommendation could be deemed unsuitable.[73]

The recognition of 'return suitability' might open the door for a customer to sue for loss of profits under s. 27 if the adviser had no reasonable basis to believe that the recommended product could offer a return that met the customer's objective. How far an adviser should be liable for economic losses from recommending an investment product that fails to meet the return expectation should be developed along the line of reasoning followed in tort and contract law. This article does not pursue this argument any further.

Hence, the consideration of return suitability aside from risk suitability suggests that one might have to differentiate the suitability assessment for different products. While regulators are keen to fix problems arising from complicated financial products like minibonds, it is necessary to keep an eye on the big picture and consider the potential effects on less complicated products.

4. *Summary*

We should return to a question raised earlier: should Singapore adopt the comparative approach in the context of the suitability assessment? Given the difficulties involved in risk classification, the comparative approach seems to be a better option than an absolute approach. However, how to describe the risk level of a financial product in a correct and not misleading manner remains a major problem.

In addition, this article proposes that risk suitability and return suitability are not necessarily interchangeable concepts. This does not imply a separate analysis of the return or risk aspects of a product. Instead, this article argues that both the risk and return aspects should be considered instead of placing an overwhelming emphasis on the risk analysis. Given the wide variety of financial products and services available, it is worthwhile giving further consideration to the nature of different products in formulating different guidelines in future.

V. Documentation and Suitability

If we accept that the analysis of risk is one essential aspect of product due diligence and the suitability assessment, then a relevant question is how these risks should be addressed in product documentation. However, documentation for structured notes is notoriously long and complicated given the number of parties involved. As Lord Collins observed in *UBS AG v. HSH Nordbank AG*,

> [t]he contractual documentation in this matter consists of more than 500 pages and its size and complexity, which is no doubt duplicated in many other transactions,

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[73] *Cf. Gorham v. British Telecommunications plc* [2000] 1 W.L.R. 2129 (C.A.).

> make it easier to understand, if not to excuse, why senior banking figures (but not necessarily in this case) had little understanding of this market and of the risks their institutions were undertaking.[74]

This observation is alarming for retail investors. Minibond holders should in principle receive the prospectus and the pricing statement. However, the terms and conditions of the notes could only be found on the twenty-eighth page of the Base Prospectus.[75] In addition, the basic terms and conditions could be varied in the pricing statement for each issue.[76] The sheer length of the documentation also raised the possibility of mistakes or inconsistency between terms.[77] Against this backdrop, this article first discusses in the following section some provisions that might influence the suitability of a structured product. We will then return to a theoretical point: does suitable documentation exist at all?

A. *Redemption and Liquidity Service*

Liquidity—the ability to convert an investment into cash—is an important issue for retail investors. Apart from listing minibonds on a stock exchange,[78] there are two possible liquidity arrangements: granting a put option to minibond holders, or a liquidity service provided by the arranger.

First, in the case of minibonds, there is an obvious imbalance in the design of liquidity and redemption features. Minibonds do not generally grant an option to minibond holders to sell the notes to the issuer.[79] However, it seems to be a common feature to grant a call option to the issuer entitling it to buy back the notes provided prior notice is given.[80] Even worse, where a credit event occurs to any reference entity or to the issuer of the collateral, the notes will be redeemed early, and minibond holders will bear some degree of loss depending on the extent of credit losses. In sum, a minibond holder will never be able to proactively redeem the notes in full, but the issuer is in a better position to stay away from losses.

Second, in the minibonds discussed here, Lehman Brothers provided a "liquidity service" in which a price was quoted for any investor who wished to liquidate his investment.[81] This allowed investors to sell to another investor through a local distributor. However, a shrewd banker would not commit to finding a buyer or acting as an agent for the seller/investor.[82] At times, the arranger might simply purchase the notes back from an investor and attempt to resell to others. However, no one should expect the arranger to purchase the notes back when they are out of money.

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[74] [2009] EWCA Civ 585 at para 2.
[75] Base Prospectus, *supra* note 22 at p. 28.
[76] Series 9 Pricing Statement Annex 1 Form of Pricing Supplement, *supra* note 22.
[77] *E.g.*, In *Soon Kok Tiang v. DBS Bank Ltd* [2010] SGHC 360, there were four different versions of a certain term defining the amount repayable to investors in the DBS Highnotes 5 documentation.
[78] Minibonds in Singapore are not listed on any stock exchange.
[79] An embedded put option might influence the coupon rate of the notes to reflect the premium of the option.
[80] See *supra* note 22, Series 9 Pricing Statement at v; Series 2 Pricing Statement at vii.
[81] See *supra* note 22 Base Prospectus at p. 16; Series 9 Pricing Statement at p. 15.
[82] *Ibid*.

Moreover, because there is no real market price determined by the invisible hand, and the prices quoted for any such "liquidity service" are provided periodically on a best efforts basis by a "market agent"; which in the case of the Minibonds 9 issue was another Lehman Brothers entity.[83] It is no surprise that the liquidity service literally came to a halt when Lehman Brothers entered into bankruptcy proceedings.

It is apparent that minibond holders were in a very poor position to cash in on their investment. There could have been a potential conflict of interest concern over the exercise of the call option or operation of the liquidity service on the part of Lehman Brothers. The suitability of minibonds might be improved by addressing these features of the product; or at least they should be disclosed and explained to the customer.

B. *Collateral and Priority of Payment*

Because minibonds are debt securities in part, a natural question is whether they are secured. Minibond documentation often requires the issuer to use the principal to purchase certain debt securities specified in the documentation as collateral (called "underlying securities" or "underlying assets" and sometimes "mortgaged property").[84] Subject to the documentation, the collateral is charged to secure all relevant debts relating to the minibonds, including debts to the noteholders, the trustee, the agents, and the swap counterparty.[85] Thus, in a way, minibonds are secured.

However, this sense of security might be misleading. First, the quality of the collateral is at times questionable. In both Minibonds Series 2 and 9, the collateral had to be debt securities issued by any institution from a list of foreign or Singaporean financial institutions, for which high credit ratings were required.[86] However, high credit ratings are not equivalent to a safe investment. For example, Minibonds Series 2 was secured by a portfolio of "credit-linked notes" (often termed "synthetic collateralised debt obligation securities").[87] In other words, Series 2 notes were themselves secured by risky products like minibonds. The absurdity is self-explanatory.[88]

Second, because the collateral is normally charged to secure all debts relating to an issue, the priority of claims is of importance. If we ignore the trustee and other agents, the question is who can receive money from the proceeds of the collateral: minibond holders or the swap counterparty?

In general, there are two basic forms of priority ranking: noteholder priority and swap counterparty (or derivatives counterparty) priority.[89] The choice is usually specified in the pricing statement for each issue. "Derivatives counterparty priority" was adopted in both Series 2 and 9.[90] Thus, in principle, the swap counterparty was

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83 *Ibid.*

84 Series 9 Pricing Statement at vii and p. 15.

85 Condition 4 of Ts&Cs in Base Prospectus, *supra* note 22 at p. 32.

86 Series 9 Pricing Statement, *supra* note 22 at pp. 22-23.

87 Series 2 Pricing Statement at p. 20. However, there was no such obvious problem in the case of Series 9.

88 In another example, some issues of Morgan Stanley Pinnacle notes collapsed due to the failure of the underlying securities. See Tjio, *supra* note 47 at 73.

89 Condition 4(b) of Ts&Cs in Base Prospectus, *supra* note 22 at p. 32. The parties were also able to choose "*pari passu* ranking".

90 Series 9 Pricing Statement at p. 32; Series 2 Pricing Statement at p. 30.

entitled to receive proceeds from the sale of collateral ahead of minibond holders. This seems unfair to minibond holders, especially when one considers that the documentation was provided by Lehman Brothers and it was the collapse of Lehman Brothers that contributed to the fiasco.

There are two possible ways to correct this situation. On the one hand, minibond holders will be in a better position if noteholder priority is the default position. However, this is subject to contract negotiations, and few can practically expect the swap counterparty to altruistically adopt noteholder priority unless required by law.

On the other hand, another alternative is to determine priority according to which party is in default (*e.g.*, if the swap counterparty is in default, noteholder priority applies). However, the weakness of this approach lies in the potential violation of anti-deprivation rules under insolvency law. English law seems to be more flexible in allowing this kind of 'priority switch'.[91] However, US courts may have different views on the same documentation.[92] The wording of the documentation might also lead to problems of construction if the contract drafters fail to anticipate a given situation.[93] This also raises the importance of carefully drafted jurisdiction and governing law clauses across the documentation as a whole.[94] With so many parties located in different jurisdictions, slight differences in law and in documentation might ultimately lead to major problems.

C. *Early Redemption and ISDA Master Agreement*

As noted earlier, the complete minibond structure includes two main parts: the notes and a swap. While minibond holders should have received the prospectus and pricing statement, they are left in the dark over the content of the swap agreement between the issuer and the swap counterparty. Although the ISDA master agreement is standardised and is widely used by market participants around the world, the minibonds fiasco represents a good, if not extreme, example of how the ISDA master agreement might heavily influence the risk of minibonds.

The problem lies in the version of the ISDA master agreement used and the method chosen to determine the "early termination amount" upon early termination of the master agreement. Under both the 1992 and 2002 versions, the filing of a Chapter 11 petition by either Lehman Brothers Holdings Inc. (the swap guarantor) or Lehman Brothers Special Financing Inc. (the swap counterparty) would constitute an "event of default"[95] entitling the counterparty (*i.e.* the issuer of minibonds) to terminate the swap.[96]

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91 *Perpetual Trustee Co. Ltd. v. BNY Corporate Trustee Services Ltd.* [2009] EWCA Civ 1160.

92 *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd.*, 2010 WL 271161 (Bkrtcy. S.D.N.Y.).

93 *E.g.*, *Re Sigma Finance Corp* [2009] UKSC 2.

94 The financial crisis led to some cases challenging the jurisdiction clauses of structured notes, *e.g.*, *Sebastian Holdings Inc. v. Deutsche Bank AG* [2010] EWCA Civ 998 (CA); *UBS v. Lommunale Wasserwerke Leipzig GmbH* [2010] EWHC 2566 (Comm); *Pearson v. Lehman Brothers Finance SA* [2010] EWHC 3044 (Ch).

95 International Swaps and Derivatives Association, "2002 ISDA Master Agreement" (2002), section 5(a)(vii).

96 *Ibid.*, section 6(a).

At this stage, the minibond trustee faces a dilemma: to terminate or not to terminate? This decision is partly influenced by the consequences of early termination. If the swap is terminated, the next step is to determine the "early termination payment".[97] Apart from unpaid obligations, the key element of the early termination payment is the settlement amount (under the 1992 version) or the close-out amount (under the 2002 version). Calculation of the close-out amount is reasonably clear under the 2002 version;[98] however, the meaning of settlement amount is more problematic under the 1992 version.[99]

Under the 1992 version of the ISDA master agreement, the settlement payment is determined by a combination of "market quotation" or "loss" and the "first method" or "second method".[100] The default combination is "market quotation" and the "second method".[101] If this is the case, the early termination payment is determined by reference to costs quoted by major dealers (*i.e.* market quotations) to replace the swap in default, and payments to and from the non-defaulting party could be mutual.

As observed by Briggs J. in *Lomas v. JFB Firth Rixon, Inc.*,

> The Settlement Amount (which is to be determined by the Non-defaulting Party) is identifiable primarily by reference to market quotations obtained, as at the Early Termination Date, of the amount which would be payable by (or to) the Non-defaulting Party as the premium (or reverse premium) for the setting up of a replacement transaction, on precisely the same terms as the Terminated Transaction for the remainder of its natural term.[102]

In other words,

> [o]ne effect of that formula … is that the Defaulting Party would be liable on Early Termination to pay the Non-defaulting Party the cost of putting in place a replacement swap for the remainder of the original term, whereas if the Non-defaulting Party would be likely to obtain a reverse premium by doing so, the Defaulting Party would obtain that premium as the Settlement Amount.[103]

In the case of the Minibonds Series 9, the collapse of Lehman Brothers meant that the market value of the swap was low and minibond holders were out of money. Therefore, the non-defaulting party (*i.e.* the issuer) was likely to receive a reverse premium from market quotations, thereby enabling the swap counterparty (as the defaulting party) to earn a large sum of money by terminating the swap early due to its own event of default. Though the prospectus and pricing statement did not fully specify the version of the ISDA master agreement that was to apply, this does seem to have been the position in the documentation.[104]

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97 *Ibid.*, section 6(e).

98 "Close-out amount" is defined in section 14 of the 2002 ISDA master agreement.

99 *E.g.*, *Peregrine Fixed Income Ltd v. Robinson Department Store Public Co Ltd* [2000] Lloyd's Rep. Bank 304 (Comm Ct) (regarding the choice between market quotation and loss).

100 International Swaps and Derivatives Association, "1992 ISDA Master Agreement (Multicurrency—Cross Border)" (1992), section 6(e)(i).

101 1992 and 2002 ISDA master agreements, *ibid.* and *supra* note 95, section 6(e).

102 [2010] EWHC 3372 (Ch) at para. 19.

103 *Ibid.* at para. 20.

104 Base Prospectus at pp. 22, 64.

Given the potential danger, financial advisers should take additional care in reviewing the documentation as a whole (and not merely the prospectus and pricing statement) to mitigate problems flowing from the swap agreement.

D. *Risk Disclosure and Non-Reliance Clause*

There are several legal issues worth exploring regarding the impact of risk disclosure statements and exclusion clauses on the suitability rule. First, minibond prospectuses and pricing statements invariably set out a long list of risk factors.[105] Provided the risk statement is not misleading, the fact that an investor signs a contract might operate as a contractual estoppel preventing him from claiming that he was not aware of the risk involved.[106] Singapore courts also seem to have taken the same position.[107]

One may attempt to distinguish existing case law by the fact that the claimants in reported judgments were all sophisticated investors. However, there is no authority to suggest that the law should be more generous to retail investors. This is left to future courts or legislators to clarify the position on the issue of contractual estoppel and non-reliance clauses regarding retail investors, or even small and medium-sized enterprises.

Second, one may also wonder whether it is possible to use exclusion clauses to minimise the impact of the suitability rule. For example, the Base Prospectus provides that:[108]

> [t]his Base Prospectus is not and does not purport to be investment advice. You should conduct such independent investigation and analysis regarding the Programme and any Notes to be issued under it and the other assets on which the obligations of the Issuer under any Notes may be secured (including, without limitation, in respect of the issuer and any guarantor thereof) as you deem appropriate. You should make an investment only after you have determined that such investment is suitable for your financial investment objectives.

The effectiveness of a clause of this type depends on its nature: does a provision that seeks to limit the suitability obligation constitute an "exclusion clause" under the *Unfair Contract Terms Act*?[109] Or is it merely a warning that raises the awareness of the customer?

On paper, the clause quoted above does not specifically exclude or exempt any liability. However, it may have the effect of raising the awareness of the investor and therefore of making it more difficult for him to make a claim based on unsuitability and/or the lack of risk warnings at a later stage. For retail investors, the adjudicator in the Financial Industry Dispute Resolution Centre ("FIDReC") in Singapore may have more flexibility in determining its effect without strictly complying with

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[105] Series 9 Pricing Statement at pp. 9-13; Base Prospectus at pp. 19-26.

[106] *Peekay Intermark Ltd v Australia and New Zealand Banking Group Ltd* [2006] 2 Lloyd's L.R. 511; *Springwell Navigation Corp v JP Morgan Chase Bank* [2010] EWCA Civ 1221.

[107] *Orient Centre Investments v. Societe Generale* [2007] 3 S.L.R.(R.) 566 at para. 51; *Jurong Shipyard Pte Ltd v. BNP Paribas* [2008] 4 S.L.R.(R.) 33 at para. 101. However, the facts of *Peekay* were distinguished in both cases.

[108] Base Prospectus, *supra* note 22 at p. 2.

[109] Cap. 396, 1994 Rev. Ed. Sing.

relevant statutes.[110] Thus, retail investors might have a better chance of surviving risk disclosure and suitability statements as stated above. Nevertheless, the extent to which the above disclosure could be struck down as an unfair exclusion clause is a matter requiring future consideration by the courts.

E. *Suitable Documentation?*

After examining the foregoing clauses, we may return to a fundamental question: does such a thing as suitable documentation exist? The function of a contract is to allocate risk between the parties regarding a transaction subject to their bargaining power. Therefore, there is no absolute standard for defining suitable documentation. It is a step too far to argue that certain terms will always be suitable or unsuitable for a client. After all, suitability refers in part to the willingness of the customer to accept the risk of a product.[111] Therefore, if a party has shown his willingness to accept the consequences of a contractual term, there is no particular reason to strike it out. This may support the application of contractual estoppel and reflect the courts' reluctance to allow claims made by sophisticated investors.

However, whether the above argument is sustainable in the case of the retail market is more questionable. In the case of minibonds, it is likely that no one actually bargains on behalf of investors in the first place. Retail investors make an investment more or less on a take-it-or-leave-it basis.[112] Given a clear conflict of interest, it would be naïve to assume that the arranger would draft contractual terms in favour of minibond holders. It is also questionable how far financial advisers or distributors of minibonds could or would be willing to bargain over terms and conditions on behalf of retail investors. Thus, investors in minibonds are actually placed in a difficult position: on the one hand, their rights are deeply influenced by the documentation; but on the other, hardly anyone would attempt to bargain on their behalf. Even worse, they might be barred from mounting an offensive if they have signed the documentation, whether or not they read it.

Two additional points are worthy of further discussion. First, if we put the discussion in the context of the 'not unsuitable' test, the uncertainty over 'unsuitable documentation' might be reduced if an adviser merely has to avoid promoting products subject to 'unsuitable' contractual terms. This may preserve the spirit of the Fair Dealing Guidelines[113] without putting too much of an onus on financial institutions when dealing with documentation that is not necessarily open to negotiation.

Second, the problem of unsuitable documentation challenges the fundamental approach taken in financial regulation and investor protection: should a more

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[110] Supervised by the MAS, minibonds distributors have created a voluntary settlement scheme to offer compensation to investors of structured notes. Tjio, *supra* note 46 at pp. 75-77. The FIDReC has received a substantial number of complaints regarding structured notes. As of 31 August 2010, the FIDReC has received 2,111 cases regarding credit-linked notes, including 1,355 about minibonds. Out of the 2,111 cases, 787 have been resolved by mediation and another 960 by adjudication. See FIDReC, "Annual Report 2009-2010" *FIDReC* para. 18, online: FIDReC <http://www.fidrec.com.sg/website/annualreports/FIDReC%20AR%202009-2010.pdf>.

[111] Cohen, *supra* note 18 at 1623.

[112] Law, *supra* note 64 at 29, 30.

[113] *Supra* note 38.

merit-based regulatory system or an information-based system be adopted?[114] Traditionally, the underlying rationale behind securities regulation has been information disclosure and informed consent.[115] Thus, significant efforts are devoted to establishing a duty to explain the product and its risks, as well as to ensuring the integrity of the prospectus. This is founded on the rationale that customers will make the best decision if they are aware of the characteristics of the product. In contrast, direct product regulation is a commonly adopted approach in consumer protection for physical goods.

Thus, the question is whether the law must establish a minimum standard for complex financial products, including their documentation, in the retail market. This may not sound good for the financial industry. One might also argue that more direct product information might reduce financial innovation in the retail market and lower the customer's standard of care.[116]

However, direct product regulation is not necessarily a bad idea in the current round of financial reform.[117] On the one hand, this kind of regulation is not foreign to financial regulation. Insurance regulation reflect a much more hands-on approach to the development and distribution of new investment products.[118] On the other hand, this idea does not necessarily mean that the MAS must take on responsibility for reviewing the merits of a product. Establishing a minimum standard for retail products may provide a cushion that addresses the problem of unsuitable documentation, while maintaining flexibility for financial institutions to devise products for sophisticated investors.

Then the question is what must be included in the suitability assessment of product documentation. This should depend on the characteristics of the target customers under Singapore law. As Pearson notes, "[t]he suitability obligation is emphatically directed towards the person's individual circumstances."[119] In the case of minibonds, if most investors invest in minibonds for the purpose of earning a higher return on their cash savings, the quality of the collateral and the priority of ranking in enforcing security interests should be major concerns.[120] This may reduce the need to enhance the liquidity of hybrid products like minibonds, which may require a bigger effort to establish the market.

Whether the MAS is willing to consider adopting the above approach remains to be seen. There have been efforts of this nature in Australia regarding consumer credit contracts.[121] The existence of minibonds in the retail market does raise the

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[114] Singapore has shifted from a merit-based regulatory system to a disclosure-based one after the Asian financial crisis in 1997. See generally George Shenoy, "A Blueprint for Change in Securities Market Regulation in Singapore" (1999) 25 A.B.L.R. 53; Margaret Chew, "Reform of Financial Services: The Effect on the Regulator" (2001) 5 S.J.I.C.L. 569 at 582.

[115] Tjio, *supra* note 46 at pp. 97-101.

[116] Pearson, *supra* note 7 at 144-145.

[117] There are also proponents in the US for a federal merit review. See Daniel J. Morrissey, "The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review" (2010) 44 U. Rich. L. Rev. 647.

[118] *Insurance Act* (Cap. 142, 2000 Rev. Ed. Sing.), ss. 23-24.

[119] Pearson, *supra* note 7 at 150.

[120] For example, the Securities and Futures Commission in Hong Kong seems prepared to establish some eligibility standards for structured note collateral. Ewins, *supra* note 4 at 306, 307.

[121] Pearson, *supra* note 7 at 146-151.

issue of whether we should apply a different approach to protect investors faced with unconventional hybrid products.

VI. Conclusion

In sum, this article discusses a number of issues arising from application of the suitability rule to complex financial products like minibonds. The topic gives us fertile ground for examining issues surrounding how to define a "suitable" financial product.

By examining minibond documentation, this article reaches several conclusions. First, the 'not unsuitable' test seems to be better suited to complex investment products like minibonds. Second, a comparative approach should be adopted for the suitability assessment; however, there must be further elaboration of how to classify product risk. Given the range of risks involved in minibonds, a one-size-fits-all approach could lead to an inappropriate result. Third, there must be a balance of risk and return to avoid risk mismatches for financial products. Fourth, minibonds raise the problem of documentation suitability. While it is inherently difficult to define suitable documentation, it may be worthwhile for regulators to look into certain key terms that might have a great influence on product risk exposure and establish a set of minimum standards for documentation.

This article does not propose that there must be a uniform standard covering every financial product. For this purpose, financial regulators should consider further differentiating between financial products for the purpose of the suitability assessment. This exercise should involve the MAS, the legal profession, and the financial industry working together to provide a healthy environment for offering alternative investment vehicles to retail investors.