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WHEN IS AN INDIVIDUAL INVESTOR NOT IN NEED OF CONSUMER PROTECTION? A COMPARATIVE ANALYSIS OF SINGAPORE, HONG KONG, AND AUSTRALIA

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In Singapore, Hong Kong, and Australia, standard retail investor protection laws do not apply to special categories of individual investors, which are broadly based on wealth or income. Prospectuses are not required for the sale of financial products to these investors and they do not have the full benefit of advice relating to the suitability of these products. However, with the increasing complexity of products and potentially unregulated alternative investments such as crypto-assets, this legal framework is increasingly being debated and challenged. We explore the rationale behind the special categories, the implications of falling into these categories and the appropriateness of the current framework. We argue that the existing criteria are anachronistic and inappropriate. Instead, all individuals making investment decisions should have the benefit of a rating framework that is based on both complexity and risks and be subject to a suitability test in the case of complex products.

I. INTRODUCTION

Individual investors are often being categorised as 'consumers' or 'investors'. The rationale for regulation of the two categories often differs and thus also the regulatory framework.[1] Regulation to protect financial 'consumers' or, by another name, 'retail investors', may be akin to consumer protection in some respects,[2] whereas regulation

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1 Niamh Moloney, "The Investor Model Underlying the EU's Investor Protection Regime: Consumers or Investors?" (2012) 13 Eur Bus Organisation L Rev 169 [Moloney, "The Investor Model"] at 174.

2 For *eg*, see Austl, Commonwealth, Financial Services and Regulation, *Explanatory Memorandum to the Financial Service Reform Bill 2001* (2001) [*Explanatory Memorandum*] at para 2.27, which introduced the amendment to the *Corporations Act 2001* (Cth) [*Corporations Act 2001*] that distinguished between retail and wholesale clients. The *Explanatory Memorandum* provides that:

regarding 'investors' or 'non-retail investors' is usually looser and more inclined towards promoting a vibrant financial market.

However, in advanced economies, governments expect their citizens to take increasing responsibilities for their own financial well-being and to plan adequately for their retirement and other financial needs.[3] Prior to the global financial crisis of 2008, the view in advanced economies (including the United Kingdom ("UK") and the United States ("US")) was that consumer finance regulation should focus on financial literacy, which gives investors skills and knowledge to evaluate their choices in financial products, as well as a robust disclosure framework that compels issuers and providers to disclose the risks of investments or financial goods so that purchasers are able to make an informed decision and choose products that are suitable for their needs. The regulatory approach then was fairly hands-off, and regulators were not gatekeepers as to determining whether particular financial products could be sold to the retail market. Instead, investors were left to make that decision themselves so long as appropriate disclosure was given.[4] The global financial crisis of 2008, however, demonstrated the deficiencies in the (then) existing regulatory design framework in many of these economies.[5] In particular, systemic problems revealed by the mis-selling of structured products[6] showed that, when left purely to market forces and self-regulation, the industry's self-interest resulted in sellers of financial products or providers of financial services providing less than optimal outcomes for both retail and non-retail investors.[7]

Since the crisis, there has been broad agreement that a greater degree of regulatory intervention is necessary to improve consumer outcomes as compared with pre-crisis intervention. However, there is no consensus as to how such intervention

> Generally, the consumer protection provisions [in the *Financial Services Reform Act 2001* (Cth)] will apply only to retail clients, as it is recognised that wholesale clients do not require the same level of protection, as they are better informed and better able to assess the risks involved in the financial transactions.

3 *Eg*, in the UK, see *Financial Services and Markets Act 2000* (UK), c 8, s 1C, which provides that "[i]n considering what degree of protection for consumers may be appropriate, the [FCA] must have regard to... (d) the general principle that consumers should take responsibility for their decisions".

4 See generally, UK, Financial Services Authority ("FSA"), *The Turner Review: a regulatory response to the global banking crisis* by Jonathan A Turner (2009) at 45-49, online: The National Archives <https://webarchive.nationalarchives.gov.uk/20090320232241/http://www.fsa.gov.uk/pages/Library/Corporate/turner/index.shtml>, which criticised the UK FSA (as it then was before the 2013 restructure) for not directly regulating products in all circumstances without considering whether regulation may be appropriate if characteristics of markets have become more harmful. See also Cristie Ford, "New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation" (2010) Wis L Rev 441, where she discussed the 'new governance' regulatory theories post-sub-prime crisis.

5 For the UK, see Turner, *ibid*. For the US, see the literature relating to the establishment of the Consumer Financial Protection Bureau, *eg*, Adam J Levitin, "The Consumer Financial Protection Bureau: An Introduction" (2013) 32 Rev Banking & Fin L 321.

6 In the UK, product mis-selling of various types of investment products by banks, including large banks, has resulted in enforcement actions. See *eg*, Eilis Ferran, "Regulatory Lessons from the Payment Protection Insurance Mis-selling Scandal in the UK" (2012) 13:2 Eur Bus Organisation LR 247. For Singapore and Hong Kong, see Andrew Godwin "The Lehman Minibonds Crisis in Hong Kong: Lessons for Plain Language Risk Disclosure" (2009) 32:2 UNSWLJ 547 [Godwin, "Lehman Minibonds"], relating to the sale of the Lehman Brothers Minibonds.

7 See generally John Y Campbell, "Restoring Rational Choice: The Challenge of Consumer Financial Regulation" (2016) 106:5 Am Econ R 1, online: American Economic Association <http://doi:10.1257/aer.p20161127>.

should take place once the details are considered. In the US, the Consumer Financial Protection Bureau (set up in 2011),[8] and in the UK, the Financial Conduct Authority ("FCA") (set up in 2013),[9] were established post-crisis to strengthen the protection of financial consumers.[10] However, the policies that have been ultimately adopted by these agencies reflect a far more complex picture and in many cases appeared to be contradictory.[11] In part, the reason for the difficulty is that there is no universal consensus on what are regarded as optimal outcomes for consumers of financial products and services and how such outcomes should be quantified *vis-à-vis* the costs of such regulation.[12] For example, Howell Jackson has detailed the difficulties in quantifying the benefits to consumers in financial regulation, as well as the indirect costs of regulation, including disruption to the availability of such products and services.[13]

Traditionally, the regulatory choice in jurisdictions with modern regulated securities markets has been to draw a bright line between retail and non-retail investors, with the former requiring the production of enhanced and (often costly) disclosures before they can be sold products.[14] In the publicly traded and organised markets (including the securities exchange), the efficient market hypothesis theory postulates that public disclosures will inform the prices at which the securities are traded, which is essential to having efficient capital allocation. Products that are actively traded on the securities exchange are fairly standardised, such as shares, bonds, and futures, and comparison of the assets is relatively easy. At the same time and increasingly, investors are investing in mutual, pension, or superannuation funds that are not sold on the securities exchanges in, for example, Australia,[15] Singapore,[16] and Hong

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8 See generally, Edward Balleisen & Melissa Jacoby, "Consumer Protection After the Global Financial Crisis" [2019] 107 Geo LJ 813.

9 See generally, Iris HY Chiu & Alan H Brener, "Articulating the Gaps in Financial Consumer Protection and Policy Choices for the Financial Conduct Authority—Moving Beyond the Question of Imposing a Duty of Care" (2019) 14:2 Capital Markets LJ 217.

10 Niamh Moloney, "Regulating the Retail Markets" in Niamh Moloney, Eilis Ferran & Jennifer Payne, eds, *The Oxford Handbook of Financial Regulation* (Oxford: Oxford University Press, 2015).

11 For *eg*, see generally Balleisen & Jacoby, *supra* note 8, where the authors argued that the *Dodd-Frank Wall Street Reform and Consumer Protection Act* 12 USC tit 5301 (2009) strengthened the enforcement powers of the US Securities and Exchange Commission ("SEC") but at the same time, the US, Bill HR 3606, *Jumpstart Our Business Startups Act* 112th Cong, 2012 (enacted) reduced disclosure requirements on many initial public offerings ("IPOs"). See generally Colleen Honigsberg, Robert Jackson & Yu-Ting Wong, "Mandatory Disclosure and Individual Investors: Evidence from the JOBS Act" (2015) 93 Wash UL Rev 293.

12 For a proposal that focuses on financial wellbeing as the core outcome, see Breidbach *et al*, *FinFuture: The Future of Personal Finance in Australia*, (Melbourne: University of Melbourne, 2019), online: University of Melbourne <https://www.unimelb.edu.au/finfuture>.

13 HE Jackson, "Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications" (2007) 24:2 Yale J Reg on 253 at 260.

14 See *eg*, Julia Black, "Involving Consumers in Securities Regulation—Report for the Taskforce to Modernise Securities Regulation in Canada" (23 June 2006), online: London School of Economics <http://www.lse.ac.uk/law/people/academic-staff/julia-black/Documents/black18.pdf>.

15 As of 31 March 2019, the managed funds industry in Australia had AU$3,590.4 billion of funds under management. See Austl, Commonwealth, Australian Bureau of Statistics ("ABS"), *Managed Funds, Australia, March 2019* (2019), online: ABS <https://www.abs.gov.au/ausstats/abs@.nsf/mf/5655.0>.

16 In Singapore, the fund size of Authorised Collective Investment Schemes ("CIS") and Recognised CIS offered in Singapore rose 24% to S$101 billion in 2017 (approximately US$73.8 billion). Authorised CIS are those funds that are constituted in Singapore and offered to retail investors

Kong.[17] These investments are not only used by households for purposes of asset accumulation but are also essential to daily life and retirement planning purposes due to the government's reduction on welfare spending. The question is whether the traditional distinction between retail and non-retail investors that has its roots in the public markets should continue to apply in the non-public markets as well.

Central to the debate is the appropriate characterisation of the individual investor as a 'financial consumer' or its equivalent that should be the subject matter of enhanced regulatory intervention. Should regulatory intervention be based on categorising non-retail investors who qualify for the exemptions? Or should regulatory intervention be based on categorising specified products or services that are deemed to be too risky or complicated for ordinary individual investors? How do we draw the line without unduly stifling innovation and yet ensure that investors are able to have the choice of products that cater to their own financial planning and retirement needs (and are not shut out of products that only the wealthy have access to)?

Part II of this paper explains the traditional theoretical justifications for differentiating the regulatory treatment between retail and non-retail investors. Part III explains the problems and limitations of the current approach. Part IV is a detailed case study on how the line between retail and non-retail investors has operated in the three jurisdictions: Singapore, Hong Kong, and Australia. These three jurisdictions are economically advanced markets in the Asia Pacific region with international centres. Additionally, Singapore draws much of its financial regulation framework from Australia. Part IV argues that while a bright-line rule is easy to comprehend and enforce, there are many difficulties as to how such a rule applies in practice and how it can achieve its stated goals. Part V proposes an alternative approach. Part VI concludes.

II. Traditional Theoretical Justifications for Intervention in The Case of Individual Retail Investors

Retail market-oriented regulation in the securities markets is associated with two main objectives: the first is to protect retail investors and the second is to promote long-term household saving through the markets.[18] The protection of retail investors is also seen as the key to ensuring market confidence and trust and thus maintaining the stability of the financial system. Advanced economies (including Singapore, Hong Kong, and Australia) expect that their citizens take responsibility for their own financial well-being and retirement well-being.[19] Widespread mis-selling, fraud, and activities that involve inadequately managing conflicts of interests or putting

in Singapore. Recognised CIS are constituted outside Singapore and offered to retail investors in Singapore. See Sing, Monetary Authority of Singapore ("MAS"), *2017 Singapore Asset Management Survey* (2017), online: MAS <http://www.mas.gov.sg/~/media/MAS/News%20and %20Publications/Surveys/Asset%20Management/2017%20AM%20Survey%20Report.pdf> [MAS, *2017 Survey*].

17 For Hong Kong, the amount invested in CIS in 2017 was HK$586 billion (approximately US$74.7 billion). See Hong Kong, Securities and Futures Commission ("HKSFC"), *Asset and Wealth Management Activities Survey 2018* (2018), online: HKSFC <https://www.sfc.hk/web/EN/files/ER/PDF/Asset%20and%20Wealth%20Management%20Activities%20Survey%202018_EN.pdf> [HKSFC, *Survey 2018*].

18 See *Explanatory Memorandum*, *supra* note 2.

19 See *Financial Services and Markets Act 2000*, *supra* note 3 and accompanying text.

a financial firm's interest ahead of its clients can lead to loss of confidence in the market. Further, in the public securities markets, retail investors contribute to the proper functioning of the market in a variety of means, including through ensuring liquidity[20] and ensuring the availability of the public float.

In this Part, we set out the outcomes in the regulatory framework that have traditionally differentiated between retail and non-retail investors on the basis that the former requires special intervention and the justifications for such differentiation.

A. *Different Mandatory Disclosure Frameworks for Retail and Non-Retail Investors*

Modern securities laws in the major financial markets are substantially predicated on granting access to financial products and services so long as proper disclosure is made to the prospective purchasers. This is fundamental to a disclosure-based regime; in such a regime, securities laws incentivise or mandate firms that are raising capital from the public markets to disclose as much of the information as possible to the investors.[21] Thus, a firm that is offering securities for the first time to the public will be required to produce a prospectus accompanying the sale that contains the most onerous disclosure requirements and has the longest lead time for preparation (as compared with other forms of offering memorandum in secondary offerings).

Proponents argue that these disclosure protections are necessary not only to create market confidence but also to accommodate the special place of retail investors who lack either the sophistication to understand the complexity of financial products or access to independent financial advice to evaluate such products. In contrast, non-retail investors investing in the public markets do not require the same level of protection and disclosures and are able to make their own inquiries. Thus, exemptions to the prospectus requirements exist for the offering of securities to persons who qualify as non-retail investors. Likewise, for firms that are already listed and where information is publicly available, their fund-raising exercises do not generally require prospectuses but only simplified disclosures and/or shelf registration.

The prospectus requirements for the public capital markets are also backed by a rigorous enforcement regime that allows for statutory compensation claims in connection with false or misleading disclosures against not only the issuers but also their directors and issue managers.[22] In contrast, offerings of securities solely

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20 See generally, R Kaniel, "Individual Investor Trading and Stock Returns" (2008) 63 J Fin 273 where the author argued that retail investors provide liquidity for institutional investors.

21 See generally, Donald C Langevoort, "The SEC, Retail Investors, and the Institutionalization of the Securities Markets" (2009) 95 Va L Rev 1025.

22 For Singapore generally, see Hans Tjio, Wai Yee Wan & KH Yee, *Principles and Practice of Securities Regulations in Singapore*, 3d ed (Singapore: LexisNexis, 2017) at ch 6. For Hong Kong, see generally Wai Yee Wan *et al*, "Public and Private Enforcement of Corporate and Securities Laws: An Empirical Comparison of Hong Kong and Singapore" (2019) 20 Eur Bus Organisation L Rev 319 [Wan *et al*, "Enforcement of Corporate and Securities Law"]; and E Lim, "Sponsors' prospectus liability in initial public offerings in Hong Kong" (2013) 8:2 Capital Markets LJ 177. For Australia, see specific civil and criminal liabilities in respect of defective disclosure documents, found in the *Corporations Act 2001*, *supra* note 2, part 6D.3 and additionally, there is the prospect of civil liability for misleading or deceptive conduct under the *Corporations Act 2001*, *ibid*, s 1041H and the *Australian Consumer Law* (Cth), s 18.

to non-retail investors (and thus not accompanied by prospectuses) generally fall outside the special statutory compensation regime for prospectuses.[23]

However, since the 1990s, private capital markets are also gaining importance as individual investors have been channelling their funds into collective investment schemes and other unlisted investment products.[24] These funds are channelled into wholesale markets where securities are placed using non-retail investor exemptions. Thus, investor protection has to be viewed from the lens of not only how the funds invest in the issuers' securities but also in connection with the investors subscribing for or investing in these collective investment schemes, which are usually unlisted. In these cases, as the transaction is between the consumer and the firm offering the unlisted collective investment scheme (where there is comparatively less information or market data that is widely available in the market), the focus of the regulatory framework is not only on what needs to be disclosed but also on how information is presented to investors such as through *summary disclosure documents*.

The mis-selling saga involving financial products in the few years immediately prior to the financial crisis of 2008 demonstrated how individual investors fared badly in understanding complex instruments and/or were sold structured products that were not necessarily suitable for them. Prior to the financial crisis, retail investor appetite for structured products was strong, because these products offered attractive interest rates or returns against the background of the prevailing low deposit interest rates.[25] However, the products were complex, in terms of not only how the instruments worked and the risks but also how these products should be valued.[26] Questions were also raised as to whether adequate assessment was made in respect of the suitability of these products when assessed against the risk profiles of the particular classes of retail investors.

In particular, in Hong Kong and Singapore, the issuance of the structured products linked to Lehman Brothers (including the Lehman Brothers Minibonds) during the 2005–2008 period demonstrated that the mandatory disclosure regime, with its emphasis on disclosure of all risks, had several limitations in enabling large numbers of retail investors to make an informed decision on whether these products met their needs. In Singapore, S$520 million of these products were sold to more than 8,000 retail investors.[27] In Hong Kong, around HK$20 billion of products were sold through retail banks to 48,000 investors.[28] In particular, the Lehman Brothers Minibonds exemplified several complex features: not only were the investors exposed to

See generally, Robert Austin & Ian Ramsay, *Ford, Austin & Ramsay's Principles of Corporations Law*, 17th ed (Australia: LexisNexis Butterworth) at para 22.410.

[23] For Singapore and Hong Kong, only prospectuses will attract criminal and civil liability for statutory compensation. See Wan *et al*, "Enforcement of Corporate and Securities Law", *ibid*.

[24] See ABS, *Managed Funds 2019*, *supra* note 15; MAS, *2017 Survey*, *supra* note 16; and HKSFC, *Survey 2018*, *supra* note 17.

[25] For *eg*, see Gabriel Chen, "Structured Products, anyone", *The Straits Times* (7 December 2008).

[26] For *eg*, see Steven L Schwarcz, "Regulating Complexity in Financial Markets" (2009) 87 Wash U L Rev 211.

[27] The source of the data is aggregated from the data presented in Sing, MAS, *Investigation Report on the Sale and Marketing of Structured Notes linked to Lehman Brothers* (7 July 2009), online: MAS <http://www.mas.gov.sg/~/media/resource/news_room/press_releases/2009/INVESTIGATION%20REPORT_7%20JUL%2009.ashx> at para 4 [MAS, *Investigation Report*].

[28] Hong Kong, Hong Kong Monetary Authority ("HKMA"), *Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies* (2008) at para 2.2, online: HKMA <https://www.hkma.gov.hk/media/eng/doc/other-information/lehman_report.pdf>.

the risk of the insolvency of the issuer but also to the risk of insolvency of several reference entities and the counter-party to the swap agreements that the issuer had entered into, together with the guarantor of the swap agreements.[29]

These incidents have highlighted that a disclosure regime, no matter how robust, may not be sufficient. Academic scholars and policy-makers have moved towards emphasising the *content* of the disclosure and *how* the information is conveyed to the retail investor.[30] As early as 1950, it was remarked that "[t]here is no doubt that the ordinary prospectus fully discloses all facts necessary to the investor for an independent appraisal of the merits of the security. The trouble is that nobody bothers to read it".[31]

Existing literature also demonstrates that issuers are also tempted to over-disclose, whether due to incentives of their legal and accounting advisers[32] or simply defensive over-reporting.[33] This inevitably leads to information overload, which exacerbates cognitive biases and cognitive resource constraints on the part of investors who need to make informed decisions.

This problem is acute for individual investors. "The essence of information overload is that a decision-maker may make better decisions when she brings a more

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29 See generally, Godwin, "Lehman Minibonds", *supra* note 6. The Lehman Brothers Minibonds crisis related to the investment product called Lehman Minibonds, which was credit-linked to reference entities and sold to investors. When the structure collapsed as a result of the bankruptcy of a Lehman Brothers entity that acted as the swap counterparty, investors only obtained a fraction of their original investment. The outcome of the regulatory investigation into the crisis showed that the complaints were founded on misrepresentation, complexity, and lack of suitability. See Hong Kong, HKSFC, *Issues Raised by the Lehman Minibonds Crisis—Report to the Financial Secretary* (2008), online: HKSFC <http://www.sfc.hk/sfc/html/EN/whatsnew/review_lehman.html>; Hong Kong, HKMA, *Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies* (2008). For Singapore, see MAS, *Investigation Report, supra* note 27. The MAS Investigation Report highlighted, among others, that several financial institutions had policies in place on the sale of the Lehman minibonds but had lapses in internal controls that resulted in the investment products being sold inappropriately to investors without the requisite risk profiles.

30 See generally the literature on consumer contracts, *eg*, O Bar-Gill, *Seduction by Contract: Law, Economics and Psychology in Consumer Markets* (Oxford: Oxford University Press, 2012), ch 1; I Ayres and A Schwartz, "The No-Reading Problem in Consumer Contract Law" (2014) 66 Stan L Rev at 545. See also Andrew Godwin & Ian Ramsay, "Short-form Disclosure Documents—An Empirical Survey of Six Jurisdictions" (2016) Capital Markets LJ 1 [Godwin & Ramsay, "An Empirical Survey"]; Andrew Godwin and, Ian Ramsay, "Financial Products and Short-form Disclosure Documents: A Comparative Analysis of Six Jurisdictions" (2015) 10:2 Capital Markets LJ 212 [Godwin & Ramsay, "A Comparative Analysis"].

31 Hugh Sowards, *Comments, Cases and Materials on Corporate Finance* (1950) at 696, quoted in Kenneth B Firtel, "Plain English: A Reappraisal of the Intended Audience of Disclosure under the Securities Act of 1933" (1999) 72 S Cal L Rev 851 at 870. For a recent regulatory report questioning the effectiveness of disclosure for financial products on consumer outcomes, see the joint report by the Australia Securities and Investments Commission ("ASIC") and the Dutch Authority for the Financial Markets, *Disclosure: Why It Shouldn't Be the Default*, Report 632 (14 October 2019), online: ASIC <https://download.asic.gov.au/media/5303322/rep632-published-14-october-2019.pdf>.

32 Kevin S Haeberle & M Todd Henderson, "Making a Market for Corporate Disclosure" (2018) 35 Yale J on Regulation at 434.

33 See, for *eg*, KPMG, Strange-looking, *Disclosure Overload and Complexity: Hidden in Plain Sight* (2011) at 21-23 and US, US SEC, *Speech: The Path Forward on Disclosure* (15 October 2013), online: US SEC <https://www.sec.gov/news/speech/spch101513mjw#.Ul5ut1MiXfk>.

complex decision strategy to bear on less information than when she brings a simpler decision strategy to bear on more information."[34] An individual, especially a retail investor, will generally use a simpler decision strategy simply due to more limited mental resources compared with, for example, a department in an investment bank. Even if individuals make an effort to read and understand the disclosure documents, it is inevitable that they will take into account irrelevant factors that have been disclosed and miss out relevant factors.

Regulators have also expressed concerns about this issue; the US Securities and Exchange Commission ("SEC") has acknowledged that there is a serious information overload problem: "if investors are overloaded, more disclosure actually can result in less transparency and worse decisions".[35] The US SEC has recently put out for public consultation amendments to regulations "intended to improve the readability of disclosure documents, as well as discourage repetition and disclosure of information that is not material".[36]

Therefore, merely insisting on mandatory disclosure of a checklist of items does not help if the investors lack the capacity to understand disclosure documents that are not presented in a user-friendly way, particularly for complex products.[37] Investors face high information costs in assessing innovative but complex and opaque products. Established research shows that even in competitive markets, providers can engage in the practice of 'shrouding' or the hiding of information about high costs that are added on to the products.[38] Sophisticated investors who understand these costs have no incentives to pass their knowledge to the less savvy investors as they are better able to take advantage of their superior knowledge and avoid these costs that ensnare the less savvy investors.[39]

Thus, in the light of various regulatory reviews that were conducted post-financial crisis of 2008, in Hong Kong, Singapore, and Australia, steps have been taken to ensure that information is disclosed adequately for the needs of ordinary retail investors.[40] In Singapore, for example, the wide-ranging review of the sale of unlisted structured products by MAS has led to, among other things, a products highlight sheet that contains disclosures in "clear, relevant and timely information".[41] In addition,

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34 Troy A Paredes, "Blinded by the Light: Information Overload and Its Consequences for Securities Regulation" (2003) 81 Wash U LQ 417 at 442.

35 Troy A Paredes, "Speech by SEC Commissioner" (Twelfth Annual AA Sommer, Jr Lecture on Corporate, Securities and Financial Law delivered at Fordham Law School, 27 October 2011), online: US SEC <https://www.sec.gov/news/speech/2011/spch102711tap.htm>.

36 Letter from Mary H Morris, Investment Officer, California State Teachers' Retirement System (8 August 2019), *Modernization of Regulation S-K Items 101, 103, and 105*, online: US SEC <https://www.sec.gov/rules/proposed/2019/33-10668.pdf>.

37 For *eg*, see generally S Lumpkin, "Consumer Protection and Financial Innovation: A Few Basic Propositions" (2010) 1 OECD J Fin Market Trends 117.

38 Xavier Gabaix & David Laibson, "Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets" (2006) 121:2 QJ Econ at 505.

39 *Ibid*.

40 See generally, for the three jurisdictions, Andrew Godwin, "Brave New World: Digital Disclosure of Financial Products and Services" (2016) 11 Capital Markets LJ 442 at 449, 450.

41 Sing, MAS, *Review of the Regulatory Regime Governing the Sale and Marketing of Unlisted Investment Products*, MAS Consultation Paper P001 (2009) at para 1.2.7 [MAS, *2009 Review*].

Australia has recently extended the requirement of plain advice to digital financial advice (such as robo-advisers) to retail investors.[42]

B. *Product Regulation and Intervention*

Even where the sale of financial products and services is subject to a strict disclosure-based regime, regulators in major markets may take the view that there are some products that should never be sold to certain classes of investors, particularly retail investors, due to, among other things, their riskiness or complexity. Proponents of behavioural economics argue that consumers face biases in making investment decisions and competence issues. Biases include loss aversion (refusal to sell the securities believing that the prices will eventually recover even when it is advantageous for them to sell to avoid further losses),[43] over-confidence (in respect of their own investment strategy),[44] illusion of control (belief that they can assert control and influence the outcome),[45] and herd behaviour (tendency to mimic the behaviour of a larger group).[46] Having greater disclosure will not assist them to make better decisions if they lack the capacity to make rational decisions.

Direct intervention by the regulators can take several forms. The most extreme is to ban certain products for sale to retail investors. However, regulators in advanced economies are reluctant to revert to a merit-based regime (as opposed to a disclosure-based regime) for a number of reasons, including the need to expand investment options for retail investors, the view that financial institutions selling these products are better suited to assess the suitability of products to individual retail investors and concerns that the regulators' certification of the sale of specific products may create a false sense of security on the part of retail investors and give rise to moral hazard.[47]

Instead, regulators have intervened in other ways by not banning the products outright but by requiring that products be sold without features that are regarded as unsound practices and that steps be taken to stamp out such practices, such as the reduction or elimination of hidden borrowing costs (*eg*, hidden fees in credit card transactions). However, targeted approaches to specific forms of fees and costs may lead to unintended consequences; for instance, these approaches may reduce borrowing costs but incentivises credit providers to shift the financial costs to other

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42 Austl, Commonwealth, ACSI, *Providing Digital Financial Product Advice to Retail Clients* (Regulatory Guide 255), online: ACSI <https://download.asic.gov.au/media/3994496/rg255-published-30-august-2016.pdf>. The Guide required that communications should be "user focused, clear and timely" at regulatory guide 225.97.

43 See generally Terrance Odean, "Are Investors Reluctant to Realize Their Losses?" (1998) 53 J Fin 1775 at 1781–1795.

44 See generally Terrance Odean, "Do Investors Trade Too Much?" (1999) 89 Am Econ Rev 1279 at 1280–1292; Kent Daniel, David Hirshleifer & Avanidhar Subrahmanyam, "Investor Psychology and Security Under- and Overreactions" (1998) 53 J Fin 1839 at 1844, 1845.

45 See generally, Austl, Commonwealth, ACSI, *Investing in hybrid securities: Explanations based on behavioural economics* (Report 427) (March 2015).

46 See generally, David Hirshleifer, "Investor Psychology and Asset Pricing" (2001) 56 J Fin 1533 at 1545–1546.

47 MAS, *2009 Review*, *supra* note 41 at para 2.1.

parts of the businesses (and thus there is no reduction in the overall costs)[48] or they may reduce access to credit.

Regulators have pursued thematic studies to gather evidence (particularly using behavioural economics) and consider policy reform in various areas. For example, following a pilot study commissioned by the Australian Securities and Investments Commission ("ASIC"), ASIC has singled out hybrid securities as financial products that are of concern as these securities are complex products that not only have debt features but also have risks that are characteristics of equity.[49] The pilot study found that investors were influenced by a range of biases in determining the allocation of hybrid securities in a mock portfolio, including being subject to an illusion of control bias and/or over-confident bias.

C. *Regulating the Distribution Network*

An important critique that emerged from the global financial crisis of 2008 is that self-regulation has its limits due to the financial incentives of the distributors and service providers in mis-selling financial products. Distributors may face conflicts of interests that may not be properly disclosed to consumers and may fail to comply with the obligations to recommend or sell products only where they are suitable for the consumers. In the wake of the crisis, advanced economies have considerably tightened up the regulation of the distribution of products for retail investors by adopting one or more of the following forms:

(1) distributors and other service providers are required to conduct customer due diligence to ascertain the suitability or appropriateness of the products to minimise the likelihood of its retail customers taking on inappropriate risks;
(2) conflicts of interests faced by distributors to retail customers are required to be disclosed; and
(3) enforcement actions are targeted at distributors or other service providers for mis-selling or misconduct.

For example, in Singapore, the regulatory framework was amended in 2010 to require, among others, intermediaries to conduct a customer knowledge assessment or a customer account review for a retail customer before he or she purchases products

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48 See *eg*, in the US context on credit card fees, Mullainathan *et al*, "The Case for Behaviorally Informed Regulation" in David Moss & John Cisternino, eds, *New Perspectives on Regulation*, (Cambridge: The Tobin Project, 2009) at 25-62.

49 See ASIC, Media Release, "ASIC increasing use of behavioural economics across its regulatory business" (18 March 2015), online: ASIC <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2015-releases/15-059mr-asic-increasing-use-of-behavioural-economics-across-its-regulatory-business/>. Another example is the well-known ongoing case of Hyflux Ltd, a Singapore-listed company, which had issued capital perpetual securities that carry a coupon but which rank below debt and above equity. When Hyflux became insolvent, many of the retail investors of the capital perpetual securities complained that they did not understand the nature of their investment. See, for *eg*, Grace Leong, "More than 100 Hyflux investors protest at Hong Lim Park" *The Straits Times* (31 March 2019), online: The Straits Times <https://www.straitstimes.com/business/more-than-100-hyflux-investors-protest-at-hong-lim-park>. The UK FCA has also studied the use of behavioural economics in interventions in the financial markets—see Kristine Erta *et al, Applying Behavioural Economics at the Financial Conduct Authority*, UK FCA Occasional Paper No 1 (April 2013) at 42–50, online: UK FCA <https://www.fca.org.uk/publication/occasional-papers/occasional-paper-1.pdf>.

that MAS regards as non-plain vanilla, such as an unlisted investment product or a listed structured product.[50] In 2012, the regulatory framework was further refined to address the sale of more complex products (defined as having derivative elements) to retail investors.

In Australia, the 'best interests' duty was imposed in respect of the provision of personal advice to retail clients.[51] Initially, it was very significant as it was intended to operate as a broad principle, but subsequently, it became viewed as a safe harbour where compliance with the steps was regarded as sufficient.[52] Other recently enacted design and distribution obligations require issuers and distributors to ensure that financial products are sold only to customers for whom the product is "appropriate".[53] Pursuant to this obligation, issuers of regulated financial products have to issue a target market determination ("TMD") specifying, among others, the class of retail clients comprising a financial product's target market and to take reasonable steps to ensure that the distribution of a product is consistent with the TMD. The appropriateness of the product is determined in respect of a retail client as a class instead of at an individual or household level.

However, more recently, jurisdictions are moving away from a sharp distinction between retail and non-retail investors in relation to product recommendations, holding that intermediaries have a baseline duty to all investors, whether sophisticated or not. For example, in Hong Kong prior to March 2016, intermediaries regulated under the HKSFC Code of Conduct were exempt from assessing the suitability of the products, the need to establish clients' financial situation or knowledge when dealing with individual professional investors.[54] These exemptions were granted on the assumption that these investors were in a better position to protect their own interests or could absorb greater risk, therefore requiring less regulatory protection.[55] In March 2016, however, the SFC amended the Code of Conduct to remove many of these exemptions on the ground that these are matters that are the 'cornerstone' of investor protection and thus apply equally to intermediaries for individual professional investors and retail investors. There are additional layers of checks to be satisfied by the financial institution, however, if a retail customer is entering into a transaction that is mismatched with his or her risk profile.[56]

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[50] MAS, Media Release, "MAS Issues Response to Feedback on Proposals to the Regulatory Regime for Listed and Unlisted Investment Products" (October 2010), online: MAS <http://www.nas.gov.sg/archivesonline/data/pdfdoc/20101028002/mas_press_release_response_to_feedbk_on_listed_unlisted_pdts_final.pdf>.

[51] *Corporations Act 2001*, *supra* note 2, s 961B.

[52] See Breidbach *et al*, supra note 12.

[53] *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019* (Cth), s 994B(8).

[54] Hong Kong, HKSFC, *Consultation Conclusions on the Proposed Amendments to the Professional Investor Regime and Further Consultation on the Client Agreement Requirements* (25 September 2014) at 6, online: HKSFC <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=14CP7>.

[55] Hong Kong, HKSFC, *Consultation Paper on the Proposed Amendments to the Professional Investor Regime and the Client Agreement Requirements* (15 May 2013) at 12, online: HKSFC <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=13CP1> [HKSFC, *2013 Consultation Paper*].

[56] Hong Kong, HKMA, *Guidance on selling of investment products and handling of client securities* (23 February 2017), online: HKMA <https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2017/20170223e1.pdf>.

III. The Problems with Current Regulation that Draws a Bright Line Rule between Retail and Non-Retail Investors

A. *'One size Fits All'*

A regulatory regime that uses a 'one size fits all' approach is often simultaneously over and under-inclusive at two levels. At the first level, the distinction assumes that each class of retail and non-retail investors is largely homogenous within the class and that investors within each class have the same objectives in investing. However, this assumption of homogenous demand is deeply flawed. For example, a cap on payday loans may benefit some consumers but may mean the lack of access to credit on the part of other consumers. Further, wealthy investors (who meet the required income or asset thresholds to be classified as accredited, professional, or sophisticated investors) do not necessarily understand the complexity of disclosure or the relevant risks[57] and do not seek professional financial advice due to the lack of high-quality independent providers or perceived conflicts of interests. During the financial crisis of 2008, financial intermediaries, which were sophisticated by any regulatory framework, made mistakes due to their inability to comprehend the complexities of subprime mortgage securities and credit default swaps, thereby causing widespread damage to themselves, their clients, and the economy.[58]

Moreover, it is often assumed that wealthy investors have the risk appetite to invest in such complex products. Yet these investors could potentially lose all their investment in poorly chosen financial products or services, rendering them in the same position of vulnerability as retail investors who lose all their investment. Regulators have been sensitive to this criticism: for example, Singapore has mitigated some of these risks by requiring that in computing the net worth of individuals, real property assets are to be excluded, increasing the likelihood that they should have sufficient liquidity to withstand the losses. Further, wealthy investors are not necessarily inclined to be risk-takers. Many extremely wealthy persons chose to invest in Bernard Madoff's Ponzi scheme for the simple reason that it promised low-risk, stable returns.[59]

B. *Financial Inclusion and Exclusion*

Households and individuals in advanced economies are expected to make their own investment decisions for their own retirement and to take larger responsibility for their

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[57] In the US, it appears that persons with less than a high school education may as a class even have higher financial literacy than elderly non-retail investors. See Tao Guo, Michael S Finke & Chris Browning, "The Unsophisticated Sophisticated: Old Age and the Accredited Investors Definition", (July 22, 2015), online: Social Science Research Network ("SSRN") <https://ssrn.com/abstract=2634818>.

[58] See generally, Taub & Jennifer, "The Sophisticated Investor and the Global Financial Crisis" in James P Hawley, Shyam J Kamath & Andrew T Williams, eds, *Corporate Governance Failures: The Role of Institutional Investors in The Global Financial Crisis* (Philadelphia: University of Pennsylvania Press, 2011), online: SSRN <https://ssrn.com/abstract=1784299>.

[59] See, for *eg*, the description of Madoff's investors in the Interview of Erin Arvedlund, Investigative Reporter and Author of "Too Good to be True" by Rebecca Roberts (August 2009) on National Public Radio, *Madoff Scheme 'Too Good To Be True'* online: National Public Radio <https://www.npr.org/templates/transcript/transcript.php?storyId=111959024>.

own financial well-being.[60] A regulatory approach that takes a proactive approach to reduce the risk of significant detriment to consumers may thus cut off access by retail investors to lucrative investment opportunities,[61] raising the issue of systemic inequality between the sophisticated and retail classes of investors and the risk of being seen as favouring the former. Even in the case of IPOs in Australia[62] and Singapore[63], the tranche of shares that is available for public retail subscription is small (as compared with the institutional tranche), and the vanilla bond market is difficult for retail investors to access in Australia.[64] Further, in the EU, disclosure rules nominally created to protect retail investors have led to retail investors being locked out of products when intermediaries are hesitant to continue selling those products.[65] It has been argued in the US that the effect of disclosure exemptions for institutional and non-retail investors is to disadvantage retail investors.[66] Thus, the exclusion of retail investors increases wealth inequality and drives a further wedge into class differences. In the US, it has been argued that the broader issue is that financial inequality may give rise to political inequality and the inadvertent concentration of wealth in the hands of a relatively few.[67]

C. *Encourages Circumvention*

Given that the regulatory distinction between retail and non-retail investors can lead to costly consequences, issuers and their advisers are tempted to design methods to circumvent the regulation or engage in regulatory arbitrage. For example, in Australia, ASIC in 2017 clamped down on accountants who inappropriately issued certificates certifying that persons were sophisticated investors[68] in offerings made

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60 See Moloney, "The Investor Model", *supra* note 1. Also compare with Sing, MAS, *Objectives and Principles of Financial Supervision in Singapore* (April 2004, revised September 2015), online: MAS <https://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Monographs%20and%20Information%20Papers/Objectives%20and%20Principles%20of%20Financial%20Supervision%20in%20Singapore.pdf> at 5, 6.

61 See generally, Bolton, Santos & Scheinkman, "Shadow Finance" in R Solow & A Lo, *Rethinking the Financial Crisis* (New York: Russell Sage Foundation, 2012) at ch 10.

62 Elysse Morgan, "Small investors still locked out of lucrative ASX floats in listing rule changes" Australian Broadcasting Corporation ("ABC") (3 November 2016), online: ABC <https://www.abc.net.au/news/>.

63 Wai Yee Wan, "Cross-Border Public Offering of Securities in Fostering an Integrated ASEAN Securities Market: The Experiences of Singapore, Malaysia and Thailand" (2017) 12:3 Capital Markets LJ 381 [Wan, "Cross-Border Public Offering of Securities"].

64 Austl, Financial System Inquiry Committee ("FSI"), *Financial System Inquiry Interim Report* (July 2014) at paras 2-87 to 2-91, online: FSI <http://fsi.gov.au/files/2014/07/FSI_Report_Final_Reduced20140715.pdf.>

65 See for *eg*, Kate Beioley, "Reits investors locked out over EU rules confusion", *Financial Times* (8 February 2018) online: Financial Times <https://www.ft.com/content/0043b028-0b35-11e8-8eb7-42f857ea9f09>.

66 So-Yeon Lee, "Why The 'Accredited Investor' Standard Fails the Average Investor" (2012) 31 Rev Banking & Fin L 987 at 991.

67 Z Gubler, "Public Choice Theory and the Private Securities Market" (2013) 91 NCL Rev 745 at 800.

68 ASIC, Media Release, "ASIC takes action over misuse of 'sophisticated investor' certificates" (7 July 2017), online: ASIC <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2017-releases/17-228mr-asic-takes-action-over-misuse-of-sophisticated-investor-certificates/> [ASIC, 2017 Media Release].

through trust structures so that they could receive offers to purchase shares without a prospectus.

D. *Financial Innovation and Consumers*

Financial innovation results in a proliferation of financial products and different types of services to meet the different demands of consumers.[69] Financial services providers are also incentivised to innovate to achieve differentiation and create greater market share.[70]

The risk of an overly prescriptive approach for retail customers is that innovation in the design and offering of products for these customers will be impeded. Yet as governments expect that their citizens will take greater responsibility for their own financial well-being and retirement, severely limiting the array of products that are available for such purposes may be counter-productive. In addition, a regime that requires prior authorisation or approval before new products can be sold to retail investors may not be practical due to the short life cycle of these products, and that since many of these products are merely combinations of existing products, having to approve them again wastes time and resources.[71]

IV. Current Debates in Singapore, Hong Kong, and Australia on Distinguishing between Retail and Non-Retail Investors

Singapore, Hong Kong, and Australia have all made attempts at reforming how they treat retail and non-retail investors following the 2008 financial crisis. This section provides an overview of the background in which these reforms were proposed and implemented and the nature and extent of the reforms (or lack thereof).

A. *Comparing the Regulatory Regimes*

The three jurisdictions considered in this paper have a roughly similar starting point. Singapore regulates investor protection through its central bank, MAS. Singapore operates a disclosure-based regime[72] that requires substantial disclosure for regulated offers, often including the preparation of a prospectus.[73] Exemptions to this regime are available regarding offers to non-retail investors (*ie*, accredited investors and certain other persons).[74] Persons providing financial advice are also regulated and must obtain a license if they provide advice to more than 30 accredited investors or to retail investors.[75]

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[69] See Lumpkin, *supra* note 37.

[70] Dan Awrey, "Toward a Supply-Side Theory of Financial Innovation" (2013) 41:2 J Comp Econ 401.

[71] See Lumpkin, *supra* note 37.

[72] Implemented in the years after the Asian Financial Crisis of 1997. The regime is found in the *Securities and Futures Act* (Cap 289, 2006 Rev Ed Sing) [*SFA*].

[73] *Ibid*, s 243.

[74] *Ibid*, s 275.

[75] *Financial Advisers Regulations* (Cap 289, Reg 2, 2004 Rev Ed Sing), r 27(d).

Similarly, Hong Kong operates a disclosure and conduct regime,[76] through sectoral governing and supervisory bodies,[77] primarily the HKMA, and HKSFC. The former deals with banks and the latter deals with non-bank financial intermediaries.[78] Similar to Singapore, offers by firms to non-retail investors (*ie*, 'professional investors') are exempted from the prospectus requirement[79] and the more stringent rules applicable for advertisements and unsolicited calls[80] but not duties to assess suitability by financial intermediaries.

The disclosure and licensing regime in Australia[81] is regulated by ASIC. Again, disclosure will generally require the creation of a substantial prospectus,[82] and the promotion of financial products and the provision of financial advice will require a license from ASIC.[83] Issuers of securities and financial service licensees are generally exempt from such disclosure in respect of persons who fall within the definition of 'wholesale client' or 'sophisticated investor' under the relevant sections of the *Corporations Act 2001*.

B. *Who is a Non-Retail Investor?*

The jurisdictions vary more when defining non-retail investors. Though taking the same starting point that the apparently wealthy are less in need of protection[84] and that this class of person has a role to play in promoting a vibrant financial sector, the regulators in each jurisdiction have chosen different approaches.

Singapore's individual accredited investors must comply with one of the following requirements: (a) have net personal assets exceeding S$2,000,000 (approximately US$1,440,000), of which their primary residence can contribute to a maximum of S$1,000,000 (approximately US$720,000) of this sum, (b) have net liquid assets of at least S$1,000,000, or (c) earn not less than S$300,000 (approximately US$216,000)

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[76] Supplemented by structural requirements specified for certain products in *The Oxford Handbook of Financial Regulation, supra* note 10. See for *eg*, Hong Kong, HKSFC, *Consultation Paper on Proposals to Enhance Protection for the Investing Public* (September 2009) at 20, online: HKSFC <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/%20openAppendix?refNo=09CP3& appendix=1>.

[77] Douglas Arner *et al*, *Financial Markets in Hong Kong: Law and Practice*, 2d ed (Oxford: Oxford University Press, 2016) at para 2.37.

[78] *Ibid* at para 2.38.

[79] The prospectus requirements are imposed under the *Companies (Winding Up and Miscellaneous Provisions) Ordinance* (Cap 32, 1933, Hong Kong), ss 37-48A.

[80] *Securities and Futures Ordinance* (Cap 571, LN 12 of 2003, Hong Kong), ss 102-109 and 174.

[81] As found in the *Corporations Act 2001*, *supra* note 2.

[82] *Ibid*, s 710.

[83] *Ibid*, s 911A.

[84] Singaporean subsidiary legislation requires counterparties to accredited investors to give a prescribed warning, which starts: "Accredited investors are assumed to be better informed, and better able to access resources to protect their own interests, and therefore require less regulatory protection." See *Securities and Futures (Classes of Investors) Regulations 2018*, (Cap 289, No 665 of 2018, Sing), r 3(3)(b)(iv) and the First Schedule [*Inventors Regulations 2018*]. Similar comments have been made by the HKSFC and ASIC in publications at Hong Kong, HKSFC, *Consultation Paper on the Proposed Amendments to the Professional Investor Regime and the Client Agreement Requirements* (15 May 2013) at 12 and Austl, ASIC, *Financial Product Disclosure*, online: ASIC <https://asic.gov.au/regulatory-resources/financial-services/financial-product-disclosure/certificates-issued-by-a-qualified-accountant/>.

within the preceding 12 months.[85] However, accredited investors must give consent to being treated as such.[86] Individual investors who are in the business of investment may also be exempted through a separate rule regardless of wealth.[87]

Hong Kong's individual 'professional investors' qualify if they have a portfolio of securities, bank deposits, and other money of at least HK$8,000,000 (approximately US$1,020,000).[88] However, only prospectus requirements are waived for such persons; as earlier discussed, product recommendations to all individual investors now require licensed intermediaries to ensure that the product is suitable.[89]

In Australia, a wholesale investor is one who has paid or will pay, at least AU$500,000 (approximately US$339,000) for the securities,[90] and a sophisticated investor is one who provides a certificate from a qualified accountant certifying that he has net assets above AU$2,500,000 (approximately US$1,690,000), or at least a gross income of AU$250,000 (approximately US$169,000) per year for the last two financial years.[91] In relation to the provision of financial services or financial products, a wholesale investor may also be one whom a licensed financial services provider is reasonably satisfied to be experienced enough to assess the product or service independently.[92] This provision appears not to have found favour in the industry.[93]

A number of points can be drawn from the above. First, regulators are implicitly concerned about the potential stifling effect that the costs of disclosure and licensing regimes impose on financial markets. There is demand for risk-taking even from retail investors,[94] so one compromise is that wealthy individuals are permitted to 'buy' access to certain opportunities.

Second, a wealth test is still the baseline for exemptions. All three jurisdictions consider a certain level of wealth—whether on a net basis (Singapore and Australia) or on the basis of assets under management (Hong Kong)—to be sufficient for exemptions to apply. This basis does not seem to have been challenged; in fact, the HKSFC has referred to Singapore and Australia's thresholds as 'comparable' jurisdictions in suggesting that Hong Kong's HK$8 million threshold is appropriate.[95]

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[85] *SFA*, *supra* note 72, s 4A(a)(i).

[86] *Inventors Regulations 2018*, *supra* note 84, r 3. Moving forward, financial institutions must treat all persons as retail investors unless they agree to be treated as accredited investors.

[87] *SFA*, *supra* note 72, s 4A(c).

[88] This sum can include joint accounts with their spouses or children, their share of joint accounts with other persons, and/or their wholly-owned holding companies. See *Securities and Futures (Professional Investor) Rules* (Cap 571D, LN 12 of 2003, Hong Kong), r 5.

[89] See Part II(C) of this paper.

[90] *Corporations Act 2001*, *supra* note 2, ss 708(8)(a) and (b) and 761G(7)(a) read with *Corporations Regulations 2001* (Cth) [*Corporations Regulations 2001*], regs 7.1.18-7.1.24.

[91] *Corporations Act 2001*, *ibid*, ss 708(8)(c) and 761G(7)(c) read with *Corporations Regulations 2001*, *ibid*, regs 6D.2.03 and 7.1.28 respectively.

[92] *Corporations Act 2001*, *ibid*, s 761GA.

[93] Austl Department of Treasury, *Wholesale and Retail Clients Future of Financial Advice Options Paper*, (January 2011) [Austl Department of Treasury, *Options Paper 2011*] at para 7.10, online: Department of Treasury <https://treasury.gov.au/sites/default/files/2020-01/wholesale_and_retail_options_paper.pdf>.

[94] ASIC, 2017 Media Release, *supra* note 68.

[95] HKSFC, *2013 Consultation Paper, supra* note 55 at para 80. This is despite the wealth tests in the other two jurisdictions being on a different basis.

Third, regulators are still regularly adjusting the formula, indicating the complexity of the issue; Singapore and Hong Kong have made significant changes within the past two years. Singapore has moved in the direction of adopting a liquid assets test[96] and has created an opt-in system for accredited investors;[97] meanwhile, Hong Kong has permitted self-certification of its wealth test but has revoked exceptions regarding ensuring product suitability and investor knowledge.

Fourth, regulators also face a tension in deciding how to set financial thresholds. A financial threshold could indicate either higher risk capacity or higher financial acumen. MAS appears to be more concerned with the former; it specifically highlighted a concern with investors "borrow[ing] to meet the financial assets thresholds".[98] In contrast, the HKSFC appears to consider experience and suitability more important.[99]

None of the three jurisdictions appear to have incorporated a different framework to assess investor suitability for exemptions; the wealth test remains king.

C. *Why have Regulators Adhered to Bright-line Objective Tests?*

Why have regulators adhered to bright-line objective tests, given the theoretical issues surrounding such tests? Experience shows that any proposed reform to the regulatory framework and scope of exemptions becomes the subject of significant interest group politics, namely, the large financial institutions. These larger firms will incur significant costs with increased regulation.

In 2011, the Australian Treasury Department put out a paper examining "the appropriateness of the distinction between wholesale and retail clients in light of recent experience".[100] A number of options for reform were proposed after surveying global practices, ranging from automatically increasing the financial thresholds based on an index to adopting a subjective knowledge assessment framework or even abolishing the distinction between the two categories entirely. All options considered in the paper—including the status quo—were noted to have significant drawbacks. For example, abolishing the category of wholesale investors entirely might simply lead to reduced access to investment products for most individual investors, and a subjective knowledge test was disfavoured by the industry due to the difficulty of administering and potential liability issues.[101]

Ultimately, reform of the categories was abandoned. In particular, moving toward a subjective knowledge model would have been difficult since an existing subjective

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[96] Singapore now excludes half the value of the primary home up to S$1 million, and all the value above that, in response to Singapore's high home ownership rate and housing prices.

[97] Moving forward, financial institutions must treat all persons as retail investors unless they agree to be treated as accredited investors.

[98] Sing, MAS, *Response to Feedback Received On Proposals To Enhance Regulatory Safeguards For Investors In The Capital Markets* (September 2015) at para 6.49 [MAS, *2015 Response*].

[99] See Hong Kong, HKSFC, *Consultation Paper on Proposals to Enhance Protection for the Investing Public* (September 2009) at para 36: ". . . only those investors with sufficient knowledge, expertise and investment experience in the relevant financial products and having an investment portfolio of an appropriate size would be regarded as professional investors".

[100] Austl Department of Treasury, *Options Paper 2011*, *supra* note 93.

[101] *Ibid* at 16-23.

knowledge test (*Corporations Act 2001*, section 761GA) was already underutilised by the industry.[102]

Singapore had also previously considered introducing a 'knowledge test' exception for prospectus requirements, where financial advisers would have to be satisfied that investors could properly evaluate the risks involved.[103] Industry reaction to the proposed reform in Singapore was overwhelmingly negative, raising concerns about the difficulty and costs of compliance, the problems of assessing clients, and potential liability for advisers.[104] The proposal was therefore dropped.[105] This is perhaps similar to the issues surrounding the underused Australian 'knowledge test' provision.

The recent Singaporean reform to restrict the value of the primary home from contributing more than S$1,000,000 to the asset test indicates that reform is possible with industry support.[106] It is generally accepted in Singapore that high housing prices may suggest a misleading view of a person's financial capacity. The same concern is present in Australia; Singapore, which has a high home-ownership rate,[107] faces fewer difficulties with potential discrimination between renters and buyers, a concern raised in Australia when a similar proposal was made.[108] It remains to be seen how the transition to an opt-in scheme will fare; industry feedback when it was proposed was less positive.[109]

Meanwhile, the Hong Kong experience also suggests difficulties with assessment tests that are specific to individual investors. Under the pre-2016 HKSFC Code of Conduct, financial intermediaries were exempted from ensuring suitability for individual professional investors if such investors were assessed to be knowledgeable and experienced.[110] However, it appears that this assessment was rarely used to obtain the exemption,[111] and this exemption was removed in 2016.

Ultimately, it appears that industry buy-in is a significant factor in successful reform; the mandate of regulators to promote vibrant capital markets may constrain them from implementing investor protection mechanisms as it may impose additional liabilities on the industry.

D. *Is the Category of 'Non-retail Investor' Fit for Purpose?*

However, despite the practical difficulties of implementing any other basis for a 'non-retail investor', it is questionable whether the category even achieves what it sets

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[102] *Ibid*.
[103] Sing, MAS, *Policy Consultation on Amendments to the SFA and the FAA* (December 2006) at 36.
[104] Sing, MAS, *Response To Feedback Received—Policy Consultation On Amendments To Securities And Futures Act And The Financial Advisers Act* (October 2007) at 12-15.
[105] *Ibid* at 13, 14.
[106] MAS, *2015 Response*, *supra* note 98 at 26-28.
[107] Sing, Department of Statistics, *Household Statistics*, online: Department of Statistics <https://www.singstat.gov.sg/find-data/search-by-theme/households/households/latest-data>.
[108] Austl Department of Treasury, *Options Paper 2011, supra* note 93 at 18.
[109] MAS, *2015 Response*, *supra* note 98 at 17-25.
[110] Factors included investor experience, trading volume, and knowledge.
[111] HKSFC, *2013 Consultation Paper*, *supra* note 55 at para 56.

out to achieve—a balance between investor protection and market access. The recent changes in Singapore and Hong Kong—*ie*, simply adjusting the formula or imposing universal suitability requirements—fails to address the core issue of whether market participants can in fact make informed decisions about what they are purchasing; such adjustments rely on two assumptions that appear to be incorrect.

1. *The first assumption: Retail investors are protected*

Leaving aside the problem of over-disclosure, new developments in regulating crypto-assets highlight the difficulties of simultaneously over and under regulating risks to retail investors in the first place. Persons who are classified as retail investors may have little opportunity to participate in traditional investments that are regulated as securities.[112] In contrast, they have had relatively little difficulty in participating in online purchases of crypto-assets, to the point where the People's Republic of China's central bank has felt it necessary to ban initial coin offerings ("ICOs").[113] Other regulators, such as MAS[114] and the HKSFC,[115] have taken a compromise position—if a 'digital token' is functionally a security, it will be regulated as one. A similar position applies in Australia, which regulates them if they are 'financial products'.[116] The literature documenting the risks in ICOs and crypto-assets is extensive.[117] While it is beyond the scope of this article to discuss debate on whether such alternative investments should be regulated under securities regulations, (re)imposing substantial suitability requirements for securities financial products will have no effect if an individual investor chooses to participate in unregulated markets that fall outside securities or financial regulation.[118]

It may even be that the disclosure regime, intended to protect retail investors, has ironically created the opposite result: the industry limits participation of retail investors due to higher transaction costs associated with disclosure, but this drives retail investors into unregulated markets.

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[112] See *eg*, limited retail investor opportunity and participation for IPOs as discussed in Wan, "Cross-Border Public Offering of Securities", *supra* note 63 at 381-411.

[113] See Andrew Godwin, "China's crackdown on cryptocurrency trading—a sign of things to come", *The Conversation* (20 September 2017), online: <https://theconversation.com/au>.

[114] Singapore, MAS, *A Guide to Digital Token Offerings* (Nov 2018) at para 2.3, online: MAS <https://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Monographs%20and%20Information%20Papers/Guide%20to%20Digital%20Token%20Offerings%20last%20updated%20on%2030%20Nov.pdf>.

[115] Hong Kong, HKSFC, *Statement on Initial Coin Offerings* (5 Sep 2017), online: HKSFC <https://www.sfc.hk/web/EN/news-and-announcements/policy-statements-and-announcements/statement-on-initial-coin-offerings.html>.

[116] Austl, ASIC, *Initial Coin Offerings and Crypto-Assets* (May 2019), online: ASIC <https://asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings-and-crypto-assets/>.

[117] See *eg*, Dirk A Zetzsche *et al*, "The ICO Gold Rush: It's a Scam, It's a Bubble, It's a Super Challenge for Regulators" (2018) University of Luxembourg Law Working Paper No 11/2017, online: SSRN <https://ssrn.com/abstract=3072298>.

[118] It is noted that investment in such products may continue to be governed under the jurisdiction's consumer protection legislation (even if they fall outside the securities or financial regulation).

2. *The second assumption: Non-retail investors can buy advice*

As discussed earlier,[119] regulators appear to take the view that non-retail investors are in a position to protect themselves by buying advice. This, unfortunately, may not be a feasible solution for many persons.

Contrary to the suggestions that non-retail investors can manage their risks by buying advice, it appears that many of their counterparties are very careful to ensure that they do *not* provide advice by way of carefully crafted contracts. See, for example, the case of *Shine Grace Investment Ltd v Citibank*,[120] in which a plaintiff (essentially a corporate vehicle for an individual) alleged that accumulators were mis-sold. The Court rejected the suggestion that the HKSFC Code of Conduct had any relevance to the matter "it is well established that the SFC Code does not have the force of law"[121] and rejected any "freestanding common law duty" on the part of the bank to ensure that any explanations given were accurate and complete.[122] The plaintiff in *Zillion Global Limited v Deutsche Bank AG*,[123] similarly a corporate vehicle that was allegedly mis-sold accumulators, failed on the basis that the bank owed no duty of care to provide advice even if such advice had in fact been provided.[124]

Cases where the general law has offered protection are rare and seem to apply only when plaintiffs are vulnerable and have good reason to be financially unsophisticated.[125] But such plaintiffs are rarely seen in ordinary circumstances; furthermore, the ordinary individual investor is unlikely to litigate.[126]

Even in *Crestsign Ltd v National Westminster Bank Plc*,[127] in which the English High Court recognised a very limited duty to accurately explain products in which the bank had volunteered an explanation of (the same duty that was rejected in Hong Kong), the threshold for the bank discharging its duty was extremely low. The remark of the judge in that case appears to sum up the common law position, even with all its variance, on this subject: "[w]hile the result may seem harsh to some, it is not the role of the common law and the Court to act as a regulator."[128] So it is back in the hands of the regulator to deal with this issue.

It may well be that the general law cannot offer much assistance to investors who have been provided poor advice. Hong Kong has attempted to ban such exclusions

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[119] See Part IV(B) of this paper.

[120] [2018] HKEC 2123 (HC Hong Kong).

[121] *Ibid* at para 104.

[122] *Ibid* at para 116.

[123] [2019] SGHC 165.

[124] *Ibid* at para 154.

[125] See *Chang Pui Yin v Bank of Singapore* [2017] 4 HKLRD 458 (CA Hong Kong) and *Als Memasa v UBS AG* [2012] 4 SLR 992 (CA).

[126] A recent example reported in Australia involved a farmer and his wife, who were categorised as sophisticated investors and invested the proceeds from the sale of their farm in a high-risk mining investment, which subsequently went sour. Mario Christodoulou & David Lewis, "How Macquarie Bank risked the retirement savings of its customers and got away with it" *ABC* (31 May 2018), online: ABC <https://www.abc.net.au/news/>.

[127] [2014] EWHC 3043 (Ch).

[128] *Ibid* at para 177.

or limitations of duty through an amendment to its HKSFC Code of Conduct in 2015,[129] but it is not clear yet what practical effect it will have.

Following from the above, it is suggested that incremental reforms cannot address the critical problems with a wealth test. The tests create an all-or-nothing framework: either an investor passes the test, in which case they are free to risk their assets with limited protection, or they do not, in which case they are locked out. But if this model does not appear workable, what can be done to strike a balance between investor protection and market access?

V. A Proposal for Reform

The problem of over-disclosure has been highlighted above.[130] Providing any investor with substantial disclosure in the context of a complicated product will not necessarily help them to understand how the product works or its risks. The lessons from behavioural finance show that investors can easily be overwhelmed by information overload and biased presentations.[131] This is the starting point for any reform: how do we ensure that investors *actually* understand what is before them?

Relying on non-adviser financial intermediaries such as bank officers to explain the product to investors is no solution. Such intermediaries may not actually understand or even have read the disclosure materials;[132] they will also rarely directly owe legal duties if the contracts are, as is usual, drafted in their favour.[133] A further problem is that the issuer, or the intermediary, of these products is responsible for preparing an expensive investor-facing prospectus or other documents. Leaving aside the high transaction costs, this creates an incentive not only for over-disclosure but also for clever selection and presentation of data; for example, a fund that is only a year old could state a hypothetical five-year return based on past data or put management fees or lockout periods in a footnote.

A move towards a pure 'consumer' model of investor regulation is equally unhelpful. The essence of consumer regulation is where "[t]he consumer is treated as incapable of informed consent to risk, so that the laws of supply and demand are judged not to operate virtuously, or even at all. The public sector intervenes paternalistically in the interests of fairness."[134] This model for investor regulation is unworkable in economies in which the state promotes financial self-reliance; the state cannot replace individual decisions. It can merely do its best to ensure that investors' consent *is* informed.

We therefore propose that one solution to this problem could be the implementation of a *complexity and risk rating framework* for complex products and abolishing the distinction between retail and non-retail individual investors at least as it pertains to the disclosure regime for complex products.

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[129] Hong Kong, HKSFC, *Consultation Conclusions on the Client Agreement Requirements* (December 2015) at para 39. R 6.5 now prevents a licensed person from incorporating any contractual terms "inconsistent with its obligations under the Code".

[130] See Part II(A) of this paper.

[131] See Part II(B) of this paper.

[132] For a discussion about this risk, see Godwin, "Lehman Minibonds", *supra* note 6.

[133] As discussed above in Part IV(D) of this paper.

[134] Joanna Benjamin, "Narratives of Financial Law" (2010) 30 Oxford J Leg Stud at s 2(E).

A. *Complexity-Risk Framework for Investment Products*

Financial products raise twin issues of concern to retail investors: risks and complexity.[135] To deal with the former problem, the market for investment products relies on how investment products are assessed for risks. However, a framework on complexity is lacking. In this regard, the Singapore regulators have previously had lengthy consultations; in 2014, MAS proposed a complexity-risk rating framework for investment products, where all investment products would be rated for complexity of structure and whether the investors could lose all, part, or more of their investment amount, and issuers of these products were required to rate them in the disclosure documents for retail investors.[136] However, the framework was shelved due to challenges in implementation and push-back from the industry. Instead, MAS replaced the framework with a list of excluded and non-excluded investment products, where the former category includes products that are considered to be generally understood by retail investors. In 2018, the legislation was amended to provide that all investment products that are sold to retail investors have to be classified as prescribed capital markets products (which are shares, plain vanilla bonds, real estate investment trusts ("REITS"), and CIS), or non-prescribed capital markets products, and have to be notified to the stock exchange or financial intermediary distributing these products. This classification requirement does not apply to products sold to non-retail investors.[137]

However, as discussed throughout in this paper, the fundamental problem with exempting non-retail investors, or bright-line tests in general (*eg* drawing a distinction between prescribed and non-prescribed products) is that experience suggests that *all* individual investors, regardless of wealth, may fail to understand the structure, nature, and risks of complex products even with adequate disclosure (and putting aside the more difficult question as to how a product might affect key outcomes). The classification of a product as a non-prescribed product will not in itself protect a retail investor; they could, for example, have been poorly advised by a bank officer that the investment is 'safe', as occurred with the sale of the Lehman minibonds in Hong Kong, or mistake a complicated non-prescribed product for a simple non-prescribed product that they had earlier experience with, or they could be overconfident about their chances. A more robust framework (which extends also to non-retail investors) is needed.

B. *Designing the Complexity-Risk Ratings Assessment*

At present, the regulator in the three jurisdictions examined in this paper will generally only intervene in disclosure-based regimes if disclosure has been insufficient or materially misleading. However, it has been proposed that ASIC be granted intervention powers, which will allow it to intervene and take temporary action based on poor

[135] See Schwarcz, *supra* note 26.

[136] Singapore, MAS, *Consultation Paper on Proposals to Enhance Regulatory Safeguards for Investors in the Capital Markets* (July 2014) [MAS, *2014 Consultation Paper*].

[137] *SFA*, *supra* note 72, ss 309A and 309B. See also Sing, MAS, *Response to Feedback Received—Consultation Paper on Draft Regulations Pursuant to the SFA and FAA* (June 2018).

outcomes, that is, where financial and credit products have resulted in or are likely to result in significant consumer detriment.[138] Even recent reforms to promote 'plain language' disclosure[139] may not be sufficient to solve the problem of over-disclosure. It is not difficult for issuers and intermediaries to craft documents to avoid liability with the knowledge that those investors who have *not* been diligent will fall victim to *caveat emptor*. Further, requirements to create short-form disclosure documents put the issuer/intermediary in a position of conflict: it wants to sell the product and present information concerning the product in the best light, but will also be forced to highlight the risks in a clear, concise, and effective manner.

A possible solution is to have the regulator design a template *risk and complexity statement*. This would be prepared in respect of a financial product, provide a description of the product, and outline the level of risks and complexity for investors. It would enable investors to assess whether the product meets their needs when measured against their risk appetite, their financial literacy, and their financial experience.[140] It would also enable financial advisers, when engaged by an investor, to advise more effectively. Such statements would *not* advise on the merits of the investment and would merely present material information in relation to risk in a clear and neutral manner unencumbered by any potential conflicts of interest.

One example of a similar approach can be found in MAS' 2014 proposals to introduce a complexity framework that issuers would be obliged to use to rate their products.[141] This was to be a simple quantitative score indicating, on a scale of four to 18, how complex a product was, for ease of scoring. Regulators could partner with researchers to develop frameworks[142] or develop such frameworks in-house. This paper does not offer an opinion on what the contents of such a framework should or must be. Regulators are, and should be, free to develop one which works in the context of their financial industry. All we suggest is that given the proposals that follow, regulators may wish to move beyond a simple quantitative score and permit descriptions in simple language.

Unfortunately, the MAS framework was never implemented because of industry pushback; as earlier discussed, the industry did not wish to be responsible for producing these ratings. Neither Hong Kong nor Australia has attempted to impose a complexity framework through regulation yet.

Given the Singaporean experience with industry pushback, adopting such a framework would likely require an independent party to carry out such ratings. It may be that credit rating agencies are one possible solution. For example, an Australian company, Australia Ratings, advertises itself as Australia's only rating agency to carry a

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[138] See Austl, ASIC, *19-157MR ASIC Consults on New Product Intervention Power Use* (26 June 2019), online: ASIC <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2019-releases/19-157mr-asic-consults-on-new-product-intervention-power-use/>.

[139] See Godwin & Ramsay, "An Empirical Survey", *supra* note 30, and Godwin & Ramsay, "A Comparative Analysis", *supra* note 30.

[140] A similar innovation—in the form of a "risk awareness statement"—was suggested in Godwin, "Lehman Minibonds", *supra* note 6.

[141] See MAS, *2014 Consultation Paper*, *supra* note 136.

[142] One example can be found in Benedict SK Koh *et al*, "A risk-and complexity-rating framework for investment products" 71:6 (2015) Fin Analysts J 10, which originated in a project commissioned by the Investment Management Association of Singapore. This was later used by MAS in developing their framework.

retail Australian Financial Services License that "enables both retail and wholesale investors to use our credit ratings to help them gauge credit risk and complexity of financial products sold in the Australian market".[143]

C. *Funding the Complexity-risk Ratings Assessment*

In view of the costs involved in obtaining such ratings, we propose that a two-stage framework be adopted: a product that is classified as inherently non-complex (such as MAS's prescribed capital markets products) should not require a rating in order to be sold to individual investors, but all other products, if desired to be sold to an individual investor, must be assigned a rating by an independent agency.

It is unlikely that the current private sector rating agencies will suffice. Even if agencies obtain the necessary licenses and are willing to take on the legal risk of providing such ratings—a risk that may result in claims that they provided financial advice—the ratings must be paid for. It is uncertain whether the ordinary consumer investor (retail or non-retail) would pay additional fees to obtain these ratings. The costs would need to be borne collectively by investors and may not even be workable financially; it may be that there is simply not enough funding for an investor-pays model to support adequate analysis of complex products.[144] Alternative funding models are equally problematic; requiring financial intermediaries and issuers to obtain ratings from private agencies may lead to conflicts of interest.[145]

Further, it is difficult to ensure that private rating agencies can produce meaningful and accurate reports. These agencies, especially smaller ones, may not have the expertise or experience to deal with complex products. The 2008 financial crisis revealed that a number of complex products were seriously overvalued by credit rating agencies.[146] Having the regulator supervise every single accredited credit rating agency for the purpose of rating complex products to ensure their competency would be unworkable in practice. A problem of 'ratings shopping' may also arise; issuers will have the opportunity to approach multiple agencies and select the most favourable one to them.[147] Worse still, it appears that creating new private-sector agencies may be counterproductive. Empirical data appears to show that a competitive market for rating agencies actually *increases* the bias of ratings.[148] In addition, it has been argued that a private sector rating agency merely functions as a 'regulatory license' provider; obtaining a rating increases value by ticking a checkbox

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[143] Australia Ratings, "About Us", online: <https://www.australiaratings.com/about-us/australia-ratings>.

[144] Tin A Bunjevac, "Credit Rating Agencies: A Regulatory Challenge for Australia" (2009) 33 Melbourne UL Rev 39 at 57.

[145] See Leo Tang, Marietta Peytcheva & Pei Li, "Investor-Paid Ratings and Conflicts of Interest" (2018) J Bus Ethics at 1-14, which suggested that both investor-paid and issuer-paid ratings agency funding models result in actual bias in ratings.

[146] US, SEC, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies* (8 July 2008), online: SEC <https://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

[147] See Skreta & Veldkamp, "Ratings Shopping and Asset Complexity" (2009) 56:5 J Monetary Econ 678 at 690.

[148] Bo Becker & Todd Milbourn, "How Did Increased Competition Affect Credit Ratings?" (2011) 101:3 J Fin Econ 493.

on a regulator's list, rather than functioning as an independent analyst regarding the fundamentals of the product.[149]

We therefore recommend that the public sector, *ie* the regulator, intervene. A possible solution would be for the regulator, together with industry, to create an independent, non-profit body that would appoint or employ qualified raters to assess products that are submitted to it. A model involving the creation of a body by the regulatory and the industry is Singapore's Financial Industry Disputes Resolution Centre, an independent mediation-arbitration institution funded by the financial industry as a whole to provide alternative dispute resolution between industry and consumers.[150] Similarly, a small levy on industry, combined with a fee payable by any issuer seeking a rating, might fund a product complexity rating agency, which would be responsible for completing the template complexity and risk forms and, if necessary, providing a short write-up or explanation of the product in an unbiased manner and in simple language. The industry should commit to providing the necessary documents to the body and to communicate candidly with this body, failing which they will not be able to obtain a rating.

In order that industry buy-in can be achieved, it is proposed that the regulator not be involved save in the governance of the body and ensuring the qualifications of the panel of raters. There should be no 'appeal' process to the regulator by industry, and no public disagreement by the regulator regarding the rating of a particular product. The regulator should use other tools to deal with potentially contentious products. The regulator's participation is merely to provide the rating framework and to issue interpretations of the framework only if absolutely necessary. This participation would, in short, function as an investor-education tool.

Of course, the backing of the regulator is necessary for the public to have confidence in the body, but the independence of the panel of raters should be stressed. The regulator must not be seen to be either promoting or discouraging investment in any particular financial product. To the extent that the risk sections of the regulator-provided template deal with risk, we agree with MAS' observation that "[a] 'low' risk rating may generate false comfort for investors, when the product could turn into a 'high' risk one over a short span of time".[151] The function of this panel is to present data in a layperson-friendly manner, not to advise investors on products. As such, we propose that the template should not rate a product on whether it is 'risky'. Rather, it should replicate the ideals of the present disclosure regime in terms of outlining the level of risks and complexity for investors. Presently, private issuers have incentives to obfuscate and over-disclose the risks presented in their documents. The mandate of the panel will be to present these same risks, but only the relevant ones, and in a clear and concise manner. It is for other institutions, including credit rating agencies, to actually say whether a product *is* risky or not.

The risk-rating framework would sit alongside—or be incorporated within—the disclosure document prepared by the product or securities issuer and would hopefully reduce the length of the disclosure document and over-disclosure to the public. It is

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[149] Frank Partnoy, "The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies" (1999) 77 Wash U L Q 619.

[150] See Shahla F Ali, "Financial Dispute Resolution in Singapore" in Shahla F Ali, *Consumer Financial Dispute Resolution in a Comparative Context* (Cambridge: Cambridge University Press, 2013) at ch 6.

[151] See MAS, *2014 Consultation Paper*, *supra* note 136.

also hoped that this would ultimately reduce the transaction costs involved in creating a financial product or issuing securities—and would therefore encourage more (but still responsible) financial innovation.

It is suggested that this approach would combine the principles of a disclosure-based system with the benefits of an active regulator—investors are free to purchase whatever they wish, but the approach, through the regulator-prescribed complexity-risk rating, would increase the likelihood that they would make a decision on the basis of informed consent.

D. *Investor Access to Complex Products—A Financial Capacity, Experience, or Literacy Test?*

Notwithstanding the above-suggested reform, it is possible that investors may still fail to understand the nature or risks of a complex product even after it has been rated and described accurately to them. It may be necessary to impose further restrictions, especially since this framework is meant to replace the retail/non-retail investor distinction.

We therefore propose that regulators, to supplement the rating scheme, prescribe a test to assess whether an individual investor is in fact suitable to purchase these products. This test would be administered by a licensed financial intermediary, eg, a financial adviser or a bank. To ensure that industry is not burdened with administration and liability issues, an investor would be permitted to purchase such products if any one of the following requirements is met:

(a) the investor has not more than a certain percentage of their investment portfolio in complex products;
(b) the investor certifies that they have had previous experience with, including having traded in, products of that category;
(c) the investor passes a simple test regarding the product category; or
(d) the investor has attended and completed a certified course regarding the product category.

The first criterion permits investors who wish to simply take the risk to do so, provided that they are sufficiently diversified. The second permits experienced investors to continue investing in products with which they are familiar. The third, which may be administered by the regulator or the independent ratings agency (it is unlikely that financial intermediaries would wish to administer it), allows investors who demonstrate relevant financial literacy to purchase the products. The fourth criterion encourages investors to improve their financial literacy—and may provide the rating agency with an alternative source of funding.

VI. Conclusions

We have suggested in this paper that the 'non-retail individual investor' category may not achieve the purpose for which it was designed. All individual investors—whether wealthy or not—may have the same difficulties understanding the risk and complexity of the financial offerings available to them. However, these investors

are expected to be responsible for preserving and growing their savings and must be allowed opportunities to take suitable financial risks. Mandating more or less disclosure is unlikely to make a real difference; what is needed is a framework that directly addresses investor weaknesses, whether relating to understanding, capacity, or capability.

We have therefore proposed that regulators consider a different framework as a basis for regulating financial consumers. Incorporating lessons learned from behavioural finance and psychology, regulators should start by considering the question 'how do we help investors understand and make financial decisions?' rather than the question 'how do we ensure investors have sufficient information to make an informed decision?', which has been the focus of the disclosure regime to date. This paper offers one such framework.