Comments and Feedback on:

Consultation Paper on Proposals to Enhance Regulatory Safeguards for Investor in the Capital Markets (Consultation Paper P012-2014/ July 2014).

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Part I – Safeguards for Investors in Non-conventional Investment Products

On the proposed regulation of precious metals buy-back arrangements (Comments on Q. 1-4).

1. The broadening of securities regulation to include buyback arrangements involving gold and other precious metals is one to be welcomed. For the sake of convenience, references to 'gold' in this submission should be taken as shorthand for "gold and other covered precious metals".

2. Generally, such schemes involve a 'purchaser' paying over a sum of money for gold on the vendor's promise to subsequently 'repurchase' it at a higher price. However, there is invariably no delivery of the gold. If the purchase factually resulted in the physical delivery of the precious metal, the purchaser would at the minimum have the security of a physical commodity which may be sold on the gold market.

3. The structural problem with such schemes is twofold. Firstly, the price paid by the purchaser is invariably much higher (upwards of twenty percent) than the prevailing market price[1]. Purchasers are not often made aware of this fact. This implies that the vendor must generate returns higher than this 'premium' in order to be realistically able to honor the repurchase clause and 'repay' the purchaser. The possibility of such high returns is usually unattainable without the assumption of substantially risky investment strategies, and such vendors habitually use incoming funds from later purchasers to repay earlier purchasers – an

[1] Vendors often claim that the gold is sold at market price but such market price refer to prices of jewelry retail which is already marked up as compared to the price that which banks offer.

unsustainable situation which often leads to the vendor's eventual insolvency and the loss of monies by later investors.

4. Secondly, while the purchaser has, in theory, the right to ask for physical delivery of the gold, the terms and incentives of the contract usually seek to discourage this by imposing onerous conditions, by additional transaction fees in order to take delivery, or by promising higher returns on repurchase in exchange for an election not to take delivery. As such, few - if any - purchasers take delivery of the gold. The end result is that if (or when) the vendor is unable to honor the repurchase clause, such purchasers usually have only a *personal claim* against the vendor; at best, they are left with a dubious proprietary claim over unappropriated (and usually unsegregated) physical assets.

5. The way in which such 'arrangements' are marketed take advantage of the *perception* of potential investors that they have access to something 'physical' and 'concrete'. In short, such schemes convey the impression of ownership or security interest over a physical asset. This, of course, does not accord with reality since (as explained in paragraph 4) the contracts tend to be structured such that the investor is strongly disincentivised against acquiring any effective proprietary interest. It is this expectations gap which needs to be addressed in order to effectively inform or educate potential investors in such schemes.

6. The proposed new regulatory regime on buy-back arrangements locates the threshold in the arrangement having the "purpose or effect of … enabling [the purchaser] to receive a financial benefit from [the vendor]."[2]

7. A simple sale contract in which a gold vendor sells at market price and physical delivery is made would not be covered by the new regulatory regime. This position is the right one to take – for even if the purchaser is speculating on gold, he is not taking on the credit risk of the vendor. Such a simple sale contract is, quite correctly, not covered by the new regulatory regime. It is the buyback add-on which changes the complexion of the transaction and places it within the ambit of the proposed regime.

8. However, it should be observed that the addition of a buy-back promise in these circumstances is actually quite unobjectionable *as long as the pricing of the put-option is transparent and fairly priced*. It does not merit the full slew of regulation under Part XIII of the Securities & Futures Act. The issue here resides with *transparency* in the pricing of the put-option. In its over-inclusiveness, therefore, the proposed regulatory regime potentially levies a high transaction cost on otherwise fairly priced

[2] The full text also extends to an arrangement considered to have the 'purported purpose or effect' of enabling the purchaser to receive a financial benefit from the vendor: proposed reg 3(2) in Annex 2.

buyback arrangements through the presumptive requirement for a prospectus.

9. This points us to another issue – that of regulatory design. The general disclosure obligation found in SFA s. 243 requires the disclosure of all relevant information that investors and their professional advisers require in order to make an informed decision on the nature of the security and the risks associated with it. In theory, a disclosure based regime posits that the issuer who makes adequate disclosure should be entitled to register and sell the contemplated securities. Worked to its logical conclusion, there should be nothing to stop the registration of the prospectus if the vendor merely says that the company is in the business of buying and selling gold, provided of course that full information is given of the affairs of the business entity. If the disclosure regime is to hit at the heart of the matter, the investors must be made acutely aware that the depositor is essentially operating as a deposit-taking business. Section 243, however, does not clearly require candid disclosure of what the transaction *functionally* entails.

10. While superficially selling gold, the vendors were in substance borrowing money from the public. The promise that gold can be delivered is functionally a *promise* to provide collateral for what is essentially a loan transaction. By bringing such gold buyback arrangements within Part XIII of the SFA, the proposed regulation should be lauded for placing what is functionally a fund-raising exercise within Part XIII.

11. The regulator must, however, by way of further regulations, bring up the functional ramifications of the transaction design. Selling gold at a high premium on the market price with built-in incentives not to take delivery cannot in honesty be termed a good faith sale of gold. It may tick the boxes if one takes a formalistic legal approach to characterizing the transaction. Candor and honesty in disclosure requires going beyond the formal legal characterization to what it substantively is – a collateral available to the investor only at a high price. The investor needs, therefore, to be acutely aware that the promise for delivery of gold is what it is – *merely a promise*. There is actually no collateral unless the gold is appropriate or delivered. In this regard, there needs to be an explanation of what counts as appropriation – for the law on when a 'buyer' acquires an effective proprietary interest in goods is by no means one well-understood by the man in the street. Professional advisers may know what this means – if they have sufficient legal background. Similarly, the investor with good legal knowledge may appreciate the complexities of appropriation in the acquisition of a proprietary interest over goods. However, one cannot expect the average man in the street to appreciate that any suggestion of collateral or ownership is illusory without the payment of substantial transaction costs required by the terms of the arrangement. *Caveat emptor* would do little to stem the criticism against the regulator that the risk is embedded in complex legal

concepts that the common investor does not appreciate, and that little has been done to draw out the illusory nature of the collateral.

12. In addition to requiring the vendor to highlight the functional equivalence and hence preclude the vendor from hiding behind the legal characterization, we recommend that for mass marketed products, there should be a mandatory summary page for each product. This should set out in plain language: the principal terms of the bargain, provide a comparison between the contract price and market price of gold, the steps necessary to acquire an effective proprietary interest (whether in the nature of ownership or security interest). The extent to which the purchaser is taking on the credit risk of the entity should also be set out.

13. We end this segment with comments on the room for circumvention. The regulatory regime, as presented drafted, provides room for circumvention. First, it catches only acquisition of *legal* title to precious metals. It will not cover the scenario where the transaction is structured such that the vendor is the constituted the legal title holder of gold, while the purchaser holds only *beneficial* interest. Second, financial benefit is defined by reference to payment. Technically, a promise to deliver marketable securities would fall outside the ambit of the regulation – the vendor would not be *paying* a sum of money or money's worth. Similarly, if the vendor's promise consists of a delivery of gold which is coupled with a promise by a third party 'guarantor' to purchase the gold at a higher price, the investment would not be caught by the regulation since it covers only a promise to pay made by the vendor.

Summary of comments on proposed regulatory changes concerning buy-back arrangements involving precious metals.

14. Classifying such transaction covered by the regulation as a 'debenture' speaks to its functional nature. However, this label is not one readily understood by the general public. Indeed, lawyers debate over the precise meaning of a debenture at common law. The MAS must require candid disclosure of the functional nature of the transaction. If it functions like an unsecured loan, this should be made clear to the public. The investor needs to be aware that the realization of his expectations depends critically – or even solely – on the promisor's ability to honor his promise. If the promisor is insolvent, the investor in practical terms loses everything he has invested.

15. If the acquisition of gold functions in a manner which disincentives the acquisition of a proprietary interest over the gold, the nature of the disincentive and the cost of obtaining that collateral or proprietary interest needs also to be made manifest. Only then can the investor see that the investment functions, without more, as a mere promise to pay. The vendor cannot be permitted to hide behind the *illusion* of collateral. If acquisition of a legally enforceable proprietary interest comes at a cost, that cost needs to be set out in clear terms.

16. We suggest a need to pay attention to accurate labeling from a functional perspective. A buy-back scheme that involves a higher transaction cost to obtaining physical gold should not be permitted to be described as a gold buy-back scheme *sic et simpliciter*. Neither would terming it a "debenture involving gold buy-back arrangement" suffice. If it functions as a loan to an entity, that functional nature should be highlighted along with the credit risk that one is being asked to assume.

<u>Part II – Complexity-Risk Ratings Framework</u>

On the proposal to introduce a Complexity-Risk Ratings Framework (Comments on Q 1-3)

1. One of the main regulatory concerns stated in the MAS Consultation Paper (Part II, at Para 1.2) is that retail investors may face difficulties in understanding the risk-return profiles of complex investment products, especially if such products have derivatives embedded in their structures which are not purely for hedging purposes. Common examples of such products available at the time of writing this response paper include FX-related structured products such as Dual Currency Investments (DCI) and Accumulators. Therefore, the paper proposes to ameliorate such difficulties by introducing a 2-dimensional 'complexity-risk ratings framework'.

2. While this response paper broadly agrees with the proposed *methodology* used to rate both complexity as well as Risk (at Part II, paras 2.4 and 2.12 respectively), what is of concern is whether such ratings are *effective* in conveying product risks to the *average non-finance literate investor*.

3. Of particular concern is the risk bucketing approach (as illustrated by Table 2 of Part II), which uses generic descriptions such as 'low', 'medium', 'high' etc for each category. The problem with such labels is that they tend to be subjective and opaque. A product labelled as being of 'medium' risk by an independent regulatory rating body does little to inform the average person-in-the-street as to *how much* she stands to lose, and *under what conditions*. At first glance, it leaves her with merely a *general idea* as *to what a third party thinks of the product*, and nothing *objective* upon which to act or to exercise her own rational judgment on whether she is willing to accept the product risks and invest.

4. Although it is arguable in counter-point that such an investor should read the product prospectus and plot her own payoff tables to determine what the objective payoff would be under different circumstances, demanding so is likely to be counterproductive since the whole point of the exercise is to present the retail investor with accessible, objective, and most importantly, easily-understood information. It is unlikely that a non-financially literate person would be able to plough through tens (if not hundreds) of pages of prospectuses, and unrealistic to expect that they would understand every part of it.

5. Thus, this response paper suggests a simplified alternative which may objectively convey the salient features which all investors require to assess risk: a binary pay-off table (See Tables A-C below).

Table A

Product: NZD/SGD DCI Accumulator		
Situations	**Positive Return**	**Loss**
Current Price: 0.95 SGD	**0%**	**0%**
Price of NZD rises above 1.1 SGD	+11%; No additional return	
Price of NZD rises to 1.07 SGD	+11%	
Price of NZD rises to 1.05 SGD	+10%	
Price of NZD falls to 1.0 SGD		-50%
Price of NZD falls below 0.9 SGD		**-100%**
Price of NZD falls to 0.85 SGD		**-150%**

Table B

Product: Synthetic Bond with Embedded Events of Default		
	Positive Return	**Loss**
US 3month Treasury rises to xx%	+10%	
US 3month Treasury falls to xx%		-50%
Reference Entity experiences an event of default*		**Up to -100%**

*List of Reference Entities with Credit Ratings: Company X (BBB), Company Y (ABB)

Table C

Product: Gold Buyback Scheme		
Current Price:	**1280.61 USD / oz**	
Investor's Purchase Price:	**1383.06 USD / oz**	
Situations	**Positive Return**	**Loss**
Price of Gold rises by 10% USD	+5%	
Price of Gold rises by 8% USD	**0%**	
Price of Gold rises by 6% USD	**0%**	
Price of Gold rises by 4% USD	**0%**	
Price of Gold rises by 2% USD	**0%**	
…		

6. As seen in Tables A and B, objective information would be presented in a simple binary in order to illustrate (a) under what circumstances the investor may expect positive or negative returns as well as (b) the quantum of the return. Such information is often the most immediate and relevant information which such retail investors would attend to. This enhances the efficacy of the disclosure. In addition, financial jargon such as "spot price" and "strike price" should be avoided or minimized in favor

of clear and simple language such as "current price" and "contracted buying/selling price" in order to prevent confusion.

7. Requiring this table on the front of any product 'summary' sheet forces the product seller to simplify complicated structured products which may embed derivatives into a simple objective payoff chart like the one above, which when split into binary form, is easy for retail investors to understand and exercise their judgment upon.
8. While it is acknowledged that certain risk factors such as events of default (common in Collateralized Debt Obligations) are difficult to quantify, such risks may still be brought to the attention of the investor. This can be seen in Table B. In addition, credit rating agencies' ratings of each 'reference entity' may be displayed alongside each entity (if listed) in order to give investors a *prima facie* gauge of the creditworthiness of each entity.
9. In addition, tax dollars may be saved by requiring product sellers to themselves calculate this and incorporate this information, since no independent committee need be formed to analyze each product and to formulate a risk profile.
10. Lastly, the complexity rating system (layers of derivatives) should be retained since it encapsulates information which would alert investors to the presence of multiple level Credit-Default Obligations (especially in the context of multi-level securitization instruments). Such information is not otherwise easily captured in the suggested table format above.

Part III – Refining the Investor Classes under the SFA and FAA

On the proposed amendments to AI classification

1. The proposed adoption of an opt-in regime for accredited investors ("AI") is desirable for it provides an additional level of protection by having the investor make an informed decision as to whether she is to be subject to a lower level of investor protection.

2. In contrast, the original regime was an automatic classification regime in which an investor who meets the statutory criteria of an AI will be automatically classified as such. Thus, there are situations in which investors are classified as AI without their being aware that they have been classified as such and without their awareness of the consequences of being so classified.

3. As can be seen in recent litigation of *Deutsche Bank v Chang*[3], the level of vulnerability of an investor is not something that is easy to determine in light of the increasing complexity of financial products. As such, an automatic AI classification does not afford sufficient protection for

[3] [2013] SGCA 49

investors. The refinement by way of inclusion of an opt-in regime is very much desirable by giving assurance that the investor has opted for a lower level of protection freely and in an informed manner.

4. That said, the statutory criteria for AI still performs an important role in filtering out people who the law views should not be able to freely consent to a lower level of investor protection. Lower levels of investor protection can be justified only where the law deems the person to not require the full suite of regulatory protection. For instance, where a person has a net personal assets beyond a certain prescribed amount, the law presumes that such a person has the full ability and means to seek financial advice and should justifiably be allowed to exclude herself from statutory protection. It is therefore submitted that retaining the statutory criteria for AI classification is rightfully retained and where there are suggestions to waive such requirements for certain investors, there must be a substantial justification before the criteria can be waived.

5. In the absence of further justification, the extension of accredited investor classification to joint account holders who are not AI is not desirable. The level of regulatory protection afforded to an investor should track the investor status possessed by that investor. Being a joint account holder with an AI does not intrinsically change the investor characteristic of a person and does not justify an investor being afforded less protection even if it is on a limited basis.

6. In effect, the deeming of non-AI joint account holders as meeting the AI criteria is a removal of a threshold level of protection afforded to other potential AIs. If the opt-in mechanism proposed by MAS is adopted, the AI classification affords a two level protection regime to potential AIs. The first level of threshold protection is the criteria the potential AI has to meet in order to be classifiable as such. The second level consists of the opt-in mechanism which operates on the informed consent of the potential AI. While the opt-in mechanism will reduce the importance of the AI criteria, the threshold level of protection provides a certain degree of assurance that a normal retail investor will not be able to easily contract himself/herself out of the full measure of regulatory protection.

7. Merely being a joint account holder with an AI does not provide justification for deeming such joint account holder as an AI in respect of that joint account. A *prima facie* meaningful relationship as between the AI and the joint account holder should not enter into the calculus of determining whether to afford less protection to the joint account holder.

8. We end this section with a suggestion in the refinement of the S$2 million monetary threshold in the AI definition. In respect of limiting the contribution of the net equity in an individual's primary residence in the computation of a person's net assets for AI classification, it is suggested that CPF amounts also be limited in the computation of net personal assets. At the current S$2 million threshold, the CPF minimum sum of

S$155,000 and a net equity in the primary residence of S$1 million, it is possible to envision an investor meeting the S$2 million threshold with more than 57% of his net personal assets comprising of illiquid assets and/or retirement funds. As much as it is undesirable to allow a person whose assets consist in bulk of his/her primary residence to opt in as an AI, it is also undesirable for a person whose investor consists in bulk of his/her primary residence and CPF to be able to freely opt in to a reduced level of investor protection. Such investors should likewise not be seen as having the means to seek professional advice because like the primary residence, CPF as an asset is illiquid and not freely available for drawdown until the drawdown conditions are met. Even at drawdown age, such monies are meant to provide for a basic livelihood and should not be too readily accessible for purposes of potentially risky investments.

30 August 2014