INSIGHTS FROM CFA SOCIETY SINGAPORE

By CFA Singapore Advocacy Team

Assessing the suitability of complex financial instruments

A client's knowledge and financial situation must always be considered before an investment is recommended

REMEMBER Lehman Brothers? Or more specifically, Lehman Brothers minibonds?

Thousands of retail investors attracted by higher yields compared to fixed deposits in Singapore lost their savings investing in Lehman Brothers' minibonds. It was especially painful for some who plunged their hard-earned retirement savings into these complex structured products. The bankruptcy filing of Lehman Brothers in September 2008 in the US rendered the bonds issued by the company and distributed by Singapore financial institutions worthless.

There was intense anger.

Many turned up at Hong Lim Park to seek redress. At the public space for public protest in the city-state, participants swamped reporters to air their grievances. There were claims that the money lost meant inability to treat life-threatening illness. There were investors in their twilight years lamenting the inability to recoup losses to their savings as they do not have many productive years left. There were also allegations of mis-selling by financial advisers especially when the less-educated investors put a substantial proportion of their retirement savings into products they could not understand and of a higher risk. Were the complex financial products suitable for these investors?

Duty to clients: the suitability standard

Investment advisers have a duty to consider carefully the needs, circumstances, and objectives of clients, when determining the appropriateness and suitability of a given investment or course of investment action. An appropriate suitability determination will not, however, prevent some investments or investment actions from losing value.

In judging suitability, the adviser should review many aspects of the client's knowledge, experience related to investing, and financial situation. These aspects include, but are not limited to, the risk profile of the investment as compared with the constraints of the client, the impact of the investment on the diversity of the portfolio, and whether the client has the means or net worth to assume the associated risk. The investment professional's determination of suitability should reflect only the investment recommendations or actions that a prudent person would be willing to undertake. Not every investment opportunity will be suitable for every portfolio, regardless of the potential return being offered.

The responsibilities of gathering information and making a suitability analysis before making a recommendation falls on those professionals who provide investment advice in the course of an advisory relationship with a client. Others, who are simply executing specific instructions for retail clients when buying or selling securities or issuing research reports as sell-side analysts, may not have the opportunity to judge the suitability of a particular investment for the ultimate client.

Know your client (KYC)

In the recently released CFA Institute "Sales Inducements in Asia Pacific" report on review of sales and distribution of mutual funds, the three authors from the Asia Pacific office – Mary Leung, CFA; Sara Cheng, JD; and Piotr Zembrowski, CFA – set out guidelines for suitability assessment.

Suitability rules and KYC steps

The Monetary Authority of Singapore's Financial Advisers Act (FAA) suitability rule requires financial advisers to have a reasonable basis when they recommend an investment product. A financial adviser should take all reasonable KYC steps and ensure that recommendations are suitable, taking into account the client's financial objectives, risk tolerance, financial situation, investment experience, and particular needs.

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Product due diligence and "know your product"

Not only are financial advisers required to "know your client", they are also required to "know your product" before selling an investment product to customers. MAS regulation requires financial institutions to offer products and services that are suitable for their target customer segments. They must undertake due diligence on any investment product that they intend to distribute, taking steps to tailor to customer profiles, investment objectives, and financial literacy of their target customer segments.

The due diligence process includes a thorough review of the product's features such as risk rating and complexity. In this regard, intermediaries often set up a new product committee that is cross-divisional and includes relevant functions of the business – including legal, compliance, risk, operations, and information technology – to review, assess, and provide a risk rating and approve the product for target customer segments.

Case study

Today's case is based on a US-based FINRA (Financial Industry Regulatory Authority) enforcement action from 2015.

Mark is an asset manager in Singapore. Residents receive tax advantages by investing in local securities. To capitalise on this advantage, Mark's firm offers clients shares in a closed-end investment fund, organised under local financial laws and regulations, that holds at least 67 per cent local securities and is permitted to borrow against up to 50 per cent of its assets. The fund is usually leveraged to the extent legally permitted.

Many of Mark's clients have a modest net worth and conservative or moderate investment objectives. Mark convinces them to invest 85 per cent or more of their assets in shares of the closed-end fund. Mark's actions are:

A. Appropriate because they take advantage of the fund's unique tax benefits for his clients.

B. Inappropriate because the fund uses leverage to boost returns.

C. Appropriate as long as Mark fully discloses the risks and benefits of the fund to his clients.

D. Inappropriate because the fund is an unsuitable investment for his retail clients.

Analysis

In this case, given the favourable tax advantages of the investment vehicle, investment in shares of the closed-end fund may be suitable and appropriate for Mark's clients at some level. In addition, the fund's use of leverage may not be inappropriate or make the investment unsuitable.

That said, Mark should always fully disclose the risks and benefits of his recommendations to his clients.

Given the financial circumstances and investment objectives of his clients, the high concentration of the fund's shares in his clients' accounts combined with the leverage make the weighty investment in the fund unsuitable. Despite the favourable tax advantages, highly concentrated clients bear the increased risk that a single market event affecting the value of the fund's shares would significantly decrease their total account value. This risk is exacerbated by the fact that the closed-end fund is internally leveraged, which could magnify the fund's loss during a market event that causes share values to drop steeply. Choice D is the best response.

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The writers are CFA Charterholders who volunteer with the Singapore society on advocacy issues with a view towards promoting financial literacy among retail investors and improving overall standards and integrity in the industry. Should you have comments and feedback, do write to the CFA Society Singapore Advocacy Committee: advocacy@cfasingapore.org