CONSULTATION PAPER

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Proposed Changes to the Complex Products Regime

Monetary Authority of Singapore

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1 Preface

1.1 The MAS complex products regime was first put in place in 2012 following the global financial crisis, in line with developments internationally to enhance investor protection. Financial innovation has since led to an increasing number of investment products with more complex risk-return profiles being manufactured and marketed to retail investors. Access to a wider range of products is beneficial to investors, as it provides them with more options to direct their investments according to their investment objectives. However, with increasing product complexity, investors may face difficulties in understanding the risk-return profile of a product, and how their expected payoffs will vary under different scenarios.

1.2 The objective of the complex products regime is to aid retail investors in better understanding the features and risks of a complex product before transacting in one. MAS prescribes a list of products which are well-established in the market and have terms and conditions generally understandable by the market, termed Excluded Investment Products (EIPs). Products that do not fall within the prescribed list of EIPs are regarded as more complex products, also referred to as Specified Investment Product (SIPs), and must be sold with enhanced distribution safeguards. These safeguards include requiring intermediaries to assess a customer's investment knowledge and experience before the customer invests in an SIP.

1.3 Since its implementation, MAS has periodically updated the complex products regime to take into account industry developments and market feedback. The prescribed list of EIPs has been refined from time to time to facilitate retail investors' access to a broader range of relatively simple investment funds.[1]

1.4 To further enhance and update the complex products regime, MAS invites comments from interested parties on the proposals set out in this consultation paper. The proposals cover–

[1] In general, investment products that are listed on overseas exchanges or involve the use of derivatives are classified as SIPs. In 2012, MAS allowed intermediaries to classify investment products listed on overseas exchanges as EIPs, if they are able to determine that such products are equivalent to an EIP. Further, in 2015, MAS allowed funds that invest only in simple products such as shares or gold to be classified as EIPs, if the use of derivatives is for efficient portfolio management including the hedging of risks.

(i) the classification of collective investment schemes, debentures, perpetual securities and preference shares as either EIP or SIP; and

(ii) the distribution safeguards that apply to the sale of SIPs.

1.5 In developing the proposals, MAS seeks to maintain the balance between providing retail investors with access to a wide range of investment products and having in place sufficient safeguards to aid investors in making informed investment decisions.

1.6 Please note that all submissions received will be published and attributed to the respective respondents unless they expressly request MAS not to do so. As such, if respondents would like:

(a) their whole submission or part of it (but not their identity), or
(b) their identity along with their whole submission,

to be kept confidential, please expressly state so in the submission to MAS. MAS will only publish non-anonymous submissions. In addition, MAS reserves the right not to publish any submission received where MAS considers it not in the public interest to do so, such as where the submission appears to be libellous or offensive.

1.7 Please submit written comments by 15 December 2021 at the following link -

https://form.gov.sg/6180f73502e9a70015c06944

1.8 Should you encounter any technical difficulties in your submission, you may submit your comments to –

Markets Policy and Infrastructure Department
Monetary Authority of Singapore
10 Shenton Way, MAS Building
Singapore 079117
Fax: (65) 62203973
Email: mas_mcp@mas.gov.sg

2 Complexity Criteria

Collective Investment Schemes ("CIS")

2.1 Currently, only CIS that invest in simple products such as shares or gold and use derivatives solely for the purpose of hedging or efficient portfolio management are classified as EIPs.[2] These investment restrictions are required to be disclosed in the CIS prospectus.

2.2 MAS has observed that there are CIS that generally meet the investment restrictions but maintain residual discretion to invest a small part of investor funds outside the scope of its primary investment approach. As a result of retaining this residual discretion to invest in products in addition to those listed in the current EIP-CIS criteria, these CIS are classified as SIPs.

2.3 MAS considers that there are merits to expanding the EIP-CIS criteria to allow retail investors easier access to a wider choice of diversified and professionally managed funds in their investment portfolio.

2.4 Offers of units in a CIS to investors in Singapore are regulated under Division 2 of Part XIII of the SFA. Unless exempted, an offer of units in a CIS must comply with the following requirements:

(a) The CIS must be authorised (if it is constituted in Singapore) or recognised (if it is constituted outside Singapore) by MAS; and

(b) the offer of units in a CIS must be made in or accompanied by a MAS-registered prospectus and product highlights sheet (PHS).

2.5 All authorised and recognised CIS are therefore regulated under the CIS Code, which sets out detailed rules on the management and operation of schemes. These include rules on permissible investments, diversification requirements and concentration limits, which limit the risks (e.g. counterparty risks in derivatives) to investors.

2.6 Given that such funds that are offered to retail investors are already well regulated under the CIS Code, MAS proposes to classify all authorised and recognised CIS

[2] This is set out under the Securities and Futures (Capital Markets Products) Regulations 2018. The same approach applies in determining whether sub-funds of investment-linked policies are EIPs/SIPs.

(and correspondingly ILP sub-funds that invest in authorised/recognised CIS[3]) as EIPs, except for a small group of more complex funds. Expanding the scope of EIP-CIS in this way will make it easier for retail investors to invest in diversified and professionally managed funds, including exchange traded funds (ETFs).

2.7 As mentioned in paragraph 2.6, there is a small number of more complex funds that employ alternative investment strategies, or embed unique features not typically encountered in traditional funds[4]. These types of more complex funds are currently subject to additional disclosure requirements[5]. In view that retail investors may be less familiar with these funds, and investors in such funds are more likely to require prior financial knowledge or experience to be able to understand the investment risks, such funds should continue to be classified as SIPs and subject to enhanced distribution safeguards.

Question 1. MAS seeks comments on the proposal to classify all authorised and recognised CIS as EIPs, except for a small group of more complex funds as described in paragraph 2.7 which are currently subject to additional disclosure requirements and enhanced distribution safeguards for SIPs.

[3] This includes directly managed ILP sub-funds which are not subject to authorisation/recognition but are subject to similar requirements under MAS Notice 307.

[4] These refer to:

(a) Funds that use advanced investment strategies that are traditionally associated with hedge funds, including market directional, corporate restructuring, convergence trading or opportunistic strategies; and
(b) Leveraged/Inverse (L/I) Products that have a daily reset feature that differentiates them from long-only ETFs, effectively resetting their exposure offered to the underlying index on a daily basis. The implication is that over a period of time, such an ETF does not necessarily give investors the cumulative return of the long-only ETF, which seeks to replicate the returns of the underlying index.

[5] These requirements include highlighting that the product is meant for sophisticated investors as well as including important information to facilitate investors’ assessment of the unique features and the difference in risk profile of these products as compared to traditional funds.

Debentures

2.8 Currently, all debentures other than asset-backed securities (ABS) and structured notes, are classified as EIPs. Given this, there is a range of debentures with differing features that may be offered to retail investors as EIPs. These include debentures with the following features:

(a) The interest payment is not solely based on a single fixed or floating rate, but for example, where the return is dependent on the performance of a defined asset pool.

(b) The debentures are convertible, for example, where the debt may be converted to equity.

2.9 Retail investors may mistakenly assume all debentures have similar pay-out structures similar to plain vanilla bonds, which promise the return of principal with regular interest payment. However, debentures with interest payments that are not solely based on a single fixed or floating rate have very different structures or risk profiles from traditional debentures which pay a regular interest rate return to investor. Convertible debentures are also more complex than plain vanilla bonds as they have both fixed-income and equity-like characteristics – such debentures may be converted to shares at the option of either the investor or the issuer, and could gain or lose value along with the underlying stock.

2.10 As most retail investors may commonly understand debentures as an instrument that promises the return of principal with regular interest payment, the added complexity of debentures with features (a) and (b) in paragraph 2.8 may not be fully appreciated or understood by investors who do not have prior financial knowledge or experience in dealing with such investment products. This may affect investors' understanding of the risk-return profile of the product and consequently their ability to make an informed investment decision. As such, MAS proposes to classify debentures with these features as SIPs instead.

Question 2. MAS seeks comments on the proposal to classify debentures with the following features as SIPs:
(a) Where the interest payment is not solely based on a single fixed or floating rate; or
(b) Where the debentures are convertible.

Hybrid Securities

Perpetual Securities

2.11 Perpetual securities are debentures which the issuer may redeem, or not at all, at its discretion, and do not have a specific redemption or maturity date where the principal amount will be repaid. The issuer may also have the discretion to defer or skip interest payments. These are currently classified as EIPs.

2.12 MAS has observed that offer documentation of perpetual securities (e.g. PHSes, Offer Information Statements) are generally clear about the terms and conditions of perpetual securities, as well as the risks associated with investing in such products. However, there may be investors who do not fully understand the features and risks of perpetual securities, given the feature of discretionary redemption on the part of the issuer.

2.13 In other jurisdictions, the sale of perpetual securities to retail investors is subject to varying levels of distribution safeguards. Australia relies on the provision of risk warnings and enhanced disclosures to investors; while in the European Union, Hong Kong and the United Kingdom, financial institutions are required to assess the suitability of the product for the investor, taking into account his/her investment knowledge and experience, before allowing them to invest in such products.

2.14 It is likely that investors have differing levels of understanding of the features and risks of perpetual securities. This, in addition to the varying regulatory requirements in other jurisdictions for the sale of perpetual securities, has prompted MAS to seek comments on the approach that is most appropriate for investors in Singapore.

2.15 There is a range of possible policy options to take in this regard. At one end of the spectrum is to revise the current classification of perpetual securities, and to require that perpetual securities be sold to retail investors with distribution safeguards for SIPs. This would mean that retail investors would have to be assessed by intermediaries as to whether they have the prior financial knowledge or experience to understand the features and risks of perpetual securities before they are able to make the investment.

2.16 Another option would be to further assist the retail investor in better understanding the features and unique risks of perpetual securities. This would include enhancing the requirements on the marketing and disclosure documentation of perpetual securities. The enhancements would require highlighting, in an easy to understand manner, the features and risks of the product that differ from a plain vanilla bond. This is intended to minimise the likelihood of retail investors' confusion that this product is similar to a plain vanilla bond. The enhanced requirements would include:

(a) disallowing perpetual securities to be marketed or described as bonds; and

(b) requiring the inclusion of cautionary statements in advertising material that highlights the key features and risks of perpetual securities, such as the statement set out below.

Table 1: Example of cautionary statement on perpetual securities

KEY FEATURES OF PERPETUAL SECURITIES
• The issuer may not redeem the securities on the scheduled call dates. • The terms of the securities may allow the issuer to stop paying distributions to you. • The issuer is not required to return the principal amount to you as the securities have no maturity date.

Question 3. MAS seeks comments on –
(a) Whether perpetual securities should be classified as EIPs or SIPs;
(b) Whether there is a need to enhance the marketing and disclosure requirements on perpetual securities to ensure that the key features and risks are adequately highlighted to investors. If so, what are your views on requiring intermediaries to provide a cautionary statement and what should be contained in such a statement; or
(c) any other suggestions on safeguards for the sale of perpetual securities.

Preference Shares

2.17 Preference shares and perpetual securities are often thought about as similar products, and indeed share the following similarities –

(a) no obligation to repay the principal;

(b) a right for issuer to redeem the instrument (call option); and

(c) non-cumulative dividend/distribution provisions[6].

2.18 Given this, preference shares are typically classified together with perpetual securities as hybrid securities in other jurisdictions, and subject to similar enhanced disclosure and distribution requirements to safeguard retail investors. Therefore, MAS is similarly reviewing the current EIP classification of preference shares.

Question 4. MAS seeks comments on
(a) whether to align the EIP/ SIP classification of preference shares with that of perpetual securities and subject the sale of these products to the same safeguards;
(b) any other suggestions on safeguards for issuance of preference shares.

3 Distribution Safeguards

3.1 The distribution safeguards that apply to the sale of complex products by financial advisers (FAs) are set out in the Notice on Recommendations on Investment Products (Notice No. FAA-N16).

3.2 Under the Notice, FAs are required to assess a customer's investment knowledge and experience before allowing the customer to transact in an SIP, via the Customer Account Review (CAR) for listed SIPs, and the Customer Knowledge Assessment (CKA) for unlisted SIPs. The criteria for determining if a customer is assessed to have either the knowledge or experience is currently prescribed by MAS and takes into account a person's educational and professional qualifications, or investment and work experience. In particular, the customer is required to satisfy one of the following criteria before transacting in an SIP –

(a) holds a diploma or has higher qualifications in accountancy, actuarial science, business/ business administration/ business management/ business studies, capital markets, commerce, economics, finance, financial engineering, financial planning, computational finance and insurance;

(b) has a professional finance-related qualification;

[6] The term "noncumulative" means that the issuing company does not pay stockholders any unpaid or omitted dividends. If the issuing company chooses not to pay dividends in a given year, investors forfeit the right to claim any of the unpaid dividends in the future.

(c) has transacted in listed or unlisted SIPs at least 6 times in the preceding 3 years; or

(d) has a minimum of 3 consecutive years of working experience in the past 10 years, in finance, investment, accountancy, actuarial science, treasury or financial risk management activities.

Alternatively, the customer may participate in relevant learning modules provided by an independent body[7] to demonstrate that he or she has the knowledge to transact in listed or unlisted SIPs.

Advised transactions

3.3 If the customer is assessed to have either the knowledge or experience, FAs are required to still *offer to* the customer the choice of whether or not to receive advice on the SIP. On the other hand, if the customer is assessed not to have the requisite knowledge or experience, but wishes to proceed with the purchase of the investment product, the FA is required to *provide advice* to the customer, after which the customer can still make the investment against the FA's advice.

3.4 Hence, even if the customer is assessed not to have the requisite knowledge or experience, the customer can proceed with the transaction after the FA provides advice. The assessment of whether the customer has the requisite knowledge or experience is thus inconsequential in the case of advised transactions, where the intent from the outset is to advise the customer. Furthermore, FAs are already required to have a reasonable basis for any recommendations made, and this includes giving due consideration to the customer's knowledge or experience in SIPs when the investment product recommended is an SIP[8].

3.5 To streamline regulatory requirements, MAS proposes to remove the requirement to conduct a CKA or CAR when FAs advise on an SIP transaction. FAs will still have to take into consideration a customer's knowledge or experience in SIPs in the suitability assessment, without being required to conduct the CKA or CAR as a separate

[7] These refer to learning modules by the Singapore Exchange Limited (SGX learning module) or the Association of Banks of Singapore and the Securities Association of Singapore (relevant ABS-SAS learning module) for the purpose of demonstrating sufficient understanding of the features and risks of listed and unlisted SIPs respectively.

[8] Paragraph 9 of Recommendations on Investment Products (Notice No. FAA-N16)

assessment. Approval of the FA's senior management will still be required if the customer chooses to transact in an SIP which is not recommended by the FA.

Question 5. MAS seeks comments on the proposal to remove the CKA/CAR assessment for advised transactions. FAs may instead integrate the consideration of the customers' knowledge or experience in SIPs in the suitability assessment when making a recommendation on SIPs.

Annex A

LIST OF QUESTIONS

Question 1. MAS seeks comments on the proposal to classify all authorised and recognised CIS as EIPs, except for a small group of more complex funds as described in paragraph 2.7 which are currently subject to additional disclosure requirements and enhanced distribution safeguards for SIPs. 6

Question 2. MAS seeks comments on the proposal to classify debentures with the following features as SIPs: 7

(a) Where the interest payment is not solely based on a single fixed or floating rate; or..7

(b) Where the debentures are convertible. 7

Question 3. MAS seeks comments on – 9

(a) Whether perpetual securities should be classified as EIPs or SIPs; 9

(b) Whether there is a need to enhance the marketing and disclosure requirements on perpetual securities to ensure that the key features and risks are adequately highlighted to investors. If so, what are your views on requiring intermediaries to provide a cautionary statement and what should be contained in such a statement; or 9

(c) any other suggestions on safeguards for the sale of perpetual securities. 9

Question 4. MAS seeks comments on 10

(a) whether to align the EIP/ SIP classification of preference shares with that of perpetual securities and subject the sale of these products to the same safeguards; 10

(b) any other suggestions on safeguards for issuance of preference shares. 10

Question 5. MAS seeks comments on the proposal to remove the CKA/CAR assessment for advised transactions. FAs may instead integrate the consideration of the customers' knowledge or experience in SIPs in the suitability assessment when making a recommendation on SIPs. 12

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