

## ***ASIC, Regulating Complex Products Report 384 (“Report”)***

Feedback from Andrew Godwin and Professor Ian Ramsay, Melbourne Law School – 28 March 2014

Thank you for inviting feedback on the above Report. By way of background, we are currently undertaking a research project with funding from Melbourne Law School and the Centre for International Finance and Regulation (see <http://www.cifr.edu.au/>). We set out some information on the project below:

### *Name of Project:*

Financial Products and Short-form Disclosure Documents – Challenges and Trends

### *Background to project:*

In recent years, there has been a global trend towards the use of short-form disclosure documents in relation to the sale of retail financial products. A variety of different names have been used to refer to such short-form disclosure documents, including “shorter product disclosure statement” in Australia, “key fact statement” in Hong Kong and “product highlight sheet” in Singapore. In addition, the EU is currently considering the introduction of a “key information document” for standardised use across all products.

### *Objectives of project:*

The objectives of the research project are as follows:

- to review the international trend towards short-form disclosure documents and the policy reasons behind the trend;
- to examine the different approaches that have been adopted by the selected jurisdictions; and
- to identify the criteria and the factors that should be taken into account when jurisdictions consider which approach to adopt.

In this way, the project seeks to assist regulators in determining appropriate responses and strategies through a guide to the approaches in the selected jurisdictions, the legislative and policy underpinnings and the short-form disclosure documents themselves.

The project analyses the challenges and trends in relation to short-form disclosure documents from a comparative perspective. Developments in the following markets have been examined for this purpose: Australia, New Zealand, the EU, Hong Kong, Singapore and Canada. These jurisdictions were chosen because they have all embraced a move towards short-form disclosure documents in recent years and have implemented – or are in the process of implementing - significant reforms for this purpose.

### *Research outputs:*

There are several project outputs that we are completing. These include the following:

- a book chapter entitled “Clear, Concise and Effective – The Evolution of Disclosure Documents in Australia and New Zealand” (“**Book Chapter**”);

- a working paper that reports on the findings of our analysis of the selected jurisdictions (“**Working Paper**”) - we propose to share this with ASIC over the next week or so; and
- a workshop that we are proposing to convene with representatives from ASIC and other interested stakeholders to share and discuss the findings of our research.

We would be grateful to receive any comments or suggestions from ASIC in relation to the above project.

### **General Feedback on the Report**

The Book Chapter and the Working Paper contain some analysis on complex products that may be of interest to you. Given that we will be sharing this with ASIC shortly, we have kept the comments below to a general level. We would be happy to discuss our comments with ASIC in further detail.

As a general comment, we note that our research findings are consistent with many of the issues and concerns identified in the Report. In this regard, we endorse the decision of ASIC to examine the risks posed to retail investors by complex products.

#### ***Complexity***

Our research supports the observation on page 4 of the Report:

*...complexity can also increase the likelihood that retail investors will not have a sufficient understanding of the risks associated with a product to make an informed investment decision.*

Specifically:

- Complexity inhibits the ability of retail investors (and their financial advisers) to understand the product and the risks associated with the product; and
- Complexity increases the risk of mis-selling.

This was borne out in the experience of Hong Kong and Singapore in the wake of the collapse of the “Minibonds” investment product. Andrew Godwin has previously published research that discusses the relevant issues in this regard: “The Lehman Minibonds Crisis in Hong Kong: Lessons for Plain Language Risk Disclosure” (2009) 32(2) *The University of New South Wales Law Journal* 547.

#### ***Regulating complex products***

Regulators in many jurisdictions have encountered difficulties in determining how to regulate products on the basis of complexity. The reasons for this include the following:

- There are practical difficulties in determining what products fall with the definition of ‘complex products’ and what consequences should follow from such a determination (e.g. a requirement for complex products to be sold on an advice-only basis). This has been a challenge for many of the jurisdictions that we examined in our research. For example, Singapore previously contemplated – but did not pursue – a proposal to adopt a definition of “complex investment products”, the

sale of which would only be possible with financial advice. On the other hand, the EU is currently considering a proposal to require complex products to carry a complexity label at the top of the Key Information Document (KID) for products that the manufacturer deems complex and possibly not suitable for retail investors.

- As noted in the Report, complexity does not necessarily correlate to higher risk. It would be unfortunate if retail investors were excluded from investing in certain products solely on the basis of complexity.

### ***The Role of disclosure***

Our findings suggest that disclosure must be viewed as part of a package of measures, which include measures to strengthen financial advice and financial literacy. In particular, it is important to consider how disclosure impacts on the role of financial advisers and their ability to advise their clients on complex product and the related risks. Effective disclosure is just as important for financial advisors as it is for the investors whom they advise.

In recent years, the regulatory focus in many jurisdictions has shifted from attempting to explain how complex products work in a “clear, concise and effective manner” towards ensuring that the risks and the consequences of risk are properly understood by retail investors. We endorse the following observation in the Report:

- 11 *Financial products and markets are continually growing in complexity. The more complex a product becomes, the more difficult it is for investors to understand its key features and risks. More complex products are also more difficult to describe in a clear, concise and effective manner in disclosure documents.*

It is for this reason that we suggest<sup>1</sup> that consideration be given to the use of a stand-alone risk awareness statement for complex products. The thinking behind this is that if risks are drawn specifically to the attention of investors in the form of a stand-alone statement, and if investors are required to read and sign such a statement, they will think more carefully about the product and be better able to determine the threshold question as to its suitability for their purposes.

The concept of a risk awareness statement is based on the following propositions:

- retail investors will pay due regard to risk only if it is isolated from (i.e. not buried within) other information (what might be described as “risk in isolation”);
- retail investors will understand the nature and extent of risk only if (1) they understand how it arises in relation to the investment product (i.e. risk in context); and (2) the product and the associated risks are explained in lay language (i.e. risk in lay language); and
- retail investors will pay due regard to risk warnings only if they have been expressed in a direct and unambiguous manner (i.e. risk in stark language).

It would be useful to undertake some market research to test the above propositions, including the proposition that investors will think about investing in a product more carefully if they are required to sign a risk awareness statement.

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<sup>1</sup> See Andrew Godwin, “The Lehman Minibonds Crisis in Hong Kong: Lessons for Plain Language Risk Disclosure” (2009) 32(2) *The University of New South Wales Law Journal* 547.

We would argue that a stand-alone risk awareness statement would help to overcome the impact of heuristics and behavioural biases, as noted in the following paragraph on page 19 of the Report:

41 *For complex products, psychological research indicates that, when faced with complexity, people respond automatically and unconsciously to try to simplify the decision-making process. This can cause them to make decisions based on less relevant but easily assessed criteria, while neglecting more relevant but hard-to-assess information, leading to poor financial decisions. In this way, product complexity can frustrate the aims of comprehensive disclosure. Indeed, comprehensive disclosure can exacerbate the problem by triggering the automatic and unconscious response described.*

It would also overcome the limits of disclosure, as noted in the following paragraphs of the Report:

48 *While Australia's financial services regulatory regime places a strong focus on the role of disclosure in overcoming information asymmetries between financial services providers and investors, as complexity in financial products increases, the utility of disclosure to help investors understand a product is likely to decrease.*

49 *While we have invested significant resources in improving the quality of disclosure in complex products (e.g. by implementing 'if not, why not' benchmark disclosure for products such as OTC CFDs), complexity may diminish the value of disclosure that fully meets legal requirements and our guidance on presentation and content, and mean that we need to look to other areas of regulatory focus.*

Further, a risk awareness statement could act either as a substitute for investor assessment (as in the EU, Japan, Hong Kong and Singapore) or as a complementary measure to support investor assessment.

It would also help to overcome the concern identified in paragraphs 103 and 104 of the Report:

103 *Unlike some international jurisdictions, Australian regulation generally does not impose requirements to assess product suitability for investors in an execution-only situation. Issuers and other intermediaries may choose to issue or sell complex products directly to investors, rather than through a financial adviser (e.g. by adopting a general advice or seminar model to promote products). By doing so, they do not need to meet any requirements to assess product suitability for investors.*

104 *Given that investors may have difficulty in assessing whether a complex product meets their financial situation, objectives and needs, and disclosure alone may not be able to overcome product complexity, there is a risk that investors may acquire a product that is not suitable for them.*

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