Comment

PRODUCT SUITABILITY, DUE DILIGENCE AND MANAGEMENT RESPONSIBILITY

The New Regime of Regulation 18B of the Financial Advisers Regulations

In response to the structured products crisis of 2008, many changes were made to the Singapore regulatory landscape over the past three years. More recently, in July 2011, the Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) were amended and an important new provision – reg 18B – was added. Regulation 18B requires a financial adviser and its senior management to conduct a comprehensive due diligence exercise before selling a new product. This comment considers reg 18B's overall scheme, its interpretational difficulties, the demands of the diligence requirements, its interrelation with s 27 of the Financial Advisers Act (Cap 110, 2007 Rev Ed) and the extent to which the regulatory regime has been altered.

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I. Introduction

1 It was not so long ago that the global financial crisis triggered by the collapse of Lehman Brothers rocked the world. In Singapore, the structured products saga involving Lehman Minibonds, DBS High Notes and other derivative instruments brought substantial losses to more than 10,000 investors. The ensuing period witnessed an array of actions and responses by the Monetary Authority of Singapore ("MAS"), some involving the participation of industry stakeholders. The developments resulted in significant changes to the regulatory landscape, the foremost of which were:

(a) the extension in April 2009 of the Consumer Protection (Fair Trading Act)[1] regime to financial products;

* The author benefited from discussions with Christopher Chen, Tan Sin Liang and Andrew White.

1 Cap 52A, 2009 Rev Ed.

(b) the issuance in April 2009 by MAS of the Guidelines on Fair Dealing[2] ("FDG");

(c) the issuance in October 2010 by MAS of the Guidelines on the Product Highlights Sheet;[3]

(d) the issuance in November 2010 by MAS of various new or revised notices and guidelines on miscellaneous matters;

(e) the July 2011 amendments to the Financial Advisers Regulations[4] ("FAR") in July 2011; and

(f) the issuance in July 2011 by MAS of a revised Notice on Recommendations on Investment Products and a Notice on the Sale of Investment Products.[5]

2 Regulation 18B of the FAR, the focus[6] of our attention, was introduced against the backdrop of all these changes made to enhance due diligence by financial advisers and the protection of investors.

3 As a side note, it is observed that the new measure – the essence of which is to require enhanced due diligence for new financial products – was introduced by way of a provision in a piece of subsidiary legislation (the FAR) rather than through an amendment to the Financial Advisers Act[7] ("FAA") itself, such as by amending s 27 – which basically requires a financial adviser to have a reasonable basis for making recommendations as to financial products – or adding a s 27A. Neither was it encapsulated in an MAS Notice (which curiously is supposed to have statutory force),[8] guideline or some other circular.

2 Guideline No FAA-G11, issued on 3 April 2009.

3 Guideline No SFA 13-G10, issued on 21 October 2010.

4 Cap 110, Rg 2, 2004 Rev Ed. Financial Advisers (Amendment) Regulations 2011 (GN No S 433/2011).

5 Notice No FAA-N16, issued on 28 July 2011 and Notice No SFA 04-N12, issued on 28 July 2011, both of which took effect on 1 January 2012.

6 Apart from reg 18B, the Financial Advisers (Amendment) Regulations 2011 (GN No S 433/2011) also added a para 8A to reg 31 of the Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) to address introduction activities by bank tellers.

7 Cap 110, 2007 Rev Ed.

8 Monetary Authority of Singapore ("MAS") notices are issued pursuant to s 58 of the Financial Advisers Act (Cap 110, 2007 Rev Ed), which empowers MAS to issue written directions. Although s 58(3), like s 64(7) (which empowers MAS to issue codes, guidelines, policy statements, *etc*), says that any written direction so issued is "deemed not to be subsidiary legislation", s 58(5) declares that any person who fails to comply with a requirement specified in a written direction is guilty of an offence. Indeed, notices issued by MAS routinely contain a boxed note drawing specific attention to s 58(5). The crux of the matter is simple: if a written direction or notice is not subsidiary legislation, how could a breach or non-compliance of it be an offence?

II. Regulation 18B

A. Overall scheme of reg 18B

4 The intent of reg 18B is clear enough – financial advisers should do due diligence before selling new products. The overall scheme is as follows:

(a) a financial adviser must do due diligence to ascertain suitability before allowing a new product to be sold: reg 18B(1);

(b) the requisite due diligence exercise includes product due diligence, client due diligence and other aspects of the overall system to support the sale of the product: reg 18B(2);

(c) the due diligence exercise requires the personal attention of every member of the financial adviser's senior management: reg 18B(3);

(d) delegation of the due diligence tasks is permitted but with qualifications: reg 18B(4);

(e) a financial adviser must not sell a new product which the due diligence exercise indicates is not suitable: reg 18B(8); and

(f) the contravention of reg 18B without reasonable excuse is an offence: 18B(10).

B. Due diligence prerequisite

5 The basic prerequisite is set out in ostensibly simple and clear terms in reg 18B(1):

> Before selling or marketing any new product in Singapore to any targeted client, a financial adviser shall carry out a due diligence exercise to ascertain whether the new product is suitable for the targeted client.

6 The provision, it seems, desires financial advisers to sell products that are suitable to its clients and to conduct due diligence to ascertain suitability. The notions of suitability and due diligence are reinforced by reg 18B(8), which provides:

> For the avoidance of doubt, no financial adviser shall sell or market any new product to any targeted client if the due diligence exercise required to be and carried out under paragraph (1) indicates that the new product is not suitable for the targeted client.

So if the due diligence exercise results in the financial adviser finding the product unsuitable, the financial adviser must not sell or market the product.

7 Let us take a closer look at some of the terms used in the above provisions.

C. "New product"

8 Firstly, "new product" is defined as any investment product[9] that "has not previously been sold or marketed" by the financial adviser or any of its representatives. Regulation 18B therefore does not apply to existing products, that is, products which at the coming into force of the provision (*ie*, 28 July 2011)[10] were already being sold or marketed by the financial adviser or any of its representatives. One consequence of this definition is that existing products are unaffected by the new due diligence requirements even if the products had never been assessed and approved by the senior management of the financial adviser; reg 18B is forward looking, and presumably it was considered too much of an imposition to require enhanced due diligence for existing products.[11] It should be noted that "new product" is defined to include a product which "varies in any manner (other than in respect of the maturity date)" from any existing product.

9 A second consequence, probably unintended, is that technically speaking a product may be new in that it had not been sold or marketed before 28 July 2011 but once it is sold or marketed at any time thereafter, even if that were done without complying with the new due diligence requirements, it is not a new product within the meaning of reg 18B. The first instance of selling or marketing the product is an offence but the subsequent instances do not appear to be.[12] A formulation which would have avoided the anomaly is one which provides that the enhanced due diligence is required for "any product" rather than "any new product", and to add the qualification that reg 18B does not apply to products that have been sold or marketed by the financial adviser or any of its representatives before 28 July 2011.

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9 Other than foreign exchange contracts, futures contracts and securities traded on a securities exchange: reg 18B(9).

10 Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) reg 18B(1).

11 But note that para 2.2.1 of the Monetary Authority of Singapore Guidelines on Fair Dealing (Guideline No FAA-G11, issued on 3 April 2009) already required financial advisers to do product assessment and market segmentation.

12 Although, again, there may be an infringement of the Monetary Authority of Singapore Guidelines on Fair Dealing (Guideline No FAA-G11, issued on 3 April 2009).

D. "Targeted client"

10 Regulation 18B(9) defines "targeted client" as "any client … to whom the financial adviser intends to sell or market the new product" but excludes from its ambit the accredited investor, the expert investor and the institutional investor[13] – categories of investors who are regarded (although the point is debatable) as being able to look after their own interests.

11 It should be noted that the term repeatedly used in reg 18B is "targeted client" and not "targeted client segment" which raises the vexed question of whether the financial adviser is liable for due diligence in respect of the particular sale to an individual client, an issue which will be taken up later in this comment.

E. Details of due diligence requirement

12 Regulation 18B elaborates upon the due diligence exercise required by reg 18B(1) and recites that it includes an assessment of a whole spectrum of matters:

> (a) the type of targeted client the new product is suitable for and whether the product matches the client base of the financial adviser;[14]
>
> (b) product details: investment objectives,[15] key risks[16] and costs and fees;[17]
>
> (c) processes in place for a representative to determine whether the product is suitable for the targeted client;[18]
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> (d) how the product is to be marketed or sold[19] and whether additional measures are necessary to mitigate any conflict of interest between the representative and the client;[20]

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13 The Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) (see reg 2) adopts the definitions of these terms in s 4A(1) of the Securities and Futures Act (Cap 289, 2006 Rev Ed).

14 Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) reg 18B(2)(*a*).

15 Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) reg 18B(2)(*b*).

16 Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) reg 18B(2)(*c*). The term is defined in reg 18B(9) to include market risk, liquidity risk and product-specific risk.

17 Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) Reg 18B(2)(*d*).

18 Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) Reg 18B(2)(*e*).

19 Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) Reg 18B(2)(*f*).

20 Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) Reg 18B(2)(*g*).

(e) qualifications and training required for a representative;[21] and

(f) whether the current systems of the financial adviser support the sale of the new product to the client.[22]

13 Broadly speaking, the due diligence matters fall into three categories.

14 The first is product due diligence, which involves product assessment[23] and market segmentation.[24] Paragraph 2.2.1 of the FDG sets it out more clearly:

> The financial institution should undertake formal due diligence on any investment product it intends to distribute, in order to: (a) assess and fully understand the features and risk-reward characteristics of the product; and (b) identify customer segments for which the product is suitable, and customer segments for which the product is clearly not suitable.[25]

15 It is significant that with reg 18B, there is now a statutory requirement of product due diligence, which hitherto was only required by the FDG.

16 The second is client due diligence, often referred to as the "KYC" (know your client) process conducted by representatives to ascertain the client's background so as to enable the representative to recommend a suitable product.[26]

17 The third category concerns a wide variety of matters which fall within the expression in reg 18B(2)(*i*) – "whether the current systems of the financial adviser adequately support the sale of the product". Whilst the words "adequately support" may be rather vague, one should be mindful of the regulator's expectation, enunciated in the FDG, that

21 Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) Reg18B(2)(*h*).
22 Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) Reg 18B(2)(*i*).
23 Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) reg 18B(2)(*b*), (*c*) and (*d*).
24 Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) reg 18B(2)(*a*).
25 Observe that the Monetary Authority of Singapore Guidelines on Fair Dealing (Guideline No FAA-G11, issued on 3 April 2009) provision requires the financial adviser to identify not just suitable customer segments but also unsuitable customer segments.
26 Note that with effect from 1 January 2012, the client due diligence exercise must include an assessment of the investment knowledge and experience of the client: see Monetary Authority of Singapore Notice on Recommendations on Investment Products (Notice No FAA-N16, issued on 28 July 2011) and Monetary Authority of Singapore Notice on the Sale of Investment Products (Notice No SFA 04-N12, issued on 28 July 2011).

board and senior management should deliver fair dealing outcomes to its customers. Of particular relevance are Outcome 2 (offering products and services suitable to target customer segments) and Outcome 3 (competent representatives who provide customers with quality advice and appropriate recommendations).

18 In summary, reg 18B(1) requires a financial adviser to perform three categories of due diligence – product due diligence, client due diligence and (overall) systems due diligence.

F. Management responsibility for due diligence

19 The due diligence requirement outlined above is a demanding one, and the burden is placed specifically on the senior management of the financial institution. Regulation 18B(3) states it in onerous terms:

> No financial adviser shall sell or market any new product to any targeted client unless *every* member of the senior management … – (a) *personally* satisfied himself that the new product is suitable for the targeted client; and (b) *personally* approved the sale or marketing of the new product to the targeted client [emphasis added].

20 Two things are noteworthy here. The first is that, unlike the conduct of business provisions of the FAA, such as s 25 or s 27, where the legislation is content just to prescribe and proscribe conduct in relation to the financial adviser generally, reg 18B(3) specifies the persons within the institution who are responsible for compliance. It states in no uncertain terms that the due diligence requirement is the responsibility of every member of senior management – that is, every executive director.[27]

21 Secondly, the expectation is set remarkably high – every executive director must, on the basis of the due diligence exercise, be personally satisfied as to the suitability of the new product and must personally approve the sale or marketing of the product. A reader's instinctive response would be: how is such personal fulfilment of due diligence practical or even possible? The answer depends on what the due diligence exercise entails.

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27 Regulation 18B(9) of the Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) defines "member of senior management" as "any person for the time being holding the office of chief executive officer or executive director of the financial adviser, including any person carrying out the duties of any such office if the office is vacant". A similar (but more succinct) definition is used in the Monetary Authority of Singapore Notice on Recommendations on Investment Products (Notice No FAA-N16, issued on 28 July 2011).

22 As discussed above, the due diligence exercise comprises product due diligence, client due diligence and systems due diligence. As regards product due diligence (regs 18B(2)(*a*)–18B(2)(*d*)), it is clear that the regulation expects every executive director to be involved in the assessment of every new product, to understand it and to decide whether to give his approval. The exercise involves an actual appraisal of the new product. As reg 18B(2) moves to the matter of client due diligence, we see the wording has changed, and the provision requires executive directors to assess "the processes in place" for the representative to determine whether a product is suitable for the client. The impression one gets is that, here, the executive directors' responsibility is to assess the robustness of the KYC process or system; it does not extend to assessing product suitability to each individual client. Finally, as regards the third aspect of the due diligence exercise – whether the overall system adequately supports the sale of the new product – it is quite clear what reg 18B requires is that the executive directors assess the robustness of the system.

23 On the above interpretation, reg 18B requires executive directors to assess each new product but as regards all other aspects, including client due diligence, what it requires is that they assess the adequacy and robustness of the system. On a practical basis, this requisite due diligence can be carried out at a board meeting where a team of individuals, such as the head of products, the chief risks officer and the head of compliance, makes a presentation on the new product and on all aspects of the overall support system. As regards the product, all executive directors are expected to participate in the actual assessment of the product and its segmentation; as regards all other aspects, they are only expected to assess the robustness of the system. Such a paradigm of due diligence appears fair, reasonable and workable.

G. Delegation by senior management

24 Can senior management delegate its duty to conduct due diligence? Regulation 18B(4) gives a qualified answer, for it allows senior management, acting with unanimous consent,[28] to designate a person or a committee of persons (such person or persons not being part of senior management)[29] to personally carry out the requirements of satisfaction

28 Where consent is not unanimous, the executive directors who consented to the delegation are guilty of an offence: Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) reg 18B(6). It thus behooves consenting directors to ensure that all other directors also agree to the delegation.

29 This restriction is a curious one. Considering the gravity of the task, could it not be appropriate or desirable to allow a board to decide that an executive director be tasked with the responsibility either singly or as the leader of a committee of persons?

and approval. However, the provision goes on to say that every executive director "shall ensure that the designated person or every member of the designated committee … fulfills those requirements". The instinctive question is: as a matter of practicability, how could every executive director possibly *ensure* the designated person or committee fulfills the requirements? The answer has to be that he cannot. Whilst he can take reasonable steps to ensure fulfilment, he cannot ensure fulfilment. It would appear that the intention behind reg 18B(4) is that the task can be delegated but the responsibility and the liability remain. Such a stance is reminiscent of the regulatory philosophy reflected in several statements contained in the MAS Guidelines on Risk Management Practices for Board of Directors and Senior Management, such as:[30]

> … the Board should consider carefully the extent and nature of demands that will be placed on it and identify areas that could appropriately be addressed by Board committees. Such committees can handle matters requiring detailed review and in-depth consideration. However, the Board should recognise that *no delegation is absolute* [emphasis added].
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> While senior management might typically delegate some of its risk management to other committees or personnel, its *accountability cannot be delegated* [emphasis added].

It seems the liability of every executive director to ensure due diligence is absolute.

25 Such a stance contrasts sharply with the position under company law where directors, if authorised by the articles of association, may delegate their powers and if such delegation is done with reasonable belief that the delegatee will competently discharge his duties in the company's interests, the directors will not be in breach.[31] The common law position is reinforced by s 157C of the Companies Act,[32] which allows a director to rely on reports and other information given by an employee, a professional adviser or a designated director or committee of directors so long as the former acts in good faith, makes proper inquiry where needed and has no knowledge that such reliance is unwarranted.

26 It is observed that reg 18B(10) affords the financial adviser a defence of "reasonable excuse". In contrast, reg 18B(5) deems a failure by an executive director to fulfill his duty of due diligence under reg 18B a failure by him to discharge the duties and functions of his office under

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30 Issued in February 2006, at paras 1.2.3 and 2.7 respectively.

31 See, eg, *Halsbury's Laws of Singapore* vol 6 (Company Law) (LexisNexis, 2010 Reissue) at para 70.262.

32 Cap 50, 2006 Rev Ed.

s 57(1)(*c*) of the FAA, but makes no mention of "reasonable excuse". The question then is whether two provisions of the FAA may be of application and assistance here. The first is s 57(1)(*b*), which provides that if MAS is satisfied, *inter alia*, that an officer (of the financial adviser) "has, without reasonable excuse, failed to secure compliance" with the FAA, it may, if it thinks it necessary in the public interest or for the protection of investors, direct the financial adviser to remove that officer from its employment. But it might be argued that the provision is inapplicable on two grounds, the first being that technically it concerns the compliance of the FAA and not the FAR, and the second being that it deals with the subject of the regulatory sanction of the removal of an officer. The second provision is s 84(1) of the FAA, which provides:

> Any officer of a licensed financial adviser who fails to take all reasonable steps to secure –
>
> (*a*) compliance with any provision of this Act …
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> …
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> shall be guilty of an offence …

27 A similar objection can be made that s 84(1) is concerned with a breach of the FAA and not a breach of the FAR. The counterargument would be that technical niceties aside, s 57(1) and s 84(1) provide strong indication of the legislative intent that directors and officers who act reasonably should not be held liable for infractions relating to financial products. On this rationalisation, it may be contended that like the financial adviser, executive directors who have reasonable excuse will also not be guilty of contravening reg 18B. The actual legal position on this point is far from clear.

28 Of course, how a court would interpret the term "reasonable excuse" is another question altogether and no doubt the fact that the liability of executive directors under regs 18B(3) and 18B (4) appears to be absolute poses significant difficulty. And the question is linked to the next question.

H. Due diligence – Objective or subjective requirement?

29 Regulation 18B requires a financial adviser and its senior management to conduct due diligence before selling new products. The question arises: does a financial adviser comply with reg 18B so long as a due diligence exercise is carried out or does the exercise have to meet a minimum or acceptable threshold? Put another way: is the requisite standard of diligence subjective or objective? There are two indications from reg 18B itself. The first is that the term "due diligence" has the inherent meaning of diligence that is due or, to express more

expansively, to take such measures and precautions as are appropriate, having regard to the objective of protecting investors or, to borrow from the FDG, ensuring fair dealing outcomes. The second is the implication drawn from reg 18B(8), which refers to "the due diligence exercise *required to be and carried out*" [emphasis added]. Further, when considered against the backdrop of the complete regulatory framework and especially the paramount criterion of a "fit and proper person",[33] who is expected to comply with all regulatory provisions, including notices, guidelines and all other circulars and notes, it is clear that all financial advisers must abide by an objective standard which is heavily influenced or guided by regulatory expectations.

30 The short answer, therefore, is that reg 18B probably requires financial advisers to abide by a high, objective standard of due diligence.

I. Does management responsibility extend to client due diligence?

31 Perhaps the most vexed interpretational difficulty with reg 18B is whether the responsibility of senior management extends to the actual client due diligence exercise. There are several reasons for the view that it does.

32 Let us look at the provisions again. Regulation 18B(1) says that before selling a new product to a targeted client, a financial adviser has to carry out a due diligence exercise to "ascertain whether the new product is suitable for the targeted client". As noted earlier, the words used are "targeted client" and not "targeted client segment". The obvious argument is that the word segment would have been used if that was the intention, as was done in Outcome 2 of the FDG ("[f]inancial institutions offer products and services that are suitable for their target customer segments") and para 2.2.1 of the FDG, which expressly says that financial institutions "should undertake formal due diligence on any investment product … in order to identify customer segments".

33 Likewise, the plain reading of reg 18B(3) appears to reinforce this view as it provides that every member of senior management must personally satisfy himself that the new product is suitable for the

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33 Financial advisers and their representatives must be "fit and proper" persons: see s 9(1)(*m*)(i) and s 23(1)(*g*)(ii) of the Financial Advisers Act (Cap 110, 2007 Rev Ed). The Monetary Authority of Singapore Guidelines on Fit and Proper Criteria (Guideline No FSG-G0) lay down the expectations of competence, honesty, integrity and financial soundness, and provide elaboration on these attributes.

targeted client and must personally approve the sale of the product to the targeted client. There is further support from reg 18B(8) which says:

> [N]o financial adviser shall sell or market any new product to any targeted client if the due diligence exercise required to be *and carried out … indicates* that the new product is not suitable for the targeted client. [emphasis added]

34 Bear in mind also the regulatory stance, as stated in para 3.2.1 of the FDG that financial institutions "should *ensure* that all representatives have the knowledge and skills to provide quality advice to customers …" [emphasis added] and in para 3.2.4 of the same that financial institutions "should have a zero tolerance policy for failures by representatives to follow prescribed advisory and sales process". Holding senior management liable for client due diligence, a vital part of investor protection, is in keeping with this stance of absolute liability.

35 But there are also credible arguments for the stand that management responsibility does not extend to actual client due diligence. The strongest of these is the logical interpretation of reg 18B(2). It is clear from reading the provision that as regards product due diligence (items (a) to (d) of reg 18B(2)), senior management is required to assess the actual details of the product and to decide on the category of client for which it is suitable whereas as regards client due diligence, what is required is an assessment of "the processes" by which a representative determines the suitability of the product to the targeted client and not the actual determination itself.[34] The insertion of the words "the processes" leads to an almost irresistible inference that senior management need not assess actual client due diligence.

36 Further, it can be argued that it is practically impossible for every member of senior management to ensure that the client due diligence is properly carried out. The retort to this is that it is equally impracticable, where there is delegation under reg 18B(4), for every member of senior management to "ensure" that a designated person or committee fulfills the due diligence requirements; yet such liability is imposed on each of them.

37 There is genuine doubt as to which of the two positions is correct. On balance, this author's view is that the latter position appears more persuasive.

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34 But note that reg 18B of the Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed) says that the due diligence exercise "includes" an assessment of the processes; it may be argued that the exercise could extend to the actual client due diligence itself.

J. Other questions and doubts

38 There are other problems in interpreting and applying reg 18B.

39 Firstly, when the executive directors meet to assess and approve new products, what degree of agreement is required? Must the decision be unanimous? The reason why such a thought even arises is because a board decision to delegate the due diligence task requires unanimity, and in the event the decision is not unanimous, the consenting directors are in breach of their duty as director. The severity of the law towards the issue of delegation leads one to wonder whether a simple majority is sufficient for a decision to approve a new product.

40 Secondly, one wonders about the role of non-executive directors in the assessment and approval of new products. It would be extraordinary if non-executive directors were to be excluded from such important meetings. Since non-executive directors provide a degree of neutrality and balance, it seems desirable, even imperative, that they be present and vote at such meetings. So far as the decision to delegate the due diligence exercise is concerned, it would appear that, technically, the decision would be unanimous if all executive directors agree, even if one or more non-executive directors disagree.

41 Thirdly, does reg 18B require a financial adviser to ensure that the products that it sells are suitable to the clients? If so, it certainly goes further than s 27 of the FAA, which only requires the financial adviser to have a reasonable basis for recommending products. The general tenor of reg 18B is consistent with s 27, as it requires financial advisers to carry out due diligence to ascertain suitability but stops short of requiring financial advisers to ensure suitability. An important qualification, however, is that where the financial adviser's due diligence exercise indicates that a product is unsuitable for the targeted client, it is clear from reg 18B(8) that the product must not be sold. This leads us to the next area of interest – a comparison of reg 18B with s 27 of the FAA.

III. Regulation 18B and s 27 FAA compared

42 There are similarities and differences between the two provisions.

43 Section 27(1) prohibits a financial adviser from making a recommendation on a product unless it has a reasonable basis for making that recommendation. Regulation 18B(1) says that a financial adviser should not sell a product unless it has conducted a due diligence exercise to ascertain its suitability to the client. In substance the essence of the two provisions is similar – a financial adviser must take reasonable steps to ascertain that a product is suitable for its client.

Reasonable basis for recommendation equates with due diligence to ascertain product suitability.

44 Section 27(2) explains that a financial adviser has such reasonable basis if he had gathered information on the client, made investigations as to the product and based on the information and investigations he had ascertained that the product is appropriate for the client. Essentially, the financial adviser must, having done client due diligence and product due diligence, come to a conclusion that the product is suitable for the client. Again this is similar to reg 18B(2), which requires client due diligence (reg 18B(*e*)) and product due diligence (regs 18B(2)(*a*)–18B(2)(*d*)) and through the process arrival at the conclusion that the product is suitable (regs 18B(3) and 18B(8)). The differences here are that reg 18B appears to address the assessment of the client due diligence process rather than the actual process itself (as discussed earlier) and that reg 18B is much more specific as regards the product due diligence process. Another difference is that reg 18B makes reference, additionally, to general systems due diligence.

45 Yet another important difference, alluded to earlier, is that reg 18B specifically identifies the executive directors as the persons upon whom the due diligence burdens fall and the regulation apparently imposes personal and absolute liability on each executive director.

46 So while the overall intent is similar and the two provisions overlap substantially, there are significant differences within their respective regimes. The challenge for financial advisers is to work out a practical framework that complies with both regimes.[35]

IV. Offences and offenders

47 Regulation 18B, which at first glance seems relatively straightforward, thus in fact comprises a spectrum of scenarios of offences and offenders:[36]

> (a) no due diligence exercise is conducted – the financial adviser breaches regs 18B(1) and 18B(3); it would appear that the executive directors are not guilty of any breach;

35 As well as other provisions, such as the Monetary Authority of Singapore Notice on Recommendations on Investment Products (Notice No FAA-N16, issued on 28 July 2011), and the Monetary Authority of Singapore Guidelines on Fair Dealing (Guideline No FAA-G11, issued on 3 April 2009).

36 In addition to these, there is also an offence by the financial adviser if records of the due diligence exercise are not kept as required by reg 18B(7) of the Financial Advisers Regulations (Cap 110, Rg 2, 2004 Rev Ed).

(b) the due diligence exercise indicates that product is not suitable and yet product is sold – the financial adviser breaches regs 18B(3) and 18B(8); the executive directors breach reg 18B(5);

(c) the due diligence exercise indicates product is suitable, but product is in fact unsuitable – if the standard of due diligence required is an objective one and the financial adviser's due diligence exercise falls below that standard, then the financial adviser breaches reg 18B(1) and reg 18B(3); the executive directors are probably not in breach;

(d) the due diligence exercise is conducted, but not all executive directors approved of the sale – the financial adviser breaches reg 18B(3); the culpable directors breach reg 18B(3) (read with reg 18B(5));

(e) due diligence was done through delegation but:

(i) the delegation was not done with unanimous consent – the financial adviser is not in breach;[37] the consenting executive directors breach reg 18B(6);

(ii) not all members gave personal attention to ensure that the delegate fulfilled the requirements – the financial adviser is implicitly in breach of reg 18B(4) (read with reg 18B(3); the culpable executive directors are in breach of reg 18B(4) (read with reg 18B(5));

(iii) due diligence exercise indicates product is not suitable (same as in (b) above); and

(iv) due diligence exercise indicates product is suitable when in fact it is not suitable (same as in limb (c) above).

48 Note, however, that the financial adviser is not guilty if it had reasonable excuse (reg 18B(10)) whereas, as discussed earlier, it is uncertain whether such a defence avails the executive directors.

V. Conclusion

49 It would be accurate to say that the requirement of product due diligence is actually not new. In fact, it was alluded to in s 27(2)(*a*) of

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37 Unless the financial adviser may be regarded as having committed the offence through, *inter alia*, the attribution approach (ascertaining the "directing mind and will" of the corporate institution) or through vicarious liability. A very good summary of the legal issues in this area is found in S Yeo, N Morgan & Chan W C, *Criminal Law in Malaysia and Singapore* (LexisNexis, 2007) at paras 37.5 ff.

the FAA in the first place, albeit in vague and general terms. Also, with the issuance of the FDG in 2009, product assessment and market segmentation became regulatory mandated. However, reg 18B is significant as it gives focus and specificity to the need for due diligence. Regulation 18B contains an express legal requirement for financial advisers to conduct comprehensive due diligence before selling new products and it places the responsibility and liability squarely on the shoulders of all the executive directors of the financial adviser.

50 As with legislative amendments in general, the new regulation comes with a fair share of interpretational difficulties, not the least of which is whether executive directors bear absolute liability for actual client due diligence. Also, one wonders if the logistical and legal burden of due diligence placed on executive directors is not an unduly heavy one. It is debatable whether the intended changes have been brought about with sufficient clarity and whether the new regime which reg 18B ushers in will enhance the regulation of financial advisers in a way that is workable, effective and fair. Perhaps in the ebb and flow of financial regulation, the tide of compliance expected of financial advisers has reached a high point.