CHARTA LEARNING · LESSON NOTES

Investor Protection and Compliance Risk

FRM Part II

1 A story: the client who trusted the firm

- A retiree needs income and cannot afford losses
- Adviser is paid more to sell a complex note
- The note falls; she loses money she needed
- Gap in knowledge plus bad incentives
- Compliance risk: loss when rules are not followed

IN THE LESSON

- Picture a retired teacher who walks into Kestrel Wealth with her life savings.
- She needs a steady income and cannot afford to lose much.
- The adviser is paid more for selling a complex structured note, so that is what she buys.
- The note falls in value, and she loses money she needed to live on.
- Nothing illegal had to be said for this to happen.
- The client knew less than the firm, and the firm was paid to sell.
- That gap in knowledge, together with incentives that point the wrong way, is exactly what investor protection rules are designed to close.
- Compliance risk is the risk of loss, fines and lost reputation when a firm fails to follow those rules.

2 The core logic of investor protection

Five ideas run through every investor protection rule

Idea	Tool that delivers it
Know the client	Client categorisation
Sell only what suits	Suitability, appropriateness
Get the best result	Best execution
Manage conflicts	Conflict-of-interest rules
Disclose costs	Cost disclosure

IN THE LESSON

- Every investor protection rule shares one core logic, and it fits in five ideas.
- First, know the client: find out who they are, what they know, and what they need.
- Second, sell only what suits the client.
- Third, get the best result when you carry out the client's order.
- Fourth, manage conflicts of interest, meaning situations where what is good for the firm or the adviser is bad for the client.
- Fifth, disclose costs, so the client knows what they are really paying.
- The table pairs each idea with the tool that delivers it.
- Know the client becomes client categorisation.
- Suitability and appropriateness tests deliver the second idea.
- Best execution rules deliver the third, conflict rules the fourth, and cost disclosure the fifth.
- Keep these five in mind: every rule that follows is one of them.

3 MiFID: the European directive

- MiFID: EU directive applied from November 2007
- Client categorisation into three categories
- Suitability tests: advice and portfolio management
- Appropriateness tests: execution-only complex products
- Best execution and conflict-of-interest rules

IN THE LESSON

- Start in Europe.
- MiFID, short for the Markets in Financial Instruments Directive, is the European Union directive applied from November two thousand and seven.
- It set common rules for firms that give investment services across the Union.
- For investor protection it brought four main things.
- First, client categorisation, sorting every client into one of three categories.
- Second, suitability tests, which apply when the firm gives advice or manages a portfolio.
- Third, appropriateness tests, which apply when a client buys a complex product on an execution only basis, meaning the client decides and the firm simply carries out the order.
- Fourth, rules on best execution and on conflicts of interest.
- We take each in turn, starting with the categories.

4 Three categories of client

Protection falls as you move down the table

Category	Protection
Retail: e.g. a private investor	Most: full tests, full rules
Professional: e.g. a large fund	Less: presumed experienced
Eligible counterparty: e.g. a bank	Least: a market professional

IN THE LESSON

- MiFID sorts clients into three categories, and the protection falls as you move down the table.
- A retail client, such as our retired teacher, is presumed to know the least, so she gets the most protection: the full tests, full information and the strictest rules.
- A professional client, for example a large company or an investment fund, is presumed to have the experience to judge its own risks, so it receives less protection.
- An eligible counterparty, such as a bank or an insurer dealing with another firm, gets the least protection of all, because it is a market professional in its own right.
- The point to remember is that the category decides how much protection a client receives, so getting the category wrong removes protection the client should have had.

5 Suitability against appropriateness

The trigger decides the test

	Suitability	Appropriateness
Trigger	Advice, portfolio mgmt	Execution-only, complex
Asks about	Knowledge, finances, aims	Knowledge, experience
If it fails	Do not recommend	Warn the client

IN THE LESSON

- Now the two tests, which exams love to mix up.
- The suitability test is triggered by advice or by portfolio management, where the firm itself makes or recommends the decision.
- It asks whether the product suits the client as a whole: their knowledge and experience, their financial situation, including how much loss they can bear, and their investment objectives.
- The appropriateness test is triggered by an execution only sale of a complex product.
- It is narrower.
- It asks only whether the client has the knowledge and experience to understand the risks.
- If not, the firm must warn the client, but the client may still go ahead.
- So suitability is the deeper test, because the firm is taking responsibility for the decision.

6 Example 1: which test applies at Kestrel?

Four Kestrel clients: read the trigger, then name the test

Retiree asks what to buy	advice	**Suitability**
Doctor signs a mandate	portfolio management	**Suitability**
Buys a complex note online	no advice, complex	**Appropriateness**
Buys listed shares online	own initiative, simple	**Often no test**

IN THE LESSON

- Let us apply the triggers to four Kestrel clients.
- First, the retired teacher asks her adviser what to buy.
- That is advice, so the suitability test applies.
- Second, a doctor signs a mandate letting Kestrel manage her portfolio.
- Kestrel makes the decisions, so again it is suitability.
- Third, a client buys a complex structured note online, with no advice at all.
- That is an execution only sale of a complex product, so the appropriateness test applies.
- Fourth, a client buys ordinary listed shares online, on his own initiative.
- Shares are not complex, and execution only business in simple products can often proceed without either test, although the client is told that no test is done.
- The exam skill is to read the trigger first.

7 Best execution and conflicts of interest

- Best execution: best possible result for the client
- Price, costs, speed, likelihood of completion, size
- Conflicts: identify, then prevent or manage
- Disclosure is the last resort
- Telling the client does not remove the conflict

IN THE LESSON

- MiFID's other two pillars protect the client after the product is chosen.
- Best execution means that when Kestrel carries out a client's order, it must take steps to get the best possible result for the client.
- Price matters, but so do the costs, the speed, the likelihood that the trade is completed and settled, and the size of the order.
- So the best result is about the total outcome, not just the quoted price.
- Conflict of interest rules require a firm first to identify its conflicts, then to prevent or manage them, for example by separating teams or changing pay.
- Disclosure to the client is the last resort when a conflict cannot be managed well enough.
- Telling the client about a conflict does not make it go away.

8 Example 2: best execution is the total cost

Buy 10,000 shares. A: $50.02 + $0.01 fee. B: $50.00 + $0.04 fee

Venue A: total cost	10,000 × $50.03	**$500,300**
Venue B: total cost	10,000 × $50.04	**$500,400**
Best execution	A is $100 cheaper	**Venue A**

Best price is not best execution: judge the total cost

IN THE LESSON

- Here are numbers.
- A Kestrel client wants to buy ten thousand shares.
- Venue A quotes fifty dollars and two cents a share, with a fee of one cent a share.
- Venue B quotes a better price, exactly fifty dollars, but charges a fee of four cents a share.
- At venue A the total cost is ten thousand times fifty dollars and three cents, which is five hundred thousand three hundred dollars.
- At venue B it is ten thousand times fifty dollars and four cents, which is five hundred thousand four hundred dollars.
- Venue A is one hundred dollars cheaper, even though its price looks worse.
- The trap is to judge best execution by the quoted price alone.
- The client pays the total, so the total is what counts.

9 MiFID II: wider scope and more transparency

- MiFID II with MiFIR: applied from January 2018
- Scope: commodity derivatives, non-equity instruments
- New venue: the organised trading facility (OTF)
- Extended pre-trade and post-trade transparency

IN THE LESSON

- MiFID worked for shares, but the financial crisis showed gaps.
- MiFID two, applied from January two thousand and eighteen together with a regulation called MiFIR, widened and tightened the rules.
- First, it widened the rules, especially on transparency, to commodity derivatives and to non equity instruments, such as bonds and derivatives, whose trading had been far less covered before.
- Second, it added a new kind of trading venue, the organised trading facility, or O T F, to bring more trading in bonds and derivatives onto regulated platforms.
- Third, it extended pre trade and post trade transparency.
- Pre trade transparency means publishing prices before a trade, and post trade transparency means publishing the price and size after it.
- All three changes help clients see the market they trade in.

10 MiFID II: protecting investors more tightly

- Product governance: define the target market
- Protection starts at design, not only at sale
- Tighter inducement rules: third-party payments
- More cost disclosure: all costs added together
- More record keeping, so sales can be checked

IN THE LESSON

- MiFID two also tightened investor protection itself, in four ways.
- First, product governance and target markets.
- The firm that designs a product must define its target market, meaning the type of client it is meant for, and the firms that sell it must stay within that market.
- So protection now starts when the product is designed, not only when it is sold.
- Second, tighter inducement rules.
- An inducement is a payment the firm receives from a third party, such as a commission from a product provider.
- Third, more cost disclosure, so the client sees all the costs added together.
- Fourth, more record keeping, so that what was said and done can be checked later.
- We now put numbers on costs and inducements.

11 Example 3: disclosing the total cost

Portfolio $400,000. Three layers of cost a year

Product costs	1.2% × $400,000	**$4,800**
Kestrel's service fee	0.6% × $400,000	**$2,400**
Trading costs	0.2% × $400,000	**$800**
Total cost to the client	4,800 + 2,400 + 800	**$8,000 = 2.0%**

Showing only the 0.6% fee would hide most of the cost

IN THE LESSON

- Kestrel manages a portfolio of four hundred thousand dollars for a client.
- Its costs come in three layers.
- The funds inside the portfolio charge one point two per cent a year, which is four thousand eight hundred dollars.
- Kestrel's own service fee is zero point six per cent, two thousand four hundred dollars.
- Trading costs are zero point two per cent, eight hundred dollars.
- Added together, the client pays eight thousand dollars a year, which is two per cent of the portfolio.
- The idea of fuller cost disclosure is that the client sees this single total, both in dollars and as a percentage.
- Shown only the service fee of zero point six per cent, the client would think the portfolio was far cheaper than it is.

12 Example 4: an inducement

Fund company pays Kestrel a trail of 0.5% a year on $400,000 an advisory client holds

Trail commission	0.5% × $400,000	**$2,000 a year**
The conflict	favours payer's funds	**Biased advice**
Independent or portfolio mgmt	cannot keep it	**Pass to client**
Non-independent adviser	tighter conditions	**Must disclose**

Disclosure alone does not let an independent adviser keep it

IN THE LESSON

- Now an inducement.
- A fund company pays Kestrel a trail commission of zero point five per cent a year on four hundred thousand dollars that an advisory client holds in its funds, which is two thousand dollars a year.
- Why does this matter?
- Because an adviser who is paid by the product provider has a reason to pick that provider's funds, whether or not they suit the client.
- Under MiFID two, an adviser that calls itself independent cannot keep third party commissions, and the same ban applies when a firm manages a portfolio.
- If Kestrel's advice is independent, the two thousand dollars must be passed on to the client, not kept.
- An adviser that is not independent faces tighter conditions too, including disclosing the payment.
- The trap is to think disclosure alone lets an independent adviser keep the money.
- It does not.

13 Dodd-Frank: the United States response

- Dodd-Frank: United States, 2010
- Created the Consumer Financial Protection Bureau
- The Volcker Rule: limits banks' own-account trading
- Standard OTC derivatives: clear, exchange or SEF, report
- A whistleblower programme

IN THE LESSON

- Across the Atlantic, the Dodd Frank Act of two thousand and ten was the United States response to the financial crisis.
- Four parts matter here.
- First, it created the Consumer Financial Protection Bureau, the C F P B, a regulator focused on protecting consumers of financial products.
- Second, it brought in the Volcker Rule, which limits banks from trading for their own account with their own money.
- Third, for standardised O T C derivatives, meaning standard contracts traded privately between two parties rather than on an exchange, it required central clearing, trading on an exchange or on a swap execution facility, called an S E F, and reporting of trades.
- Fourth, it created a whistleblower programme, which rewards people who report breaches to the regulator.

14 Mistakes to avoid: match the rule to its trigger

Read the trigger first, then name the rule

Trigger	Rule
Advice, portfolio management	Suitability test
Execution-only, complex product	Appropriateness test
Carrying out an order	Best execution: total result
Payment to independent adviser	Cannot keep it: pass on
Designing a product	Product governance: target market

IN THE LESSON

- The exam point for this half is to match each rule to its trigger.
- Here are the pairs to learn.
- Advice or portfolio management triggers the suitability test.
- An execution only sale of a complex product triggers the appropriateness test.
- Carrying out a client order triggers best execution, judged on the total result.
- A third party payment to an independent adviser triggers the inducement rule, so the payment cannot be kept.
- A product being designed triggers product governance and a target market.
- And a standardised O T C derivative in the United States triggers clearing, trading on an exchange or S E F, and reporting.
- The common mistake is to apply suitability to every sale.
- It belongs to advice and portfolio management.

15 Case studies: the same causes return

- Not bad luck: the same root causes return
- 1. Mis-selling of complex products to retail clients
- 2. An undisclosed conflict: the SEC's Abacus CDO case
- 3. Fraud: the Madoff Ponzi scheme
- For each: what, why, and which control

IN THE LESSON

- Now the second half: what the case studies teach.
- When you read about firms that broke investor protection or compliance rules, the first temptation is to see each one as bad luck, or as one bad person.
- The lesson of the cases is the opposite.
- The same root causes return again and again.
- We look at three kinds of failure.
- Mis-selling of complex products to retail clients.
- An undisclosed conflict of interest, as in the case the United States Securities and Exchange Commission, the S E C, brought over a C D O called Abacus.
- And outright fraud, as in the Madoff Ponzi scheme.
- For each, we ask what went wrong, why, and which control would have caught it.

16 Case one: how mis-selling happens



IN THE LESSON

- Start with mis-selling.
- Read the boxes from left to right.
- It begins with incentives that reward volume: sales staff are paid by how much they sell, not by how well clients do.
- Next, the products are complex, such as structured notes, whose payoff depends on a formula linked to markets, and whose risks are hard for an ordinary investor to see.
- Then the suitability checks are weak: the questionnaire is ticked, but nobody tests whether the product fits the client.
- On the second row, the result is that unsophisticated investors buy products they do not understand and cannot afford to lose on.
- When markets turn, those losses arrive together.
- The root causes are the volume incentive and the weak suitability check, not the market fall.

17 Example 5: mis-selling at Kestrel

Kestrel sold structured notes for a year. Bonus 1% of sales

Notes sold to retail clients	1,500 clients	**$60m**
Sales bonus pool	1% × $60m	**$600,000**
Clients found unsuitable	450 ÷ 1,500	**30%**
Amount they invested	from the file review	**$18m**

Questionnaires complete on paper; nobody acted on the answers

IN THE LESSON

- Here is Kestrel's own version.
- Over one year Kestrel sold sixty million dollars of structured notes to one thousand five hundred retail clients.
- Sales staff earned a bonus of one per cent of what they sold, a bonus pool of six hundred thousand dollars, paid on volume alone.
- When the notes fell, a review of the client files found that four hundred and fifty clients, which is thirty per cent, should never have been sold them.
- Many were retirees who needed income and could bear little loss.
- Those clients had put eighteen million dollars into the notes.
- Notice what the review found.
- The questionnaires were complete, so on paper the checks were done.
- The failure was that nobody acted on what the answers said.

18 Case two: the Abacus CDO

- CDO: a security whose value depends on a debt pool
- Buyers were not told a short-seller helped pick assets
- Every statement made can be true and still breach
- Omitting a material fact is itself a breach
- Silence can mislead as much as a false statement

IN THE LESSON

- The second case is about conflicts of interest.
- A C D O, or collateralised debt obligation, is a security whose value depends on a pool of debt, in this case linked to mortgage securities.
- In the Abacus case, the S E C's complaint was that the bank selling the C D O did not tell investors that a client who was betting against the deal had played a part in choosing the assets inside it.
- The lesson the case teaches is precise.
- A sale can breach the rules even when every statement made is true.
- Leaving out a material fact, meaning one that a reasonable investor would want to know before deciding, is itself a breach.
- Silence can mislead as much as a false statement.

19 Example 6: true statements, missing fact

Kestrel markets a note linked to a basket of company bonds

Rated by a recognised agency	stated	**True**
Basket chosen by credit team	stated	**True**
Pays a fixed coupon	stated	**True**
Desk bet against, picked bonds	not stated	**Material omission**

Every statement true, yet a breach. Control: barrier plus conflicts review

IN THE LESSON

- Let us test the idea at Kestrel.
- Kestrel's sales team markets a note linked to a basket of company bonds.
- The brochure says the note is rated by a recognised agency, and that is true.
- It says the basket was chosen by Kestrel's credit team, and that is true.
- It says the note pays a fixed coupon, also true.
- What it leaves out is that Kestrel's own trading desk has bet heavily that those same bonds will fall, and suggested several of them for the basket.
- A reasonable buyer would want to know that, so it is a material fact.
- Every line of the brochure is true, yet the sale is a breach.
- The control is an information barrier plus a conflicts review before launch.

20 Case three: the Madoff Ponzi scheme

- Ponzi: pays old investors with new investors' money
- Investors relied on statements from the scheme itself
- Lesson 1: independent custody of assets
- Lesson 2: independent verification of assets and returns
- Lesson 3: escalate red flags, e.g. smooth returns

IN THE LESSON

- The third case is fraud.
- A Ponzi scheme pays existing investors their returns out of money paid in by new investors, rather than from real investment gains.
- It survives only while new money keeps arriving.
- In the Madoff case, investors and the firms that sent them money relied on statements that came from the scheme itself.
- The case teaches three lessons.
- First, the need for independent custody, meaning the assets are held by a separate custodian, not by the manager.
- Second, independent verification, so someone outside checks that the assets and the returns really exist.
- Third, the need to escalate red flags, such as returns that are implausibly smooth.
- A red flag that nobody escalates protects no one.

21 Example 7: a red flag in the returns

A fund reports 60 months of returns. Compare it with a broad index

Months reported	five years	**60**
Fund: losing months	3 ÷ 60	**5%**
Index: losing months	24 ÷ 60	**40%**
Fund: yearly return	every year	**10% to 12%**
Index: yearly return	range	**−20% to +25%**

Implausibly smooth: escalate and verify independently

IN THE LESSON

- Here is the kind of red flag that should be escalated.
- Kestrel's due diligence team, the people who check a fund before Kestrel recommends it, reviews a fund that reports five years, or sixty months, of returns.
- The fund lost money in just three of those months, five per cent of the time.
- A broad stock index over the same sixty months fell in twenty four of them, forty per cent of the time.
- The fund reports between ten and twelve per cent every year, while the index ranged from a loss of twenty per cent to a gain of twenty five.
- Smooth returns are not proof of fraud.
- But they are implausible for the strategy claimed, so they must be escalated, and the assets verified independently.

22 Example 8: the cost goes far beyond the fine

Unsuitable clients held $18m; notes fell 25%. Kestrel earned $1.8m fees

Client losses	25% × $18m	**$4.50m**
Interest on the losses	8% × 2 years × $4.5m	**$0.72m**
Redress to clients	4.50 + 0.72	**$5.22m**
Remediation, litigation	1.8 + 1.0	**$2.80m**
Fine $3.00m, so total cost	5.22 + 2.80 + 3.00	**$11.02m**

Against only $1.8m of fees earned

IN THE LESSON

- Back to Kestrel's mis-selling.
- The cost of failure goes well beyond a fine.
- The notes held by the four hundred and fifty unsuitable clients fell by twenty five per cent, so their losses were four and a half million dollars on the eighteen million invested.
- Kestrel must pay redress, putting clients back where they would have been, with interest.
- At eight per cent simple interest a year for two years, interest adds seven hundred and twenty thousand, so redress is five point two two million.
- Reviewing files and fixing systems, called remediation, costs one point eight million, and litigation one million, together two point eight million.
- The fine is three million.
- In all, eleven point zero two million dollars, against fees earned of one point eight million.

23 What the numbers in Example 8 say

- Total $11.02m: over 6 times the $1.8m of fees
- The fine was only 27% of the total
- Largest cost: redress with interest, 47%
- Remediation and litigation: about as much as the fine
- Missing: lost reputation, which lasts for years

IN THE LESSON

- Look at what that example says.
- The total cost was eleven point zero two million dollars, more than six times the one point eight million of fees Kestrel earned on the notes.
- The fine, which is what the headlines report, was only twenty seven per cent of the total.
- The largest single cost, forty seven per cent, almost half, was redress with interest.
- Remediation and litigation together cost about as much as the fine.
- And one cost is missing from the table because it cannot be measured in advance: lost reputation.
- Clients who read about mis-selling move their money elsewhere, and new clients stay away, for years.
- So a firm that judges compliance by the size of possible fines badly underestimates what a failure will cost it.

24 The lessons: culture, incentives and controls

Six defences the cases point to

Lesson	What it does
Compliance culture	Raise problems safely
Aligned pay	Reward client outcomes
Product governance	Right product, right market
Information barriers	Separate sales and trading
Surveillance	Spot misconduct early

IN THE LESSON

- What, then, do the cases teach a firm to build?
- First, a strong compliance culture, where staff are expected to raise problems and are protected when they do.
- Second, incentives aligned to client outcomes, so pay rewards how well clients do, not only how much is sold.
- Third, product governance, so complex products are designed for a defined target market and kept away from clients outside it.
- Fourth, information barriers, which separate teams such as sales and trading so that one side's interests or knowledge do not taint advice.
- Fifth, surveillance, meaning monitoring of trades and communications to spot misconduct early.
- Sixth, independent due diligence on funds and managers, including checking custody and verifying assets.

25 Exam point: link each failure to its control

Questions describe the failure and ask for the control

Failure	Control that catches it
Mis-selling to retail	Suitability, target market, pay
Undisclosed conflict	Conflicts review, barriers, disclosure
Ponzi fraud	Custody, verification, escalation
Hidden staff misconduct	Surveillance, whistleblowing

IN THE LESSON

- The exam point for this half is to link each failure to the control that would have caught it.
- Mis-selling of complex products to retail clients is caught by real suitability checks, product governance with a target market, and pay linked to client outcomes.
- An undisclosed conflict, as in the Abacus case, is caught by conflicts review before launch, information barriers, and disclosure of every material fact.
- A Ponzi fraud, as in the Madoff case, is caught by independent custody, independent verification of assets and returns, and escalation of red flags in due diligence.
- Hidden misconduct by individual staff is caught by surveillance of trades and communications, backed by whistleblowing.
- Learn the pairs, because questions describe the failure and ask for the control.

26 Mistakes to avoid

- Not one bad apple: root causes sit in the system
- True statements are not enough: omissions breach
- Never rely on a manager's own reports of assets
- Do not count only the fine
- A completed form is not a suitability check

IN THE LESSON

- Here are the mistakes to avoid.
- First, treating a failure as one bad apple.
- The cases show recurring root causes, such as volume pay and weak checks, that sit in the system, not in one person.
- Second, assuming that true statements make a sale compliant.
- As the Abacus case shows, omitting a material fact is itself a breach.
- Third, trusting a manager's own reports of its assets and returns.
- Madoff shows why custody and verification must be independent.
- Fourth, counting only the fine.
- Redress with interest, remediation, litigation and reputation usually cost far more.
- And fifth, treating a completed questionnaire as a suitability check.
- A form that nobody acts on catches nothing.

27 Try three quick questions

1. Online, no advice, client buys a complex product. Which MiFID test?
   Answer: Appropriateness: execution-only, complex.
2. Portfolio $250,000, total costs 1.6% a year. Cost in dollars?
   Answer: 1.6% × $250,000 = $4,000 a year.
3. Smooth returns; the manager holds the assets itself. Controls?
   Answer: Independent custody and verification; escalate.

IN THE LESSON

- Now try three quick questions.
- Pause the video, think, then listen to the answers.
- Question one.
- A client with no advice uses an online platform to buy a complex derivative product.
- Which MiFID test applies?
- The appropriateness test, because this is an execution only sale of a complex product.
- If the client lacks the knowledge and experience, the firm must warn them.
- Question two.
- A client's portfolio is two hundred and fifty thousand dollars, and all its costs added together come to one point six per cent a year.
- What total cost should be disclosed in dollars?
- One point six per cent of two hundred and fifty thousand is four thousand dollars a year.
- Question three.
- A fund reports very smooth returns, and the manager holds the assets itself.
- Which controls would have caught a fraud?
- Independent custody and independent verification of assets and returns, with the red flag escalated.