

# Equity-Linked Structured Deposits: Marketing and Distribution to Retail Customers

CFA Society of the UK: Professional Ethics Case Study  
CFA UK Ethics Committee  
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## Notes & disclaimers

(1) The purpose of this Professional Ethics Case Study is educational: to help Members of the CFA Society of the UK to consider their duties arising under the CFA Institute's Code of Ethics ("Code") and Standards of Professional Conduct<sup>1</sup> ("Standards") in a hypothetical scenario; and to encourage Members to reflect more generally on ethical issues in the financial services industry.

(2) This case study was inspired by two recent final notices issued by the Financial Conduct Authority (FCA), a regulator of the financial services industry in the United Kingdom, against an investment bank and a retail financial services company in relation to a family of structured deposit products. However, the case study is not intended to be an accurate or comprehensive summary of the facts of these cases or the FCA's findings, and the character of Alex Lee is fictional.

(3) This case study does not constitute, and is not to be interpreted as, advice as to how conduct similar in nature to its hypothetical scenario might be viewed by the CFA Institute, the CFA Society UK, any regulatory authority, or any court of law. Persons seeking legal or other advice concerning specific facts should always consult an appropriate professional adviser.

(4) In reading the case members should consider their obligations under CFA Institute's Standard I(A) Professionalism:

### **Standard I(A) Professionalism**

*Members and Candidates must understand and comply with all applicable laws, rules and, regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organisation, licensing agency, or professional association governing their professional activities.*

*In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation.*

*Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.*

<sup>1</sup> CFA Institute, *Standards of Practice Handbook* (11th edn, 2014) <<http://www.cfapubs.org/toc/ccb/2014/2014/4>>. The 11th edition is effective from 1 July 2014. It includes amendments of, and additions to, the previous version.

## Scenario

IB Group is an investment bank. Its business includes sales, trading and structuring equity securities and equity-related financial derivatives.

RT Bank distributes financial products to its retail customers who are inexperienced and unsophisticated investors, with an average of around £10,000 of investable assets per customer. RT Bank's method of distribution is to attract customer interest to its products through advertising. An employee of RT Bank then has a one-on-one meeting with each potential investor, where he or she explains the features of the financial product in question. Sales are made on a non-advised basis, and RT Bank has an effective procedure in place to ensure that customers are aware of this.

Among the products distributed by RT Bank is an equity-linked structured deposit ("SD") produced by IB Group. The SD created by IB Group is linked to the performance of the FTSE 100 Index: It has a 5-year maturity; offers a guaranteed cumulative minimum return; and has a capped cumulative maximum return.

The SD is not a simple index tracker. Instead, it is based on a series of 6-month options, so that the potential maximum return would be attained only if the FTSE 100 Index rose, by an amount exceeding a specified threshold, in each of the ten 6-month periods from the SD's inception to its maturity.

IB Group has back-tested and modelled the performance of the SD:

- It is aware that, since the inception of the FTSE 100 Index in 1984, there have not been ten consecutive 6-month periods in each of which the index rose by at least the SD's threshold percentage.
- IB Group has also made financial model-based estimates of the SD's expected return. According to the model, there is a close to 0% probability that the SD would achieve its potential maximum return, and an approximately 50% probability that the SD's return would not exceed the guaranteed minimum.

The results of IB Group's back-testing and financial modelling are available to RT Bank's employees in the form of a product evaluation document which is intended to give guidance to distributors about the features of the SD. That document includes a disclaimer, according to which it is "not directed at, and should not be relied upon, by retail clients".

Separately from the product evaluation document, IB Group prepares a product brochure. RT Bank requires its employees to use this brochure for distributing the SD to its customers. The front page of the brochure includes the following prominent statements, each printed in the same font, size and colour:

- *Potential return based on the FTSE 100 Index.*
- *5-year fixed investment term.*
- *Guaranteed minimum return of 5% (gross) at maturity.*
- *Potential maximum return of 40% (gross) at maturity.*

Page 3 of the SD product brochure gives the following explanation of the potential maximum return in the following format:

*The maximum return of 40% (gross) at maturity will be achieved only if the percentage gain in the FTSE 100 Index is 5% or more for each and every one of the consecutive 6-month periods to maturity.*

In addition, the SD product brochure includes an illustrative table, showing examples of possible gross returns on an investment of £10,000 assuming that the product is held to maturity. The table contains four scenarios, each printed in the same font, size and colour. The scenarios shown are: The guaranteed minimum return; two scenarios of intermediate returns; and the potential maximum return.

The SD is a success, with customers of RT Bank making investments in the product totalling over £500 million within six months. During this time, neither IB Group nor RT Bank receives any substantial complaints about the SD from either investors or potential investors.

IB Group and RT Bank then conduct an investor survey, asking a representative sample of RT Bank's customers who invested in the SD about their experience and expectations concerning the investment. According to the survey: Around 20% of the investors expect to achieve the potential maximum return; close to 10% of the investors expect only the guaranteed minimum return; and the rest of the investors have intermediate expectations.

Based on the absence of complaints and the results of the investor survey, IB Group and RT Bank decide to continue to distribute the SD in its existing form and without amendment to the product brochure prepared by IB Group.

Alex Lee, a CFA charterholder, is an employee of RT Bank. Lee's responsibilities include the distribution of the SD, by having one-on-one meetings with individual customers who express a potential interest in investing in the SD.

## What are some potential ethical issues Lee faces and how do they relate to the CFA Institute's Code and Standards ("Code and Standards")?

### Issue (1): Misrepresentation?

**Code and Standards: Standard I(C) Misrepresentation:**

*Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.*

"A misrepresentation is any untrue statement or omission of a fact or any statement that is otherwise false or misleading."<sup>2</sup> A Member of the CFA Institute must not make a misrepresentation about which he "knows or should have known" that it "could alter the investment decision-making process."<sup>3</sup>

Would Lee commit a misrepresentation if during one-on-one meetings he informed customers of RT Bank, who are potential investors in the SD, of the expected return characteristics of the SD strictly in accordance with the product brochure prepared by IB Group?

You may wish to consider some of the following issues:

- (A) Does the product brochure clearly and correctly states the minimum and maximum returns from the SD, and explain the method for calculating the SD returns?
- (B) Does the product brochure encourage potential investors to focus on the SD's potential maximum return?
- (C) Is appropriate prominence given to the guaranteed minimum return, given that is the return most likely to be achieved? Are there any problems with the presentation of the four return scenarios in the product brochure?
- (D) Should the product brochure inform investors that according to IB Group's estimates (i) there is a close to 0% probability that the SD would achieve the potential maximum return; and (ii) that there is an approximately 50% probability that the SD's return would not exceed the guaranteed minimum?
- (E) Would a sophisticated investor and a retail investor respond differently to the product brochure?

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<sup>2</sup> *Handbook* (n 1) 41.

<sup>3</sup> *Handbook* (n 1) 41.

## Issue (2): Duties to clients

### **Standard III(A) Loyalty, Prudence, and Care**

*Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. [They] must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.*

Members must act "with the care, skill and diligence that a reasonable person acting in a like capacity and familiar with such matters would use."<sup>4</sup> A Member's obligations under this provision depend on the nature and scope of the relationship with the client in question. This does not necessarily mean that a Member must act as a fiduciary in all client interactions. Rather they must complete their obligations (e.g. trade execution or order fulfilment) with care, skill and diligence.

According to The Code of Ethics: *Members of CFA Institute (including charterholders) and candidates must Place the integrity of the investment profession and the interests of clients above their own personal interests.*

During Lee's one-on-one meetings with potential investors in the SD, what is the content of Lee's client-facing duties ?

You may wish to consider some of the following issues:

- (A) What is the scope of Lee's relationship with the customers?
- (B) Does Lee clarify his client responsibilities effectively (i.e. is he providing advice or executing trades)?
- (C) Does Lee discuss any limitations of the products and services he can offer?
- (D) Is there any conflict of interest between Lee's duty is to place clients' interests before RT Bank's interests (e.g. in fees) or his own personal interests (e.g. in commissions) given the obligations of the client relationship?

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<sup>4</sup> *Handbook* (n 1) 81.

### Issue (3): Suitability?

**Standard III(C)(1)**

*When Members and Candidates are in an advisory relationship with a client, they must:*

- (a) Make reasonable inquiry into the client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.*
- (b) Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates and constraints before making an investment recommendation or taking investment action.*
- (c) Judge the suitability of investments in the context of the client's total portfolio.*

In an advisory relationship, if a Member receives an unsolicited order from a client to invest in a particular product which is inconsistent with the IPS, then he "need[s] to make reasonable efforts to balance" the trading request with his duty as an adviser to follow the agreed IPS.<sup>5</sup> The inconsistency should be discussed with the client. How to proceed subsequently would depend, among other factors, on: (i) The impact of the proposed transaction on the customer's entire portfolio; and (ii) the customer's willingness to revise the IPS to accommodate the transaction.<sup>6</sup>

During Lee's one-on-one meetings with potential investors in the SD, what is the content of Lee's client-facing duty to ascertain the suitability of the SD for each individual customer?

You may wish to consider some of the following issues:

- (A) Does Lee have an advisory relationship with the customers of RT Bank?
- (B) Does Lee have an obligation to undertake a suitability test for each person interested in the SD product?
- (C) If there is a suitability determination obligation, to what extent should Lee develop an understanding of each potential investor's circumstances, needs and objectives?
- (D) Is Lee required to act in accordance with a written investment policy statement ("IPS") for each customer?
- (E) What would lead Lee to advising potential investors to avoid the SD product?

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<sup>5</sup> *Handbook* (n 1) 106.

<sup>6</sup> For a more detailed analysis, see: *Handbook* (n 1) 106 ("Addressing Unsolicited Trading Requests"); and 111 ("Example 8").

## Issue (4): Communication with (prospective) clients?

### **Standard V(B)(2 & 3) Communication with Clients and Prospective Clients**

*Members and Candidates must: Disclose to clients and prospective clients significant limitations and risks associated with the investment process.*

*Members and Candidates must: Use reasonable judgement in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communication with clients and prospective clients.*

This means both "general market related risks and the risks associated with the use of complex financial instruments that are deemed significant."<sup>7</sup> For structured products, the communication should include a description of "how the structure was created".<sup>8</sup>

During one-on-one meetings with potential investors in the SD, what are some possible risks and limitations Lee should address?

You may wish to consider some of the following issues:

- (A) Have the customers been provided with sufficient information to be able to make an informed decision as to whether to invest in the product? Should Lee inform potential investors in the SD that the product has a close to 0% probability of achieving the potential maximum return, and that there is an approximately 50% likelihood that the return will not exceed the guaranteed minimum?
- (B) Do customers need to understand that the SD is not a simple index tracker, but is instead based on index-linked options?
- (C) Is it sufficient to explain how the product is likely to perform (i.e. the guaranteed minimum return and the potential maximum return), without going into the underlying structure of the SD?
- (D) How does the structure of the SD affect the risk profile and the likely return of the product? Does Lee need to communicate any significant risks specific to the FTSE 100 Index options used to construct the SD (e.g. counterparty risk, credit risk)?
- (E) Would further detail be too technical for retail customers to understand?

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<sup>7</sup> *Handbook* (n 1) 171.

<sup>8</sup> *Handbook* (n 1) 174 ("Example 3").