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2 minute guide

Avoiding a "suitability gap" between Financial Advisers and Discretionary Investment/Fund Managers

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suitability matters

» Suitability is a key tenet that has in large part reshaped how retail financial services and products are distributed in the post-RDR world. Client best interests are now the paramount consideration when determining which financial products and services are appropriate. Financial Services firms must be able to demonstrate that their business models, products and services meet this standard.

» Any advice given to a retail client must ensure that the service or product is suitable when assessed against a variety of criteria, e.g.: investment goals, affordability, time to invest, tolerance for risk, capacity for loss and the like. These recommendations can only be made once a sufficiently robust and comprehensive fact file has been built up.

who determines what is suitable and who assumes responsibility for suitability when an IFA and DIM/DFM is involved?

» Instinctively, there might be an expectation that both these responsibilities rest with Financial Advisers/Advisory firms themselves. After all, they sit in that part of the value chain that has primary contact with the retail client relationship and their designated role is to give "advice".

» However, the complex nature of financial services and products blur these relationship lines. About 50 per cent of Financial Advisers work with Discretionary Investment/Fund Managers (DIMs/DFMs) to meet at least some, if not all, of the investment allocation requirements of their clients in the UK retail investment market. Moreover, this overall percentage is likely to increase further as many more Financial Advisers look to DIMs/DFMs to deliver investment solutions.

» Some in the financial advice sector believe they have "outsourced" investment management decisions to DIMs/DFMs, so too have they in turn "outsourced" the suitability responsibilities of investment allocation and management to DIMs/DFMs. That is a strong assumption for both the Financial Adviser to make and the DIM/DFM to take.

» As an aside, and in this instance, the term "outsource" should be treated with some care, as its use as a generic term where two parties are providing services to a single client leads to confusion as to who does what, especially as it has very specific meaning under current regulations.

» Therefore, it is important that a "suitability gap" does not emerge where both groups assume that the other has taken control and provides cover for the responsibility. Ignorance or wrong assumptions are not a defence to any subsequent claim.

» The **Responsibilities of the Product Provider and Distributor for the Fair Treatment of Clients** (RPPD), regulation issued by the Financial Conduct Authority's (FCA) predecessor, the Financial Services Authority (FSA), in 2007 provides key principles that should govern the responsibilities between providers and distributors in their dealing with retail clients, e.g.:

Principle 2

A firm must conduct its business with due skill, care and diligence.

Principle 3

A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

Principle 6

A firm must pay due regard to the interests of its customers and treat them fairly.

Principle 7

A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

Principle 9

Customers: relationships of trust meaning a firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to relay upon its judgement.

» There is further subsequent steer from the FCA Handbook about respective suitability (and appropriateness) responsibilities:

- COBS 9.1.1 applies to a firm making a personal recommendation in relation to a designated investment. A portfolio service is not a designated investment; as such the adviser does not have a regulatory obligation of suitability (except, see Principle 9 below) but does have one of appropriateness (COBS 10).
- COBS 9.1.3 gives the DIM/DFM an obligation of suitability as they are managing investments.

» To prevent any gap emerging, the onus is on Financial Advisers and DIMs/DFMs to agree how they will apportion responsibility between themselves based on the roles and duties they assume with respect to each other and the end retail client.

developing a framework for suitability

» It is the actual nature of the service delivery model between Financial Advisers and DIMs/DFMs that determines the respective suitability responsibilities each group assumes.

» There are 4 broad forms of relationship that Financial Advisers and DIMs/DFMs can base their operating model on, and which ultimately determines their relationship with the end retail client:

Model A

The Advisory firm arranges for the Client to have a direct (contractual) relationship with the DIM/DFM.

Model C

The Advisory firm arranges for the investment management to be carried out by the DIM/DFM but on the basis that the Client does not have a contractual relationship with the DIM/DFM. Instead, the DIM/DFM treats the Advisory firm as its Client, which is acting as the agent of the end retail client.

Model B

The Advisory firm arranges for the Client to have a direct (contractual) relationship with the DIM/DFM but the DIM/DFM relies on the Client information provided by the Adviser, and an appropriateness assessment also made by the Adviser.

Model D

A proper "outsourcing" relationship is put in place, which means the advisory firms holds all the relevant legal permissions from their retail clients to manage investments and delegate the investment management to the DIM/DFM. The responsibility for all aspects of the investment solution remains with the Advisor.

» Likewise, consideration needs to be given to who is tasked with the upfront and ongoing suitability responsibilities, e.g.:

- The initial suitability and appropriateness of the selected DIM/DFM and the DIM's/DFM's service;
- The initial suitability of the investment in terms of portfolio construction, selection and transactions; and
- The ongoing suitability of the portfolio and monitoring of the DIM's/DFM's service and performance.

» By bringing these elements together in the matrix below, Advisers and DIMs/

DFMs can work through the possible permeations as to who takes the lead, and once delineated, they can then confer their respective suitability responsibilities:

The Diminimis Suitability Matrix: who takes the lead?

	DIM Suitability		Investment Suitability			Ongoing Suitability		
	Selection of DIM/DFM	Appropriate-ness of DIM/DFM Service	Suitability of portfolio construction	Suitability of portfolio selection	Suitability of transactions	Ongoing suitability of portfolio	Ongoing monitoring of DIM/DFM service	Ongoing monitoring of DIM/DFM selection
Model A: Direct to DIM	Adviser	Adviser or DIM/DFM	DIM/DFM	DIM/DFM	DIM/DFM	DIM/DFM	Adviser	Adviser
Model B: Hybrid DIM	Adviser	Adviser	DIM/DFM or Adviser	DIM/DFM or Adviser	DIM/DFM	Adviser	Adviser	Adviser
Model C: Adviser as Agent of client	Adviser	Adviser	Adviser	Adviser	Adviser	Adviser	Adviser	Adviser
Model D: Outsourced	Adviser	Adviser	Adviser or DIM/DFM	Adviser or DIM/DFM	Adviser or DIM/DFM	Adviser or DIM/DFM	Adviser	Adviser

Source: Diminimis Ltd (2015)

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» In the first instance, it is the retail client who is exposed as they run the upfront and on-going risks of falling into a suitability gap both in terms of the selection of the appropriate investment approach and the management thereof. Shortcomings here can result in sub-optimal outcomes for the retail client.

» The Adviser and the DIM/DFM can carry liability for failing to meet suitability obligations to the client.

» Both the adviser and DIM/DFM must have a clear understanding of the legal and regulatory nature of their relationship and the services that they will provide.

» Specifically, this should form part of the advisers due diligence and understanding of the DIM/DFM, which is all too often a limited process. This makes the case for better and consistent due diligence to aid the adviser in making the right and informed choice, a topic which will be covered in a subsequent coffee with corfinancial.