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2 minute guide

Due diligence and suitability: what are advisory firms and discretionary investment/fund managers to do?

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it is a service that is being provided not a product to be bought or sold

- It is vital that the services offered to retail clients are suitable and appropriate so that they meet their investment aspirations.
- Determining who is responsible for making these assessments depends upon the relationship advisory firms and Discretionary Investment/Funds Managers (DIM/DFM) enter into with each other and, ultimately, the retail client.
- Diminimis has identified 4 broad categories these relationships might take, each placing different roles, responsibilities and obligations on advisers and DIM/DFMs:

Model A

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

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 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 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.

due diligence is a vital step in getting things right

- The Financial Conduct Authority (FCA) holds that inadequate research and due diligence are 1 of the 3 root causes for poor consumer outcomes. The others are insufficient risk profiling, and product and service costs not being considered fully.
- A DIM/DFM chosen in the past might not always be the most suitable provider today or into the future. Similarly, different retail clients will have different requirements that might mean different DIM/DFMs may be required to meet these divergent requirements. Also, over time, the individual requirements of

clients may change, meaning that the actual advice and service may no longer be suitable and therefore have to change.

» The onus is on advisers to demonstrate they have done sufficient upfront and ongoing due diligence to demonstrate that the services selected have the client's best interest in mind for the life the services are provided.

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what should research and due diligence cover?

» No single definition exists to define the full scope and mandate, along with the controls and oversight that should be in place, to support good due diligence. Similarly, no single set of templates or questionnaires exist that advisers or DIM/DFMs can rely on to ensure full compliance.

» The FCA is not prescriptive as to what constitutes good research and due diligence but rather places its regulatory focus on achieving outcomes that are client centric. Essentially, it leaves it to firms themselves to determine how much due diligence and controls are necessary to achieve results that achieve the client's best interests.

» Although this approach might appear somewhat vague, the FCA (TR15/12) recognises "the wealth management industry contains a variety of firms which have differing business models and service offerings". We infer that the regulator takes this position because of all the different permeations that are possible in the service delivery model, which in turn makes it difficult on a priori grounds to be definitive and all encompassing.

» The starting point for any research and due diligence for advisory firms is to identify what they are looking to achieve for their clients and their business when working with a DIM/DFM. It is critical they understand the options available and the resultant obligations that follow from the operating model they select.

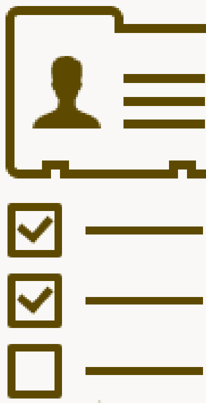
» Once the engagement model has been identified, advisers can then work backwards to identify the various components that will form part of the services they and the DIM/DFM will deliver and from which they can then identify the criteria to form part of their due diligence questionnaire.

- Unlike product due diligence, the focus is to understand that obligations not only vary by operating style but also at different stages in the client journey, i.e. initial discussion and assessments, initial portfolio construction, and then onto ongoing decisions to trade and ongoing reviews to ensure aspects continue to be appropriate activities.
- To give steer to advisers, the Personal Finance Society (PFS) has defined due diligence in its Good Practice Guide as:

> The care a reasonable and prudent person (Adviser) should take before entering into an agreement or a transaction with another party (the DIM/DFM). Gathering detailed, quality information over and above general marketing documentation is a fundamental part of the research process, in order to identify anything deemed material in the service or relationship ... advisers will be equipped to make an informed decision ensuring all the costs, benefits, known and potential risks are analysed and assessed against the Adviser Firm's pre-defined criteria.

- DIM/DFMs have particular due diligence obligations where they rely significantly on the advisor firm for client information and assessment. In these circumstances, they have to ensure that they are satisfied with the process supporting the client journey right through to the transfer of client information to themselves.
- DIM/DFMs are also required to conduct due diligence on the providers of the investment vehicles they use in providing their services to the client. These are typically the products around which they will wrap their services. The Alternative Investment Market Association was the first to bring in a standard due diligence questionnaire when it became apparent all research teams wanted the information in a consistent format, and is generally the basis for most questionnaires in this instance.

due diligence is not a tick box exercise



- Since the focal point of most qualitative due diligence exercises is the questionnaire, care and consideration should be given to both how it is constructed and how it is used on its return.

» Asking the wrong questions or not interrogating the results in sufficient depth is not helpful as it will not allow for an accurate picture of the DIM/DFM to be built up or will it offer a solid basis on which client requirements can be assessed.

» Likewise, if the returned questionnaire is simply filed away without in-depth scrutiny or is not part of a robust process of control, then a proper fact file cannot be compiled or maintained, nor can suitability be judged adequately.

» Although not exhaustive, there are a number of key elements that will have a significant impact in the design and final form the questionnaire should take if it is to avoid coming up short, i.e. it needs to establish:

- The different service styles available, e.g. bespoke or MPS;
- The engagement model between the adviser and the DIM/DFM;
- Whether the administration platform is in-house or an external wrap platform;
- If the investment team is central or local;
- Whether the adviser sees the provider of the investment solution as an integral part of a team providing a personal service to the client or is it simply a service provider;
- The approach to intermediary agreements;
- The ability to negotiate terms with the service provider;
- The approach to investment management;
- Benchmarks selected;
- The use of collectives versus direct market securities;
- How charges will be levied;
- Terms and conditions;
- Provider's reputation or brand awareness;
- The range of tax wrappers that can be accessed;
- Service flexibility and whether it can be adapted to meet individual client's needs and objectives;
- The provider's approach to research; and
- Ultimately, how these elements all fit to meet the client's investment objectives/ mandate.

» A quantitative overlay can be applied at any time in the process (but generally assumed to be in the early stages) to ensure the DIM/DFM can demonstrate an acceptable performance track record.

getting it right has important benefits

» In the first instance, good qualitative research and due diligence answers key questions that ultimately will serve the client's best interests:

- Can I work with this firm and the people?
- Can they deliver the service my clients require?
- What am I responsible for?
- What controls and oversight do I require at each stage of the process?
- Does my firm have the appropriate permissions, resource and skill set to meet these requirements?
- How the adviser/DIM/DFM interface with the investment administration platform?
- What is my client paying me to do?
- What is the DIM/DFM responsible for?
- Are the fees/costs for the service reasonable?

» Yet, in the second instance, getting the questionnaire right (and with it the due diligence process) can have important benefits for both the adviser and the DIM/DFM:

good research and due diligence makes for better business

Advisory Firms	DIM/DFMs
Confidence they have the right question set at the outset to conduct desk based qualitative research	Ability to respond quickly to requests for DDQs/RFIs
Ability to analyse and compare the information received in a systematic manner against their pre-defined criteria	Requests for further information will only come from Advisers who have shortlisted the DIM/DFM
Enable the selection of a shortlist of potential DIM/DFMs that are the closest match to their clients requirements	More efficient use of resources spent on responding to the due diligence questionnaire
Identify topics to address with the short-listed DIM/DFMs when they meet	Greater confidence in working with an Adviser, in the knowledge the Adviser is aware of their responsibilities
Identify issues to address when reviewing an existing panel of DIM/DFMs	Advisers have greater confidence in the information provided, encouraging more to use the services of DIM/DFMs

» If an industry standard approach to the questionnaire could be agreed, then perhaps even further benefits could be realised as it would;

- Help cut through the confusion in the market;
- Create a consistency of understanding;
- Make the exercise more efficient for both the adviser and the DIM/DFM;

» Ultimately reduce the scope for future client complaints against both the adviser and the DIM/DFM.

final thoughts

» Advisory firms and DIM/DFMs must to be able to identify what is important to them and their clients. It is important that they establish their key criteria early in the process.

» Ask the right questions to elicit the information that is required to make a full and proper assessment. Similarly, know what you are going to do with the information when you get it.

» The service style and four operating models Advisory Firms and DIM/DFMs can enter into have significant differences and resultant obligations. The way to bring clarity is to have a specific question set and questionnaire applied to each service style.

» By establishing key criteria at the outset makes regular reviews straightforward. The focus then centres on what has changed: in adviser requirements, the regulatory environment, the DIM/DFM and the services they offer.