Guidance consultation

Assessing suitability:

Replacement business and centralised investment propositions

April 2012

Contents

1 Executive summary

1.1 In preparation for the Retail Distribution Review, many firms are changing their business model and choosing to offer a centralised investment proposition (CIP). This includes portfolio advice services, discretionary investment management[1] and distributor-influenced funds.

1.2 We recently carried out a thematic review to assess how this change has affected consumers. This report outlines our findings and provides examples of our concerns around CIPs which, if not mitigated, could result in poor customer outcomes. Our review of CIPs also identified suitability failings of wider relevance relating to replacement business[2] which are also covered in this report. We highlighted many of these failings in previous thematic reports.[3] It is unacceptable that many firms are still not demonstrating the suitability of replacement business.

1.3 We expect all firms providing investment advice to act in their clients' best interests. As part of our supervision, we will look to see how firms are acting in this area. We will continue to take tough action where we identify poor practice.

Actions for firms

1.4 All firms providing investment advice should ensure that they have robust processes and controls when recommending replacing an existing investment. In particular that:

- the costs of the investment solution recommended are in the client's best interests and presented in a way that the client is likely to understand (page 9);
- when improved performance prospects are a driving factor for the recommendation, it is clear why the new investment is, in the firm's opinion, likely to out-perform the existing investment (page 10);
- the recommendation is suitable given:
  - the tax implications (page 11); and
  - the client's specific objectives (page 12);
- the firm collates necessary information on the client's existing investments and demonstrates why these no longer meet the client's needs and objectives (page 13).

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[1] This publication focuses on the advisory process to recommend discretionary investment management as a CIP. It does not focus on the discretionary investment management itself.

[2] We describe what we mean by 'replacement business' in Chapter 3 of this report.

[3] www.fsa.gov.uk/Pages/Library/Other_publications/pension_switching/index.shtml
www.fsa.gov.uk/pages/Library/Other_publications/platform_thematic_review/index.shtml

1.5 In light of this guidance, firms conducting replacement business should consider reviewing the following areas to ensure they are acting in their clients' best interests and treating them fairly.[4] A firm should consider:

- its replacement business sales process;
- the controls in place to mitigate the risk of unsuitable replacement business recommendations;
- the quality of the management information on replacement business and whether issues are identified and acted on accordingly; and
- the quality of challenge provided by the file review function.

1.6 A firm either selling or intending to sell CIPs should:

- consider the needs and objectives of its target clients when designing or adopting a CIP (page 16);
- ensure that it is not 'shoe-horning' clients into the CIP (page 20); and
- establish a robust risk identification and control system to mitigate risks which might arise from the specific characteristics of its CIP (page 22).

[4] COBS 2.1.1 and Principle 6.

2 Overview

2.1 In our 2012 publication, the *Retail Conduct Risk Outlook* (RCRO), we highlighted how investment advisory firms are changing their business models in preparation for the Retail Distribution Review (RDR). In many cases firms are choosing to offer a CIP which may be driven by the intention to create additional value for clients and to justify ongoing adviser charging given the ban on commission as part of the RDR.

2.2 For this report, we use the term CIP to reflect a standardised approach to providing investment advice. Examples of this include:

- **Portfolio advice services –** recommending a portfolio of investments that is designed to meet a target asset allocation. Firms may operate a number of these 'model portfolios' to meet the needs and objectives of clients with different risk profiles. Reviews of the portfolios are typically carried out periodically.

- **Discretionary investment management –** either in-house or outsourced where the adviser has some say in the investment strategy adopted.

- **Distributor-influenced funds (DIFs).**[5]

Further details on all three proposition types are found on page 64 (section 3.5) of the RCRO 2011.[6]

2.3 We recognise there can be benefits to offering a CIP for both clients and firms. Clients can benefit from more structured and better researched investments and firms can benefit from efficiencies in the management of risks associated with investment selection. However, we have concerns that, in certain circumstances, a CIP may be unsuitable for a retail investor. For example:

- **'Shoe-horning' –** firms might recommend a 'one size fits all' solution which is not suitable for the individual needs and objectives of a client;

- **Churning –** firms might advise clients to switch their existing investments into a CIP without adequate consideration of whether the switch is both suitable and in the client's best interest; and

- **Additional costs –** the use of a CIP might result in higher (and potentially less transparent) charges than the client's existing investments and with few additional, actual benefits.

[5] We have additional concerns in relation to DIFs and have published separate guidance on this matter. www.fsa.gov.uk/library/policy/final_guides/2012/distributorinfluenced-funds
[6] www.fsa.gov.uk/library/corporate/rcro

2.4 Due to our concerns, we carried out a thematic review into the use of CIPs. While the original focus of our review[7] was on CIPs, we also identified suitability failings of wider relevance, specifically with replacement business.

2.5 While this report focuses on CIPs, we acknowledge developing a CIP often goes hand in hand with a firm reviewing and altering its service proposition. It is encouraging to see evidence of firms considering the services they offer to clients in the run up to the RDR.

2.6 The purpose of this report is to provide guidance, including examples of good and poor practice, to firms when they:

- undertake replacement business; and
- offer CIPs.

Who should read this report

2.7 Chapter 3 of this report is relevant to all firms that provide investment advice[8] to retail customers whether or not they offer a CIP. Chapter 4 is relevant to intermediary firms either currently or considering offering a CIP.

Scope

2.8 Our thematic review focused on whether the:

- firm's CIP is designed to meet the needs and objectives of its target clients;
- firm's sales process is designed to ensure that a CIP is only recommended to clients when it is suitable for those clients;
- firm's advisers are competent to assess whether or not a CIP is suitable;
- CIP is promoted and recommended to clients in a way that is fair, clear and not misleading; and
- firm has adequate oversight arrangements and management information (MI) to mitigate the risk of unsuitable advice.

2.9 We assessed 181 investment files from 17 firms which recommended a CIP. As part of our review we assessed both the quality of advice and the quality of disclosure.

2.10 Overall we assessed the quality of advice to be unsuitable in 33 cases and unclear in 103 cases. We assessed the quality of disclosure to be unacceptable in 108 cases. The main drivers for these ratings are summarised in the following key findings section.

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[7] Please refer to the annex for the methodology

[8] This includes recommendations to clients to use discretionary investment management.

Key findings

Replacement business

2.11 We continue to identify firms failing to consider the impact and suitability of additional charges when conducting replacement business. Several firms in our review failed to consider the costs and features of the existing investment, and were unable to quantify the additional charges associated with the new investment. In addition, several firms failed to provide a comparison of the costs of the existing investment and the new recommendation in a way the client was likely to understand.

2.12 We saw examples of firms recommending switches based on improved performance prospects[9], but providing no supporting evidence to show that these performance prospects were likely to be achieved. While we acknowledge that firms cannot be precise about the potential for higher returns, where improved performance is an objective of the client, firms should clearly demonstrate why they expect improved performance to be more likely in the new investment.

2.13 Firms often failed to collect adequate information on the existing investment or failed to consider the features and funds available within the existing solution. Firms should collect adequate information on the existing investment to demonstrate they have taken reasonable steps to ensure the suitability of their recommendation.[10]

2.14 In addition, our work indicates that firms' file review functions failed to identify or challenge advisers on the failings we identified as part of our review.

2.15 These factors create a significant risk that clients are receiving unsuitable advice to switch investments. Firms must ensure their risk management systems and controls are fit for purpose and mitigate the risk of unsuitable client outcomes.

2.16 These findings are detailed in Chapter 3.

Centralised investment propositions

2.17 We saw examples of good practice, such as firms conducting detailed research on the typical needs and objectives of their target clients when deciding whether to offer a CIP. Several firms chose to carefully segment their client bank and offer a range of CIP solutions for different client segment. Such an approach may help a firm in improving the consistency of investment advice offered by its different advisers to similar clients.

2.18 Several firms operated a CIP as the automatic investment solution for all clients. In addition, the firms did not always ensure that their advisers were competent to identify when the CIP was not a suitable investment solution for a client. This resulted in advisers recommending the CIP to clients for whom it was not suitable.

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[9] This example is for a switch from one fund to another fund with the same risk profile. The prospect for improved performance in this example was not derived from the client being 'up-risked'.
[10] COBS 9.2

2.19 We expect firms to ensure they have robust systems and controls in place to mitigate the risk of unsuitable advice which might arise from recommending a CIP. Our review found that several firms received additional financial gains when recommending their CIP. This incentivised the firm and its advisers to recommend the CIP rather than an alternative solution. This inherent conflict of interest was not managed and created a clear risk of clients receiving advice that was not in their best interests.

2.20 Whilst we acknowledge that there may be benefits to firms and clients by offering a well thought-out CIP, firms should remember that CIPs are not suitable for all clients.

2.21 These findings are detailed in Chapter 4.

3 Replacement business

3.1 This chapter is relevant to *all* firms providing investment advice to clients and is not specific to firms that provide CIPs. It focuses on how firms should take reasonable steps to ensure the suitability of recommendations to switch any existing investment into a new investment solution.[11]

3.2 Our examples of good and poor practice are taken from our work on reviewing the suitability of CIP recommendations. However, the examples are relevant to all replacement business recommendations.

3.3 Continued failings in the suitability of such recommendations are not acceptable.

Key issues firms should consider

Poor outcomes can occur if firms, in particular, fail to:

- consider objectively their clients' needs and objectives;
- collect necessary information on their clients' existing investments and the recommended new investments, such as the product features, tax status, costs and the performance of the underlying investments; and
- implement a robust risk-management system to mitigate the risk of unsuitable advice and poor client outcomes.

Factors that influence a recommendation to switch investment

3.4 Our rules (under COBS 9.2.1 and COBS 9.2.2) require firms, when making a personal recommendation or managing a client's investments, to obtain the necessary information about the client's investment objectives.[12]

3.5 Clients typically wish to make a return on their investment. This may be by generating growth or an income. The main factors that usually dictate a client's investment return include:

(a) the charges of the recommended investment;

(b) the performance of the investment; and

(c) the tax treatment of the investment.

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[11] This report does not consider recommendations to transfer out of occupational pension schemes.
[12] COBS 9.2.1 also places a requirement on firms to obtain necessary information regarding the client's financial situation and their knowledge and experience in the investment field relevant to the specific type of designated investment or service.

3.6 We expect firms to consider all of these factors and clearly demonstrate the benefits of a new investment proposition before recommending a switch out of a client's existing investment. Even in the unusual case where making a return is not the client's primary objective (i.e. as the customer has other objectives), we still expect a firm to consider all of the factors mentioned above so that any disadvantages of the switch can be clearly explained to the client.[13]

Considering cost

Our expectations

3.7 We expect firms to consider the issue of cost for all recommendations to replace a client's existing investment.

3.8 Our publication on investment advice and platforms stated that where a more expensive solution is recommended, there needs to be a good reason and this reason needs to be justified to the client. The most common reason for unsuitable advice identified in the platform review, and the earlier pension switching review, was unnecessary additional costs.

3.9 Where the advice is to switch or transfer an existing investment to a new investment, we expect to see firms conduct a cost comparison between the two solutions. Firms should consider all the costs associated with the existing investment and the recommended product or portfolio. For example, firms should consider the impact of any trading charges levied on the portfolio.[14] Firms should also consider the impact of initial costs.

3.10 Where additional costs apply, firms must judge whether they are suitable in light of the needs and objectives of the client. Additional costs may be justifiable where they are associated with a specific benefit that is valued by the client. Firms should disclose any difference in the cost in a way that is fair, clear and not misleading.

3.11 Where firms do not have adequate controls in this area, they risk providing unsuitable advice and potentially breaching:

- Principle 6 – A firm must pay due regard to the interests of its customers and treat them fairly;
- Principle 9 – A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement;
- COBS 2.1.1 – A firm must act honestly, fairly and professionally in accordance with the best interests of its clients; and

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[13] Where suitability reports are required, a firm must explain any possible disadvantages of the transaction for the client as outlined by COBS 9.4.7.
[14] Where costs are variable such as trading costs, reasonable assumptions should be made about the extent of these charges.

- COBS 9 – 'Suitability'.[15]

Our findings

Good practice

Several firms used reduction in yield (RIY) figures in cost comparisons which also considers the initial cost associated with the recommendation. We also saw firms using comparative projections to demonstrate, on a pound for pound basis, the impact of cost differences on the value of the pension at retirement.

Poor practice

One firm provided a cost comparison in its suitability report when recommending replacement business. The annual cost of the recommended investment was based on the annual management charge. However, the product provider's illustration highlighted additional charges on some of the recommended funds which were omitted from the cost comparison. This increased the annual charge of the new investment by up to 1% which the firm did not consider.

Poor practice

One firm offered a CIP via a discretionary service, but its replacement business cost comparison did not assess the overall impact of all the charges of the new investment. The firm disclosed the specific portfolio and underlying fund charges. Although it highlighted that additional charges were levied as a result of trades, it did not pay due regard to the typical volume of trades that may be expected within each portfolio, and hence what the typical overall costs would be. Members of the senior management team and the compliance department were unaware of the impact that the volume of trades may have on the portfolios' overall costs.

Considering performance

Our expectations

3.12 Firms must not automatically assume that the CIP will provide better performance prospects than the client's existing investment. Where a firm recommends replacing an existing investment on the basis of improved performance prospects, we expect to see the firm justify specifically why the new investment is, in the firm's opinion, likely to out-perform the existing investment.

[15] fsahandbook.info/FSA/html/handbook/COBS/9

3.13 Where a firm recommends a switch to a more expensive investment because of the prospect of improved performance, we expect it to take into account the additional cost when quantifying the potential for improved investment returns. There are a number of factors that firms could consider in taking a view on the potential for additional performance and these may vary depending on the circumstances. For example, a low risk fund is less likely to offset additional costs through improved fund performance.

Our findings

Poor practice

One firm stated in its suitability reports that factors affecting its choice of investment partner included investment options and performance. However, there was no evidence that it considered and compared the options and performance of each client's existing investment with the recommended CIP solution.

Poor practice

One firm sought to explain improved performance prospects by highlighting that the client would benefit from their investments being 'actively managed' in the recommended solution, implying that the existing investment was not actively managed. However, in most cases, the client's existing investments were already actively managed.

Considering the tax position

Our expectations

3.14 Before a firm recommends replacing an existing investment, it should have due regard to the potential tax implications. Tax acts as an additional cost by reducing the client's return on their investment. Firms recommending a replacement investment should consider whether that investment is the most tax efficient option in light of the client's financial situation, needs and objectives, and also must consider any tax implications of switching.

Our findings

Poor practice

One firm did not consider the impact of taxation on its replacement business recommendations. It made recommendations which triggered liabilities to capital gains tax (CGT) but gave no consideration to mitigating the level of tax payable. By staggering the sale of existing investments over two tax years, clients would have been able to reduce or remove this tax charge by using their annual CGT allowance for two years.

Considering the client's specific needs and objectives

COBS 9.2.1 and COBS 9.2.2 set out a wide range of information a firm must collect, where relevant, about the client's circumstances and objectives depending on the nature and extent of the service provided. Where a client has existing investments, firms should collect necessary information to assess whether recommending a replacement investment is suitable and meets the client's needs and objectives.

Collecting and assessing appropriate know your client information

Our expectations

3.15 We expect firms to collect information regarding the client's *specific* objectives rather than relying on generic objectives for the client. For example, if income is an objective, we expect a firm to identify the specific reason why the client has this requirement. Additional detail around the income requirement, including the amount required and the duration, will help determine the suitability of specific investments.

3.16 Once advisers have established a client's objectives and financial priorities, they should typically help the client understand and prioritise these objectives. Where they do this, advisers should approach this matter in a fair and balanced way, in accordance with the client's best interests.[16] Advisers should never approach a fact-finding exercise with a preconceived agenda to switch the client's existing investments into a new solution as this may not be the most suitable option for the client.

3.17 When presenting a recommendation to a client we expect firms to personalise the suitability report so that it reflects the *specific* client needs identified in the fact finding exercise and why the recommendation to replace the existing investment meets those needs.[17] We do not expect to see firms using generic objectives across all suitability reports.[18]

Our findings

Good practice

One firm's client files included detailed notes taken during the 'fact-find' meeting. Not only did these detail the client's specific investment objectives, but also the underlying motivation behind the client's objectives. By providing this level of detail, the firm was better able to demonstrate that its replacement business recommendations met the needs and objectives of its clients.

[16] COBS 2.1.1
[17] COBS 9.4.7
[18] See the small firms factsheet on suitability reports for further guidance: www.fsa.gov.uk/smallfirms/resources/factsheets/pdfs/factsheet_suitability.pdf

Collating and assessing information on existing investments

Our expectations

3.18 Firms should collate necessary information on a client's existing investments to enable them to assess whether any recommendation to switch to a new investment meets the client's needs and objectives.

3.19 Firms should consider several factors[19] when reviewing the client's existing investments, including:

- **Investment flexibility.** Where an existing investment solution is flexible enough to meet the needs and objectives of the client, firms should consider whether it is in the client's best interest to switch to a new solution. For example, where a firm recommends a higher cost solution using funds that are available in the existing investment solution, we would deem this to be an unsuitable outcome for the client if there are no other justifications to demonstrate the suitability of the recommendation. We would also question whether the need for a 'wider investment choice' is adequate justification to incur additional costs if the existing product already has a wide enough investment choice to meet geographic and asset allocation needs.[20]

- **Guarantees.** Firms should consider any guarantees that are available under the client's existing investment. If these guarantees are no longer suitable for the client, a switch to a new solution may be appropriate. However, if the guarantees have value for the client, the firm should consider whether the switch is suitable in light of the loss of these guarantees. In some cases, it may be in the client's best interest to keep the existing investment and, for example, restructure the existing investment or adapt other investments to complement the one with valuable guarantees.

Our findings

Good practice

In one firm, details of each of the client's existing investments were clearly presented in the suitability report. This included details on the features and benefits of the existing investment along with the performance of the individual funds. The adviser clearly documented their recommendation for each investment, including their specific rationale for each recommendation. This included recommending retaining existing investments that already met the needs and objectives of the client.

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[19] Three of these factors are the cost and performance of the investment and the tax position, all of which are discussed earlier in this chapter.
[20] This point is also relevant for non replacement business in that we would question whether a 'wide investment choice' would be justification for a high cost solution if the client was unlikely to make use of the wide choice of funds.

Controls and oversight

Our expectations

3.20 Firms are responsible for deciding how they approach risk management and for ensuring systems and controls are fit for purpose and effective in mitigating the risk of unsuitable client outcomes.

3.21 We have seen firms employing various controls to mitigate the risk of unsuitable advice in relation to replacement business. Examples include:

- using replacement business forms to record specific information around the existing and recommended solution and the rationale for the transfer;
- rating replacement business as 'high risk' from a file checking perspective, thus resulting in a higher number of checks;
- requiring pre-approval of replacement business recommendations before presenting them to the client; and
- using MI to monitor advisers' business levels and advice types, and taking appropriate actions on any identified anomalies.

3.22 These are not the only controls that may be appropriate, nor are they necessarily the right ones for all firms. We find generally that the effectiveness of any control is down to its robust operation rather than the nature of the control itself. Different controls are likely to be effective for different firms – depending on their size, structure, their advisers and the services they provide.

3.23 To ensure that costs of replacement business are considered appropriately and the risk of unsuitable advice is mitigated, it is likely that a firm will need to adopt a consistent approach across the different parts of the business, including the senior management team, compliance, the file checkers, the advisers and any other individual involved in the advisory process (for example, paraplanners and support staff).

3.24 Firms should consider when the additional costs of replacement business are likely to make such a recommendation unsuitable. This should include considering the magnitude of additional costs and the potential benefits associated with that cost.

Our findings

Good practice

One firm placed a limit on the additional acceptable cost of replacement business at 0.5% per annum. Recommendations could only exceed this limit in exceptional circumstances after a discussion with, and approval by, the advice manager.

Note: Another firm had a range of cost levels on a traffic light scale (red/amber/green ratings) with different requirements for each. The appropriate level may vary between firms and clients. For example, a lower additional cost may be appropriate for cautious investors.

Poor practice

Several firms had not clearly defined the level of additional costs they considered acceptable for their clients. As a result, their file reviewers were not consistent in their view on when recommendations that imposed additional costs were justified. As a result we failed several files that had been reviewed and passed by these firms' file review function.

4 Centralised investment propositions

4.1 This chapter is relevant to advisory firms that offer, or are considering offering, a CIP, as described in Chapter 2 of this report. It considers:

- steps that firms should take when designing or adopting a CIP;
- our expectations of firms to ensure that individual recommendations into a CIP are suitable for each specific client; and
- our expectations of firms to act honestly, fairly and professionally, in the best interests of individual clients.

Key issues firms should consider

Poor outcomes can occur if firms, in particular, fail to:

- consider the needs and objectives of their target clients when designing or adopting a CIP;
- consider whether the CIP is suitable for each client on an individual basis; and
- establish a robust control system to mitigate risks which might arise from the CIP.

CIP design and due diligence

4.2 The needs and objectives of a firm's target clients should be at the heart of the decision to offer a CIP. A firm should give due consideration to whether a CIP is appropriate in light of these needs and objectives and if so, the type of CIP that should be offered.

Considering the needs and objectives of your target clients

Our expectations

4.3 Where a firm offers a CIP we expect it to consider the requirements of its target clients. For example:

- their knowledge and experience;
- their financial situation;
- their investment objectives; and
- the type, level and cost of the service the clients require.

Our findings

Good practice

One firm used feedback from its clients and identified that they only required a simple, low cost CIP. It used this feedback to design and implement a CIP that provided a simple ongoing review service at a cost that was lower than the market average.

Other firms engaged client-facing staff to provide guidance on their clients' typical needs and objectives when considering whether to offer a CIP.

Poor practice

Several firms inherited CIP solutions following mergers or acquisitions. Following these corporate changes, the firms failed to undertake any assessment to establish whether the CIP was suitable for the needs and objectives of their new, larger client bank.

Client segmentation

Our expectations

4.4 Where a firm has a diverse client bank, it may wish to consider segmenting its clients. This involves offering a range of CIP solutions to meet the needs and objectives of different client segments. This is in firms' interests, as well as clients, as it is likely to increase the number of clients for whom a CIP solution is suitable.

4.5 Where a firm segments its client bank, it may offer different service levels and features to suit clients with different requirements. Where service levels differ, firms should inform clients of the services and their costs in a way that is fair, clear and not misleading.

Our findings

Good practice

Several firms segmented their client bank effectively and designed appropriate solutions to cater for each segment. This included:

- a preferred fund panel for transactional clients;
- a suite of low-cost managed funds for clients with modest asset levels who required a low-cost ongoing service;
- a model portfolio service for clients with a higher level of assets and investment experience, where the additional costs were appropriate; and
- discretionary fund management for clients who required bespoke investment management solutions.

Designing or adopting a CIP

Our expectations

4.6 Firms wishing to offer a CIP must decide whether to design a CIP themselves or adopt a CIP created by a third party. Whichever option a firm chooses, it must still ensure the CIP is likely to be suitable for its target clients and meets their needs and objectives.[21]

4.7 When adopting a CIP solution provided by a third party, a firm should conduct adequate due diligence to ensure the CIP provided meets the needs and objectives of its target clients. Without completing this necessary step, firms cannot assure themselves that the CIP is likely to be suitable for their clients and therefore should not adopt the CIP. For example[22], when adopting a CIP, firms may wish to consider the:

- terms and conditions of using the CIP;
- CIP's charges;
- CIP provider's reputation and financial standing;
- range of tax wrappers that can invest in the CIP;
- type of underlying assets in which the CIP invests;
- CIP's flexibility and whether it can be adapted to meet individual client's needs and objectives; and
- CIP provider's own due diligence into the constituent investments.[23]

4.8 A firm may also decide to outsource investment selection to a third party. Where a firm outsources investment selections to a discretionary manager, both the introducing firm and the discretionary management firm have obligations to ensure that a personal recommendation or a decision to trade is suitable for the client. The obligations on each party will depend upon the nature and extent of the respective service provided. Both parties should be clear on their respective service, and ensure they meet the corresponding suitability obligations. If either or both parties are not clear, there is a risk that clients may receive unsuitable advice and/or have their portfolios managed inappropriately.

[21] For example, where a firm typically advises clients with modest assets and limited financial knowledge and experience, we do not expect to see the adoption of a CIP using non-mainstream assets.
[22] This provides examples of issues firms may wish to consider. It is not exhaustive.
[23] But the fact that a provider has carried out due diligence does not negate the need for a firm to carry out its own due diligence.

4.9 Where a firm offers in-house discretionary management, it must ensure it holds the required permissions. Where a firm chooses to delegate the discretionary management to a third party, it can meet this requirement in two ways. It can either:

a) arrange for the client to have a direct contractual relationship with the discretionary manager; or

b) retain responsibility for the discretionary management but outsource the actual management to a third-party manager. The firm is still required to hold the relevant permissions for managing investments, even though it does not actually carry out the management.

Our findings

Good practice

Several firms carried out a review of their clients' typical needs, and formulated a list of key requirements before tendering for a third-party CIP provider.

Poor Practice

Several firms adopted a CIP provided by a third party with whom they had an existing relationship. However, the intermediary firms failed to undertake any due diligence on whether the CIP solution adopted met the needs of their target clients.

Poor practice

One firm outsourced the management of its CIP to a discretionary fund manager. The advisory firm neither arranged for its clients to have a contractual relationship with the discretionary management firm, nor did the advisory firm hold the permissions to manage client investments. By managing the assets within the CIP on a discretionary basis, the firm was operating outside its scope of permissions.

Constructing portfolios that are suitable for the risk profile of distinct client segments

Our expectations

4.10 We published guidance in March 2011, entitled '*Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection*'.[24] Our expectations for investment selection are covered in detail in Chapter 4 of that guidance. Here, we are considering investment selection specific to CIPs.

[24] www.fsa.gov.uk/static/pubs/guidance/fg11_05.pdf

4.11 When designing a CIP, firms may create different portfolios of assets to cater for different client risk profiles. Where a firm creates or uses risk-rated portfolios as part of its CIP, it must ensure the portfolios align accurately with the risk descriptions and outputs from any risk profiling tool it employs. It is the responsibility of the firm to ensure this alignment. Where there is a mis-alignment, there is a risk of systemic mis-selling.

4.12 Where a firm uses an asset-allocation approach in constructing portfolios[25], it should ensure that it has a robust process to review each portfolio to mitigate the risk of portfolio 'drift'.[26] Where portfolio drift occurs, there is a danger the risk profile of the client and the risk profile of the portfolio will move out of alignment. Firms should clearly explain to clients the importance of, and the reason for, ongoing reviews of their investment portfolios. Firms may decide to address this matter by amending their service proposition and providing periodic reviews for their clients.

Our findings

Poor practice

One firm's CIP used model portfolios managed on a discretionary basis. These portfolios contained significant exposure to non-mainstream investments[27] and higher levels of equity-based investments than were appropriate for the firm's clients, particularly those at the lower end of the risk scale. The firm did not provide evidence that it had adequately considered the needs, objectives and knowledge and experience of its clients, some of whom were not financially aware and were unlikely to understand the risks associated with the firm's complex investment strategy.

Poor practice

One firm offered an asset allocation process within its CIP; however, it neither offered an annual review to rebalance the assets nor did it explain the importance of rebalancing to its clients.

Individual suitability

4.13 A CIP will not be suitable for all clients. Even when a firm conducts adequate due diligence and designs its CIP to meet the needs and objectives of its target clients, a firm must take reasonable steps to ensure a personal recommendation, or decision to trade, is suitable for *each* client.[28]

[25] and the recommendation does not have an in-built mechanism to rebalance the asset allocation
[26] Over time, the balance of assets in a portfolio is likely to move away from the asset allocation recommended due to different assets providing a different return. This risk can be mitigated by periodically rebalancing a portfolio.
[27] such as, but not exclusively, derivatives.
[28] See COBS 9.2.1 and COBS 9.2.2

4.14 A firm must ensure that its clients have the necessary knowledge and experience to understand the risks of the underlying investments held in the CIP.[29] The firm should explain these risks to its clients in a way that they are likely to understand. This is particularly important where the CIP uses non-mainstream investments.

4.15 When the CIP solution is not suitable for an individual client, a firm must either recommend an alternative suitable solution or make no recommendation to the client. It is not acceptable to shoe-horn clients into the CIP solution.

Ensuring a recommendation to switch existing investments into the CIP is suitable

Our expectations

4.16 Where a firm offers a CIP, it should not systematically transfer all its clients' existing investments into the CIP without considering the individual needs and objectives of each client. Firms should consider whether a recommendation to a client to sell their existing investments is suitable.

4.17 Chapter 3 of this report outlines our expectations for replacement business.

Our findings

Poor practice

In one firm, advisers would present their recommendation to transfer a client's existing investments to the CIP, and complete the necessary application forms, before analysing the features and benefits of the client's existing investment.

Ensuring advisers are competent and can identify when a CIP is and is not suitable

Our expectations

4.18 A firm must ensure that its advisers are competent and understand the CIP. Advisers need to demonstrate competence in all areas of advice relevant to their role. For example, where a portfolio advice service is offered, advisers must demonstrate they have the technical knowledge, skills and expertise to provide advice on this proposition.

4.19 Firms should ensure that advisers receive balanced training, which highlights not only the potential benefits and features of the CIP, but also any associated cost, risks or drawbacks. Advisers should be able to identify when a recommendation for a CIP is not suitable for a client and, in such cases, advisers should recommend an alternative solution or make no recommendation to the client.

[29] See COBS 9.2.3

Our findings

Good practice

Several firms offered a transactional service to clients for whom the CIP was not suitable. Advisers received training on the CIP and were able to identify under what circumstances it would not be suitable.

Poor practice

In one firm, the advisers were not permitted to research or recommend any investments other than the CIP. All investment recommendations would pass to a central team of advisers to implement the CIP. There was no facility in place to adapt investment solutions to individual clients outside the range of CIP solutions and the firm did not have in place arrangements to turn away clients for whom the CIP was not suitable. As a result, *all* investment recommendations consisted of a CIP solution, creating a significant risk of unsuitable advice.

Controls and oversight

4.20 We expect firms to maintain robust systems and controls to mitigate the risk of providing unsuitable advice. A firm's proposition and business mix are likely to affect how it approaches risk management. Firms are responsible for ensuring that systems and controls are fit for purpose and effectively mitigate the risk of unsuitable client outcomes.

4.21 Where firms operate a higher risk business model, they need to ensure systems and controls are effective in mitigating any additional risks.

4.22 Chapter 3 of this report highlights systems and controls in the context of replacement business.

Identifying and managing conflicts of interest

Our expectations

4.23 Offering a CIP may create a conflict of interest.[30] Two examples of potential conflicts of interest are:

- a firm, or its employees, making an additional financial gain by recommending a CIP[31]; or
- a firm adopting a CIP provided by a third party that retains a financial interest in the sales volumes of the CIP and provides additional, non related services to the advisory firm.[32]

[30] For further details on conflicts of interest see SYSC 10.1
[31] One example of this could be where the firm receives additional income for investment management services provided by a third party.
[32] For example, a firm that also provides compliance services risks not being impartial when making judgements on the suitability of the CIP.

4.24 A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.[33] Senior management within a firm should be able to identify any potential conflicts of interest arising from offering a CIP.

4.25 Where a potential conflict of interest arises, firms should take appropriate steps to mitigate the risk of this conflict resulting in unsuitable outcomes for clients. Senior management should place emphasis on managing any conflict of interest rather than relying purely on disclosing the conflict to their clients.

Our findings

Poor practice

In one firm, employees personally benefitted from the success of the CIP offering. Senior management at the firm did not recognise there was a conflict of interest with the CIP offering and were unable to demonstrate that they had effectively managed it.

Poor practice

One firm adopted a CIP that was designed and packaged by a third-party firm which had a financial interest in the success of the CIP. The firm also used the compliance oversight and file review functions offered by the same third party. This created a potential conflict as the third party was assessing the suitability of recommendations into its own proposition. The senior management of the intermediary firm had not identified this conflict and did not ensure the firm adopted an independent approach to the file review process.

File checking

Our expectations

4.26 Firms should have a robust file review process in place which is effective in mitigating the risk of delivering unsuitable advice to clients. The file review function should provide challenge to advisers on suitability matters as well as disclosure and other failings. Firms should train file checkers on the CIP and ensure they are competent in identifying when a CIP recommendation is and is not suitable for a client.

[33] Principle 8

Our findings

Poor practice

One firm set a minimum threshold for the level of investment into its CIP it considered to be suitable, but the firm failed to confirm this threshold to the third party firm that carried out the file checks. As a result, the third-party firm was not checking the suitability of advice against this key measure. In addition, had the third-party firm known about the suitability threshold, this may have helped it choose a risk-based sample of files to review.

Management information

Our expectations

4.27 Firms should have appropriate management information (MI) to monitor the risks that could lead to poor client outcomes.

4.28 The scope and nature of the MI will depend upon several factors, including the size of the firm and its business model. Examples[34] of the MI that firms may use includes:

- details on the volume of CIP recommendations versus the volume of non-CIP recommendations;
- the ongoing competence of advisers; and
- the results of file reviews.

4.29 Where a firm identifies a risk or failing, we expect it to take appropriate action to put in place adequate risk management systems in relation to the identified risk.

Our findings

Good practice

One firm commissioned the development of a bespoke MI package which the Compliance Director used every day. The MI provided real-time updates for each adviser against a variety of criteria, such as the business mix (including the proportion invested in the CIP), provider mix, product persistency, income levels and file review results. The MI package enabled the Compliance Director to regularly ask each adviser technical questions. Their answers enabled the firm to develop targeted training sessions for the advisers and fed into their ongoing competency assessment.

[34] This provides examples firms may wish to consider. It is not exhaustive.

Good practice

One firm used MI to inform senior management of the volume of business that each adviser was recommending into the CIP. The firm established a traffic light system ('RAG rating') to identify advisers who appeared to be recommending relatively high proportions into the CIP. The firm would then arrange meetings with these advisers to discuss and verify whether their recommendations were suitable.

5 Annex – methodology

5.1 The objective of the project was to investigate practices associated with the design, adoption and use of CIPs.

5.2 The assessment phase of the project was split into two stages:

Stage 1

5.3 We identified a population of 34 firms that were operating a CIP, and we requested information relating to a number of aspects of their business, but focused upon their decision to offer and the use of their CIP.

5.4 All 34 firms were subject to a desk-based review to assess whether the business model and CIP they operated fell within the scope of the project.

Stage 2

5.5 From the original 34 firms, we selected 17 firms that operated a CIP which fell within the scope of the project and that offered an appropriate spread of:

- firm sizes (from small to large firms); and
- firms operating a diverse selection of CIPs (either portfolio advice services, discretionary investment management or distributor influenced funds).

5.6 For each of the 17 firms, our detailed assessment included:

- **file reviews –** we completed between 9 and 15 file reviews for each firm, assessing both the quality of advice and the quality of disclosure; and
- **systems and controls** – this expanded on the information provided by the firm and included interviews with relevant staff involved in the establishment of the CIP as well as its distribution.