Financial Conduct Authority

Thematic Review

TR16/1

Assessing suitability:
Research and due diligence of products and services

February 2016

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1. Introduction

Background

1.1 In this report we set out the high level findings of our thematic review of the research and due diligence processes carried out by advisory firms on the products and services they recommend to retail clients. We considered how they review the market[1] and ensure that they recommend suitable solutions for retail clients.[2] This included, for example, exploring how:

- firms selected products, funds, platforms and discretionary investment management services
- created panels and centralised investment propositions (CIPs), and
- considered options for individual clients.

1.2 We undertook this project as previous thematic work and instances of consumer harm have shown that the poor quality of an advisory firm's research and due diligence is one of the three root causes for poor consumer outcomes. The other two root causes are incorrect risk profiling (see FG11/5[3]) and costs, for example, in relation to replacement business (where a client switches an existing investment or sells it and invests the proceeds in a new product under the recommendation of an adviser; see FG12/16).[4]

What is research and due diligence?

1.3 Research and due diligence form part of a wider range of requirements which, together, combine to ensure firms deliver good client outcomes. These include:

i. Competence – the advisory firm must ensure its advisers are adequately competent on the subject of the product or service concerned. Advisers are required to be competent in the regulated activities they undertake, such as advising on investments.[5]

1 This project focused on advisory firms that researched the market for solutions for clients. It did not focus on vertically integrated firms where the range of products and services are determined by the nature of the group structure.

2 Principle 9 and COBS 9.2

3 FG11/5 Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection (March 2011)

4 FG12/16 Assessing suitability: Replacement business and centralised investment propositions (July 2012)

5 TC 2.1.1R and SYSC 5.1.1

ii. **Research and due diligence** – we use this expression in this paper to refer to the process carried out by the firm to assess (a) the nature of the investment[6], (b) its risks and benefits[7] and (c) the provider[8] (to establish whether they believe it appropriate to entrust the provider with client assets). The firm needs to understand these factors in order to judge whether the solution is suitable.

iii. **Assessing suitability** – once advisers are competent in the nature of the investments and understand the individual product or service, they should be able to judge for each client if the solution is suitable.

1.4 What constitutes a reasonable level of research and due diligence will differ depending on the adviser's recommendation and the needs of the client. Although the objective of research and due diligence is the same across different investments, services and providers, there will be differences in the time and effort taken to achieve it. For example, it will usually take less time to assess a product from a familiar provider investing in familiar assets. Correspondingly it will usually take longer to assess a product from a provider with which the firm is not familiar or which invests in assets the firm has not researched before.

1.5 When firms carry out research and due diligence they should consider whether they can rely on the information supplied by the provider, such as marketing material. Firms can rely on factual information provided by other EEA-regulated firms as part of their research and due diligence process, for example, the asset allocation. However, they should not rely on the provider's opinion, for example, on the investment's risk level.[9]

What we did

1.6 We wanted to see how firms undertake research and due diligence on products and services in order to understand the risks and benefits. To enable us to do this, we assessed 13 advisory firms of different sizes and with a variety of propositions. We visited each firm, reviewed their processes and procedures for carrying out research and due diligence, and interviewed relevant staff. We did not carry out any individual file reviews to test outcomes of research and due diligence or test their approach in practice.

1.7 While the focus of the review was on advisory firms, we also visited seven external research and due diligence consultancy firms and three product or service providers to understand the wider market and their involvement in advisory firms' approach. We did not carry out an assessment of these firms against our rules.

6 The Responsibilities of Providers and Distributors for the Fair Treatment of Customers s1.24(1)
7 FG11/5 s1.16
8 The Responsibilities of Providers and Distributors for the Fair Treatment of Customers s1.24(2)
9 PS12/24 Consumer redress scheme in respect of unsuitable advice to invest in Arch cru funds (December 2012) 2 Annex 13 s6.6.

2.
Findings

Key Findings

2.1 In the main, we found that firms sought to achieve positive outcomes for their clients when undertaking research and due diligence, and generally firms demonstrated some good practice in this area. However, many firms did not show consistently good practice across all products and services. The poor practice we identified varied from issues that are easily addressed to those that are more significant. We were disappointed to identify issues relating to platform research and due diligence, particularly having previously published our expectations[10] around this topic.

2.2 We found that the culture of a firm was important to the success of its research and due diligence process. Firms which demonstrated good practice had research and due diligence as a central function of the advice process, clearly showed they had the client's best interests at heart and put this into practice.

2.3 We found that a key driver of good research and due diligence was a corporate culture of challenge. The better firms had either in-built challenge in the process and/or individuals who were knowledgeable, enthusiastic and challenged the firm's approach. Where there was no culture of challenge within the firm, the research and due diligence process showed weaknesses:

a. Firms did not seek to understand or challenge their own inappropriate bias towards products, services or providers and this led to a lack of objective consideration. In some cases this appeared to result from status quo bias.

b. Firms inadequately managed conflicts of interest between their client's interests and themselves. This was evident, for example, in the consideration of service level as an over-riding factor when selecting platforms. In some cases firms placed the level of service they received as a key factor ahead of the level of service received by their client. Although service is an important factor and the service level to the firm can affect the service level the firm provides the client, in some cases, firms no longer adequately reviewed the options available to the client because the firm was happy with the service from the providers they were using.

10 Factsheet No.012 Platforms: using fund supermarkets and wraps, COBS 6.1E.9R and COBS 6.1F.1R

Other observations

2.4 There were a number of other observations we made during this project:

- We found that all firms, regardless of size or type, can carry out good research and due diligence. The size of the firm was not a barrier to good research and due diligence. We saw examples of small firms, including those with a single adviser, carrying out robust research and due diligence.

- The processes and tools used varied from firm to firm according to size and business model. We do not state what processes or tools firms should use, but firms must take reasonable steps to ensure a recommendation is suitable for the client.

- Research and due diligence needs robust systems and controls in order to be effective. For most firms, file reviews were the main form of control. To be effective, file reviews should involve a genuine assessment of the recommendation rather than simply checking the presence of research and due diligence, irrespective of its quality or relevance to the client.

- When firms have CIPs, they must still ensure the advice is suitable for the individual client. Firms who offered a CIP typically had a centralised function to carry out research and due diligence. While this approach may be appropriate, such firms should ensure that individual advisers understand the benefits and risks of the CIP (including the products, funds and services used) to enable them to identify clients for which it is, and is not, suitable. For example, some firms, as part of this process, would update advisers with changes to the CIP though regular team meetings or training.

- At some firms a lack of structure in the research and due diligence process meant the results were not always up to date or challenged adequately. For example, some firms were not clear on the criteria they used to assess the suitability of the products and services they recommend.

- Many firms demonstrated inconsistent and insufficient research and due diligence in the selection of platforms. We believe this was caused in some cases by status quo bias and an 'if it isn't broke don't fix it' attitude. We also saw evidence of some firms retro-fitting due diligence to justify the outcome the firm had already previously decided upon. We saw one firm that only carried out due diligence on its platform selection after being prompted by its compliance consultant. When it carried out the due diligence it selected criteria based on platform features that would make its existing platform come out as the preferred option, rather than carrying out an objective assessment.

3. Next Steps

3.1 Following visits to firms during our review, we undertook a range of measures to address the issues found. We instructed three firms to make improvements in their research and due diligence process and have asked them to make an attestation that they have done so, signed by a senior individual. Following further work, we have also told one firm we want it to complete a past business review.

3.2 We will be publishing a second consultation paper on the implementation of the Markets in Financial Instruments Directive (MiFID II)[11] later this year. Based on ESMA's Technical Advice to the Commission of December 2014[12], we anticipate that this will include requirements in relation to research on products.

3.3 We will provide firms with further communications that set out our expectations in this area in further detail, to help them raise standards and adopt good practices. We are considering a range of options for the best way to do this.

11 The first consultation paper published in December 2015:
CP15/43 Markets in Financial Instruments Directive II Implementation Consultation Paper 1 (December 2015).

12 ESMA Technical Advice

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