

Bar is raised on due diligence

Advisors must consider whether another investment would be more suitable

By Glorianne Stromberg

Suitability is the latest challenge to confront the financial services industry. The term refers to the evaluation that financial advisors are required to make to ensure that the securities they recommend are suitable to meet their clients' needs, objectives and risk tolerance.

The suitability requirement is not new, but the industry's repositioning of itself as providers of financial advice is. It has raised the bar on the scope of due diligence required to ensure the industry is living up to the higher fiduciary obligations that flow from the advisory relationship. More than marketing semantics are at stake when firms and representatives hold themselves out as providing advice — and this reality is beginning to hit home.

The implosion of **Portus Alternative Asset Management Inc.** has contributed to the recognition of this reality by provoking debate on the extent of the "know your product" obligation and focusing on who is responsible for it and what type of inquiries or investigations need to be made.

Regulators regard the ultimate legal obligation for understanding the product and determining its suitability for clients as resting with the advisor, although they acknowledge that individual advisors can seek help from their firms. However, the days of relying on product wholesalers or on the fact a security is on a firm's approved list are over.

How will firms and their advisors meet the due diligence challenge? Some segments of the industry may not even know what it entails, how or when to do it or what issues to look at. Some may also have problems assessing the information they obtain or the risks involved, or determining whether the investment is prudent. In some cases, the relentless pressure firms place on their advisors to sell products makes it impractical for advisors to conduct these inquiries to fulfil their obligations to their clients.

This pressure highlights the disconnect between what firms promise and what they deliver, and the resulting structural gaps in regulation.

Inevitably, these questions will raise the issue of whether current compensation systems and organizational and operational structures are suitable and provide sufficient support.

The firms' due diligence capability will become critical for financial advisors. What impact will this have on the financial arrangements advisors have with their firms, particularly for those who operate as independent contractors with firms that offer high payouts and charge for all services they provide to advisors? Will this structure support the needed investment in expertise, or will it make advisors reluctant to incur the costs of accessing such expertise? At what point does this become an investor protection issue — a risk of which clients should be aware?

These questions are only the tip of the iceberg as far as suitability goes. Questions about advisors' competency, restricted registrations and conflicted compensation arrangements are also likely to lead the courts and regulators to look at suitability from the perspective of whether there were alternative investment options that would have been more suitable to meet the respective needs of their clients.

For example, advisors who are trained and licensed to sell only insurance and/or mutual funds have restricted the universe of options to meet their clients' integrated personal financial needs. This is particularly true when the recommended options have high costs embedded in them.

Advisors may also face suitability challenges if the products they recommend provide them with hidden benefits, such as eligibility for a higher grid payout. The days of not being able to go far wrong by choosing virtually any mutual fund, segregated fund or other insurance product have ended.

And if you think costs don't matter to clients, think again. They do matter. Even if your clients are not objecting to them, advisors should be. High costs are part of the issues of suitability, due diligence and competence — all core factors of market-driven, principles-based investor protection. **IE**