An insight into the suitability practice: the standard questionnaire dilemma

Nicoletta Marinelli
Faculty of Economics, University of Rome La Sapienza, Rome, Italy
Via del Castro Laurenziano 9, 00161, Rome, Italy
Phone +390712207253 Fax +390712207253
e-mail: nicoletta.marinelli@uniroma1.it

Camilla Mazzoli
(corresponding author)
Faculty of Economics, University Politecnica Marche, Ancona, Italy
P.le Martelli n.8, 60121 Ancona, Italy
Phone +390712207254 Fax +390712207253
e-mail: c.mazzoli@univpm.it

Research paper

Preliminary version

1. Introduction

For years, financial intermediaries have been focusing on data and information obtained from customers in order to develop and carry out their Customer Relationship Management (CRM) techniques; they have created and improved models that allow them to split customers into homogeneous groups according to some specific drivers (see Channon, 1985; Anderson and Kerr, 2002; Peelen, 2005). Knowing a customer's characteristics is crucial to intermediaries for two main reasons: in an ex ante perspective, they can create products and services which can be specifically marketed and sold to particular segments of customers (*customer segmentation)*; in the ex post, they make use of the information they obtain from clients in order to provide them with products and services that are suitable to their profile, thus reducing complaints and granting a good level of loyalty (*customer profiling*). In the literature, much effort is devoted to explaining the main drivers of customer segmentation while the work on customer profiling is less developed. Nonetheless, the profiling process that financial firms follow to sell financial products and services is crucial as it paves the way for a fiduciary relationship between the customer and the intermediary. Moreover, it has implications in terms of protecting both the investor and the intermediary. In fact, the information that is obtained from the customer in the profiling process is crucial in each step of the contract:

a) *before* the financial service or product is subscribed, in order to meet the preferences and needs of the investors;
b) *during* the contract, in order to acquire any changes in the needs and preferences of the investor;
c) *after* the end of the contract, in order to protect the intermediary against any complaint that the client could make with reference to a loss that he or she did not expect but is physiological according to the level of risk that characterises the investment.

With the introduction of the Market in Financial Instruments Directive (MiFID, henceforth), the practice of profiling customers has become *compulsory* for financial firms providing investment services[1]; specifically, the MiFID requires investment firms to assess the *suitability* and *appropriateness* of any product or service before it is offered to clients. In very broad terms, this profiling obligation aims to determine whether the customer has the necessary knowledge and expertise, together with the financial capacity and the right investment objectives to trade in financial instruments and to understand the risks associated with this trading activity. In practice, the above mentioned client information is collected by the use of a questionnaire whose

function is to better know one's customers but also to reduce the possible misunderstandings, thus protecting financial firms against possible complaints.

Actually, the MiFID does not impose a standard questionnaire to intermediaries; so each financial firm makes use of its own proprietary questionnaire that is likely to be different from its competitors'. Starting from this consideration, our analysis investigates whether the questionnaires that are currently used by financial intermediaries provide an accurate profile of the customer or, on the contrary, they only grant a partial knowledge of his or her preferences and needs. To this end, we follow both a *descriptive* and an *empirical* approach. In the *descriptive approach*, we examine the content of different questionnaires in order to highlight the main divergences and similarities among them. Specifically, we collect a sample of 14 MiFID suitability questionnaires belonging to the major Italian financial firms and addressed to retail clients. We analyse each questionnaire by comparing its level of completeness and compliancy to the MiFID requirements; moreover, we reveal the main differences among them as well as possible explanations for such divergences. In the *empirical approach*, we investigate how reliable MiFID questionnaires are, in terms of the consistency of profiles that come out when different questionnaires are filled out by the same person. In this analysis, we make use of 3 questionnaires belonging to Italian banks[2], and we submit them to a sample of 100 potential investors. In this way, each person in the sample is requested to fulfil all of the 3 questionnaires in order to verify the consistency of the 3 profiles obtained. We find that, depending on the bank questionnaire that is used, at least for some subjects, the profiles obtained vary to such an extent that the same subject could be classified by a bank as risk averse and by another bank as risk seeker.

Possible explanations for these results will be thoroughly discussed in the concluding remarks of this paper. Therein, we will suggest possible improvements in the regulatory framework in order to enhance investor protection without neglecting the need for the intermediary to match client profiling with the financial instruments on offer.

In light of the current worldwide financial turbulence, we believe these issues to be urgently addressed. The recent financial crisis has revealed not only the shortcomings of the international financial system but also the limits of the tools that are currently being used by financial intermediaries to profile investors and thus properly advise them accordingly. This seems to be the appropriate time to deal with these issues provided that, in Europe, suitability and appropriateness obligations have been in effect for 3 years and, in the US, authorities are in the process of amending suitability rules by FINRA proposal to revise NASD Rule 2310 as FINRA Rule 2111.

2. Customer profiling in the financial literature

Customer profiling does not seem to be a specifically addressed topic in the literature. Most of the studies propose criteria that financial intermediaries and advisors should use in order to split (ex ante) their clients into homogeneous groups, thus providing a *customer segmentation* perspective rather than one of *customer profiling*. However, this approach can also be extended to an ex post perspective; in fact, it allows the intermediaries or advisors to allocate their products (ex post) by making use of a grid that links groups of customers with groups of suitable products and services. Therefore, the drivers of the customer segmentation are quite similar to those employed in the profiling process; what sets them apart is the purpose of their employment. In the segmentation, drivers are essential in order to design and create products that are addressed to the different segments of clients; in the profiling, the same variables allow the matching of a group of products, designed in this way, with groups of customers.

The list below shows some of the drivers that have been suggested over the years:

- Socio-demographic and economic;
- Benefit;
- Financial knowledge;
- Financial sophistication;
- Risk tolerance.

With reference to the *socio-demographic and economic* variables, Channon (1985) suggests that income, profession and life-cycle stage should be considered when assessing the financial products and services that are more suitable for a particular investor. Violano and Van Collie (1990) add that socio-demographic variables (such as geographic, demographic, socio-economic and familiar information) should also be considered. The main advantage of the traditional criteria is that the factors are entirely comprehensible and can be easily derived from existing customer data. Nevertheless, empirical evidence demonstrates that socio-economic factors alone are not sufficient to explain actual consumer behaviour (Moschis et al., 2003). Financial consumers showing the same socio-economic features might have very different expectations from financial services and products. Moreover, Harrison (1994) maintains that traditional profiling based on socio-demographic and economic information has provided little insight into the financial services customer behaviour. Therefore, more complex methods have been proposed. Speed and Smith (1992) divide published research into 'a priori' and 'post hoc' studies. A priori stands for analysis where customers are allocated into different groups according to the socio-demographic and economic information they exhibit. The post hoc method does not define the number and type of groups in advance. Rather, customers are grouped starting from the responses they give to particular questions addressed to understand what they look for and expect from particular financial products and services. In other words, customers are clustered according to the *benefits* that they are seeking in a given product (Tynan and Drayton, 1987; Loker and Perdue, 1992; McDougall and Levesque, 1994; Minhas and Jacobs, 1996). Nonetheless, few studies have specifically addressed the issue of benefit variables in the financial service sector (Speed and Smith, 1992 and Minhas and Jacobs, 1996). Another group of variables that have been considered in the literature refers to the *financial knowledge*. Brucks (1985), Alba and Hutchinson (1987) and Mishra et al. (1993) measure the financial expertise of customers by testing their knowledge of various financial products and by querying them on their experience in dealing with financial affairs. In a related paper, Hackethal and Jensen (2008) propose a new method that is based on the *financial sophistication* of customers. Sophistication provides information as to how interested a customer is in his or her financial affairs, but also reveals their level of financial expertise and financial knowledge. Another field of studies has concentrated on *risk tolerance* as a tool to cluster investors and provide them with suitable products and services. Risk tolerance can be defined as a combination of both risk attitude and risk capacity (Cordell, 2002). These two components of risk tolerance are intrinsically different: risk attitude is a psychological attribute and assesses how much risk an investor would like to take (Weber, Blais and Betz, 2002) whereas risk capacity is principally a financial attribute and measures how much risk an investor can afford to take (Grable, Davey and Roszkowski, 2005). The assessment of risk capacity depends on observable variables (such as age, income, saving, wealth, job, family status and composition, and so on) and it is strictly related to the concept of background risk (Guiso et al., 1996, Heaton and Lucas, 2000 and Shum and Fain, 2006) that represents a limit to the degree of risk that one can assume due to income (as made by labour, proprietary and housing) and borrowing constraints. Risk attitude is more difficult to assess, as it implies a psychological concept and is usually revealed through questionnaires or psychometric tools (see Lucarelli and Brighetti, 2010).

Most of the variables that have been considered in the literature in order to profile investors assume that people in the same age, gender, life-cycle stage and so on, have homogenous financial needs and preferences. More recent literature suggests that identifying the influence of unobservable variables such as investors' beliefs is key to achieving a better understanding of the choices and behaviour of financial market participants (Heckman, 2001; Pennings and Garcia, 2009). Unobservable, individual-level differences may help to explain the underlying mechanisms of a wide variety of behavioural anomalies (Dhar and Zhu, 2006; Lee, Park, Lee, and Wyer, 2008; Graham et al., 2009). Nonetheless, to date they have not been widely used in practice to explain individual investors' decision-making or performance.
The multitude and variety of variables that have been proposed in the literature to cluster investors reflect how important and complex it is to a financial intermediary or advisor to know the needs and preferences of customers in order to provide them with suitable products and services. In the next paragraph, we will provide evidence that both the regulatory standards and the widespread practice in the financial sectors usually make use of the customer information cited above as tools to assess his or her needs and preferences and the consequent suitability of the products and services that are offered.

3. Customer profiling in the regulatory framework: MiFID versus US suitability legislation

One of the main pillars set forth by the MiFID is the detailed conduct of business rules for investment firms, with specific regard to the new suitability and appropriateness assessments of clients. This pillar aims to enhance investor protection (especially for inexperienced retail investors) against the complexity of the market and to give practical guidance for firms about how to effectively implement the process of knowing the customers' characteristics and needs. Strictly speaking, the suitability assessment is not a regulatory novelty at all, as its original roots can be found in the US legislation in the NASD Rule 2310. The Rule imposes that "in recommending to a customer the purchase, sale or exchange of any securities, a member shall have reasonable ground for believing that the recommendation is suitable for such customer upon the basis of facts, if any, disclosed by such customer as to his other security holding and as to his financial situation and needs". More recently, the Securities and Exchange Commission ("SEC") published a proposed rule issued by FINRA to re-codify NASD Rule 2310 (and related NYSE Rule 405 (1)) as FINRA Rule 2111[3]. Henceforth, the depiction of the MiFID prescriptions about suitability obligations, which is the focus of our analysis, may be better discussed if it is put in relation to the recent developments in the corresponding US legislation wherein the rule has been mutualised. To make a clear comparison, we shall focus upon three main points that may be useful to summarise the suitability framework operating in each legislation, as reported in the table below.

Table 1 Suitability obligations: MiFID versus US legislative framework

[insert table 1 here]

In broad terms, suitability refers to the obligation of a financial intermediary to propose to a customer only investments that match the customer's financial characteristics and needs. The specific *application field* of the suitability rule is a first point of comparison between the two legislations. In this perspective, the MiFID implicitly distinguishes between two groups of services:

- a first group of services that entails an element of recommendation on the part of the firm upon the final investment decision of the client, as the firm advises some products or receives an explicit

mandate from the client to manage his or her assets ('advised services', that are investment advice and portfolio management);

- a second group of services that do not imply a recommendation by the financial intermediary, resulting in a mere execution of transactions autonomously decided by the client ('non advised services', such as reception and transmission of orders, execution of orders, dealing on own account, placing of financial instruments).

The suitability obligation refers only to the first group of services, meaning that a recommendation must be made in order for the MiFID suitability obligation to arise. The same approach is shared by US law, where the suitability determination is required only at the time of investment solicitation and the suitability standards apply only upon such recommendation. Where no recommendation is made, i.e. when services other than financial advice or portfolio management are required (for example, where the client simply asks that an order be executed), the MiFID requires the firm to apply an appropriateness assessment, that may be thought of as a sort of "lighter" form of suitability[4]. If the suitability is a fairly familiar concept in advisory situations in the international arena, the appropriateness test for non-advised services is more of a novelty, that for instance does not have an equivalent in US legislation. In the latter, when a transaction is made without a recommendation, there is not an explicit requirement, but only special rules applicable to certain types of products, which may prevent or discourage an investor from purchasing, e.g. by requiring special disclosures prior to the sale and/or warning the client about the risks, or a determination that the products are not suitable for the client to purchase.

The set of *information from customers* to be gathered and used as part of a suitability analysis is a second point of comparison between the MiFID and the US legislation. In this sense, the MiFID requires that the suitability assessment has to be based upon three information sections. The first is addressed to the investment objectives of the client; in this section, the client has to express his or her preferences about the time horizon and the risk profile of the investment he or she is going to make, in order to identify those investment products that match his or her preferences about risk, return and length of time. The second section is focused on the financial capacity of the client; it relates to the client's financial ability to incur risk and is a function of some economic information, such as the amount and stability of his or her income, the amount of expenses relative to income, the diversification of assets, the amount, time frame and structure of liabilities. The third section aims to investigate the experience and financial knowledge of the client, as clients who comprehend risk are more likely to make financial planning decisions consistent with the accomplishment of their goals; typically, the types of service, transaction and financial instrument with which the client is familiar or that the client has used in the past are investigated. In US, the original NASD Rule 2310 prescribes that a member shall make reasonable efforts to obtain information about the customer's financial status, tax status, investment objectives, providing a final recommendation to collect any other information useful for making the recommendation. The proposed FINRA Rule 2111 expands the suitability rule specifically to require the consideration of the following information that was not explicitly included in NASD Rule 2310: the customer's investment experience, investment time horizon, liquidity needs, and risk tolerance. In this sense, we may say that the two legislations seem to be increasingly converging as far as the content of the suitability obligations is concerned, thereby widening the set of information required and explicitly considering crucial elements, suggested also by the literature, such as the risk tolerance and the financial knowledge of the individual.

Furthermore, both legislations do not allow firms to 'contract out' of suitability obligations. An *exception* to this may occur only where a client is deemed to be of sufficient sophistication so that he/she is no longer

regarded as “retail”. In this sense, the MiFID explicitly distinguishes between a ‘retail customer’ and a ‘professional client’[5]. Specifically, for professional clients the suitability assessment is reduced into two sections (‘investment objectives’ and ‘financial capability’), when providing portfolio management, and even into one section (‘investment objectives’), when providing financial advice, as the other information may be implicitly assumed by the firm[6]. In contrast, there is no need to assess the appropriateness any more, as the only set of information required for appropriateness (‘financial experience and knowledge’ of the client) is implicitly supposed to exist[7]. Henceforth, in the MiFID framework suitability requirements apply to both retail and professional clients, but differently: for retail clients the sources of information are more numerous, while for professional clients the data requirements are less rigorous. In relation to retail clients, investment firms may rely only on the exemption for execution only services; however, this is an exemption that concerns the “lighter” rule of appropriateness and is recognised provided only that all of the following conditions are met: (i) the service relates to non-complex products; (ii) the service is offered at the initiative of the client; (iii) the client has been clearly informed that the firm is not required to assess the appropriateness of the instrument or service offered and accordingly that the client will not have the benefits that would otherwise be provided by appropriateness determinations; (iv) the investment firm complies with its conflict of interests obligations.

The FINRA Rule 2111, recalling the previous formulation of NASD Rule 2310, is even more drastic for the case of professional clients as it provides an explicit suitability exemption with respect to institutional customers, assuming that it is reasonable to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions[8].

So far, the parallelism between MiFID and US suitability obligations does not emphasise a great gap between them; on the contrary, it seems that the two legislations are increasingly converging towards the same content and practical application of the suitability rule. However, there is still a remarkable difference between their formulation as far as the *type of intermediary* that has to follow the suitability rule is concerned. In the MiFID framework, the suitability and appropriateness obligations are explicitly provided only to investment firms providing investment services; the reference is to the securities and banking sector, so that ‘pure’ investment firms and credit institutions that provide investment services are subject to the same rules. In the original MiFID prescription, nothing is specified as far as insurance companies providing investment products are concerned[9]. Conversely, in US legislation, the suitability rule is explicitly recognised across all financial services sectors (banking, securities and insurance); in the insurance sector, both carriers and “producers” (agents) must make a determination of suitability of annuity products prior to recommending a sale; with regard to life products, the producers (but not the carriers) must determine that the product recommended is not “unsuitable”[10]. However, the substantial difference between the MiFID and US suitability legislation does not concern its explicit extension (or not) to the insurance sector, but just the application of the rule within the securities sector itself, where the suitability rule was originally proposed. In fact, in the US suitability framework a distinction is made between two categories of financial operators: securities brokers[11] and investment advisers[12]. For the purpose of our analysis, “suitability standard” as defined above applies only to brokers, while an investment adviser is required to follow a “best interest standard”; the latter is stricter than the former as it limits, in principle, an adviser’s ability to act in his or her own interest. As a consequence, a broker is required to make recommendations that are suitable for its clients; however, this standard does not imply that the recommendation is in the best interest of the customer. Conversely, an investment adviser must make only recommendations that are in the client’s best interest; the problem in this case is that there are no extensive regulatory standards defining this duty and specifying what

information should be considered in determining what the client's best interest is. It follows that the suitability duties applicable only to brokers are more rule-based, as they may be viewed as more explicit and fixed; the best interest duties applicable to investment advisers are more principle-based and may be viewed as potentially broader and more open-ended[13].

In the MiFID framework, such a distinction between "suitability" and "best interest" standards is not recognised: the principle of acting fairly, honestly, and professionally and in accordance with the best interests of the client has a tangible application in the suitability and appropriateness assessments, that generically apply to all investment firms, apart from the fact that their core business is advising services or not and from being independent advisors or not[14]. In the light of our study, even though it is not explicitly recognised in the MiFID framework, the distinction between "suitability" and "best interest" standard may be of some interest, since it provides useful suggestions for a better interpretation of our results, as will be discussed in the concluding remarks of the paper.

4. Data and methodology for the descriptive analysis

A key part of the analysis is to understand what Italian financial firms actually do to meet their MiFID suitability obligations in order to obtain the profile of their clients. Even though it is not explicitly prescribed by law, such obligations are in practice satisfied by the use of a questionnaire. So, we analyse 14 suitability questionnaires provided by the first 14 Italian financial groups in terms of promoted assets[15] in the area of portfolio management; all together, these groups share 90 per cent of the total market. Our analysis deals only with questionnaires in respect to *retail* customers and products with a significant *investment* component that require a suitability determination[16]. It is worth pointing out that the Italian regulatory authority for financial markets (CONSOB) has recently implemented the 'Level 3' (L3, henceforth) of MiFID, in order to homogenise the practices for fairness and transparency followed by Italian intermediaries regarding retail clients, with a specific concern for illiquid and complex financial products[17]. In this perspective, CONSOB dictates further obligations that financial intermediaries have to follow when assessing the suitability/appropriateness of their customers. Specifically, CONSOB requires that in order to assess the suitability/appropriateness of a product, financial firms have to implement a set of controls, regarding the coherence between the complexity, the risk profile, the liquidity of the product and the characteristics of the client as derived from the suitability/appropriateness questionnaire. These obligations have led some Italian intermediaries to make adjustments to their suitability questionnaires and, most of all, to their algorithms for assessing the risk profile in order to be fully compliant to L3. For example, better specifications of illiquid and complex products inside the questionnaire have sometimes been needed, as well as some further specifications about the investment objectives and the time horizon desired. We collected suitability questionnaires from the 14 Italian financial groups after these regulatory adjustments.

At first glance, the 14 suitability questionnaires provided by the major Italian financial groups appear to be largely different. Some of them are very analytical, whereas some of the others are very short and basic. The number of questions asked to the client is a first proxy for the comparison: there are questionnaires where the maximum number of questions equals 37 and others with a minimum of 8; in our sample, the average number of questions asked to the client is approximately 19. Indeed, in our sample the range between the maximum and the minimum number of questions is quite high and also the dispersion around the average is not negligible, with a convergence towards the left side of the frequency distribution (see figure 1).

Figure 1 Number of questions in the suitability questionnaires

[insert figure 1 here]

In order to develop a more in depth analysis of our sample of questionnaires and to derive a coherent basis for comparisons, we decided to use the information categories suggested by MiFID as an objective parameter. As we said before, MiFID asks firms to provide a suitability questionnaire made up of three sections respectively, with regards to: 'financial objectives', 'financial capacity', 'financial experience and knowledge'. These sections are compulsory and must be necessarily covered by each financial firm through the suitability assessment of its clients. At the same time, MiFID suggests a set of items that 'should' be included in each section, without formulating a legislative obligation for them directly[18]. This means that, even though MiFID stipulates some advisable questions to be included in the questionnaire, each financial firm is free to define the specific questions of its own suitability questionnaire, provided that the three main sections are covered. The set of items suggested by MiFID are summarised in table 3 and we decided to use them as a 'benchmark' to compare the completeness of various questionnaires provided by our sample of Italian financial firms.

Table 3 Set of items suggested by MiFID for the suitability questionnaire

[insert table 3 here]

The 'benchmark' questionnaire suggested by MiFID comprises 13 items, equally portioned among the three sections. All the items suggested by MiFID are clearly understandable; the only item that needs a specification is the one related to the risk assessment of the client. In this sense, MiFID makes a distinction between the preferences regarding risk taking and the client's risk profile; provided that the legislation does not explicit the specific meaning of each of them, we associated the 'preferences regarding risk taking' item with all the questions related to the risk and return characteristics of the investments the client is willing to undergo (objective risk), while we interpreted the 'risk profile' item as the one aimed at knowing the behaviour of the client in situations of riskiness and uncertainty (subjective risk)[19]. This way, we are able to make a distinction between the assessment of the objective risk and the evaluation of the subjective aspect of risk.

4.1 Results for the descriptive analysis

With these premises, we try to analyse how much the 14 questionnaires under study verge on this 'benchmark' suggested by law and if the divergence among questionnaires is significant or not. A first synthesis of our findings is summarised in figure 2.

Figure 2 Completeness of the suitability questionnaires: number of MiFID suggested items covered

[insert figure 2 here]

If we evaluate the completeness of the suitability questionnaires in terms of how much they cover the set of items indicated by MiFID, only one questionnaire is complete, as the other ones leave one or even more suggested items uncovered. The largest element of our sample (ten questionnaires) includes a number of

items between eight and ten. On the basis of this evidence, it is interesting to further identify what are the items generally covered in our sample and, conversely, what are the areas of questions generally overlooked. Starting from the 'investment objectives' section, the approach generally followed by our sample of Italian intermediaries is quite homogeneous (see figure 3). All the 14 suitability questionnaires under analysis include questions about the time horizon of investments and preferences regarding risk taking; moreover, the majority of questionnaires (85 per cent) ask the client to specify the purpose of the investment he or she is going to realise, in terms of capital conservation, capital growth, or strong capital growth. On the contrary, a generalised behaviour in our sample is to disregard questions about the risk profile of the client, as only four questionnaires include this item among the ones investigated. When the risk profile of the client is assessed, the firm asks the client to place himself or herself in a situation of financial risk or of a more common daily uncertainty and to choose the alternative that fits better his or her hypothetical behaviour in presence of that risk or uncertainty. From the perspective of our analysis, this is a critical point: our sample of Italian financial groups seems to take great care in the assessment of the objective financial risk, while less attention is given to the evaluation of the subjective component of risk. In other words, the client is always asked about his or her preferences in respect of the financial risk-return combination of future investments; conversely, the attitude of the client towards a general situation of riskiness or uncertainty is rarely comprised. This, in turn, may be due to the psychological construct of the subjective component of risk, which is difficult to measure in a valid and reliable manner.

Figure 3 Coverage of MiFID suggested items

[insert figure 3 here]

Further investigation of the 'financial capacity' section of the suitability questionnaire reveals that more diversified choices are observed among Italian financial groups (see figure 3). There is not an item, among those suggested by MiFID for this section that is covered by all the questionnaires. Nevertheless, the most frequent group of questions is the one related to the source and extent of regular income (13 questionnaires), followed by those questions regarding the overall property composition (11 questionnaires). The items concerning the evaluation of regular financial commitments and the financial portfolio composition are less investigated (only seven and six questionnaires respectively). From the perspective of our study, this is another point worthy of note: on the one hand, regular financial commitments are a proxy of the risk capacity of an individual, as the presence of financial dependents reduces the client's ability to assume risk[20]. On the other hand, the actual financial portfolio composition is another important proxy of the client's risk taking behaviour in real life, as it gives information about the financial decisions assumed in the past by the client. As a consequence, neglecting these two items means also that two important pieces of information in the general assessment of risk are overlooked[21].

Finally, in respect of the 'financial experience and knowledge' section, all the sample collects information about the type of service/products with which the client is familiar and the nature, volume and frequency of the client's transactions in financial instruments (see figure 3). In contrast, almost none of the firms takes the period over which past investments are carried out into account (only one questionnaire); 12 and 10 questionnaires respectively include the level of education and the profession among the set of questions to be filled in.

The 14 suitability questionnaires are very different not only with regard to the number of items globally asked and the adherence upon the MiFID 'benchmark', but also concerning the degree of investigation within each item. For example, even though the items of the length of time, preferences regarding risk taking, types of service/instrument with which the client is familiar, the nature/volume/frequency of the client's financial transactions are assessed by all the 14 questionnaires[22], the number of questions included in each of them varies consistently from one questionnaire to another: some questionnaires provide just one question for investigating each item, whereas other questionnaires are much more analytical and use more than five questions to analyse the same aspect.

In summary, a key finding of our descriptive analysis is that the implementation of the suitability assessment, even though it is recognised as a common MiFID regulatory requirement, is applied in a highly variable manner by our sample of Italian financial firms. The differences that do exist may stem from the fact that supervisors give only general rules for the development of the suitability questionnaire without providing a unique and shared form, in adherence to a prudential regulation approach. As a consequence, each intermediary may develop its own suitability questions according to the:

- business model: the propensity to ask some information may vary depending on the kind of business that characterises each intermediary; the orientation toward a model of commercial banking or a prevalence of the investment business within the financial group, the penetration level in the market of investment services, the development of specific financial services, the diversification and sophistication in the offer of financial products, the characteristics of their prevalent client are all elements that may exert an influence;
- compliance function: the specific questions included in the questionnaire may also depend upon how the compliance function of the firm interprets the regulatory recommendations and the relevance accorded to specific aspects in the application of the law;
- competence level of front-offices: as front-offices are the bridge between the firm and the customer in the implementation of the suitability questionnaire, a different approach in the development of the questions may also depend upon the specific competence of the front-offices in terms of technical advice, ability to build a relationship, and commercial approach to the client;
- a random component, that does not depend upon a strategic or rational motivation by the firm, but just upon erratic occurrences or behavioural biases in the people assigned to the development of the questionnaire itself.

However, in spite of different constructions of the questionnaire, some common behaviours amongst our sample of Italian financial groups may be depicted. Specifically, the majority of our sample seems to derive the risk tolerance assessment of the client in a partial way, as also recently maintained by Pan and Statman (2010): while the desirable objective risk-return characteristics of future investments are constantly investigated, the subjective risk profile of the client, as well as his or her past financial investments (risk taken in the real life) and his or her current financial constraints (risk capacity) are elements less frequently requested, even though they all exert an influence on the suitability of suggested services/products and may work as a control for the chosen risk-return combination. As outlined by Cordell (2002), risk tolerance is a multidimensional concept that may comprise "risk propensity", related to the client's real-life decision in financial situations, "risk attitude", referred to the client's willingness to incur risk, "risk capacity",

concerning the client's financial ability to incur risk, and "risk knowledge", directly related to the ability of the client's understanding of risk. The risk tolerance assessment provided by the major Italian financial firms within the wider suitability test seems to verge almost on one dimension: while the risk knowledge is always assessed, the risk propensity and the risk capacity are generally overlooked and the risk attitude is interpreted only in terms of financial risk appetite. Indeed, it seems that the suitability questionnaire provided by our sample of Italian intermediaries is drawn mainly with the aim of deriving objective parameters for the implementation of traditional asset allocation strategies (such as time horizon, purpose of investment, preferences regarding the objective risk) rather than with the purpose of making a more in depth analysis of the subjective characteristics of the clients.

5. Data and methodology for the empirical analysis

The aim of this empirical analysis is to investigate how reliable MiFID questionnaires are, in terms of the consistency of profiles that come out when different questionnaires are submitted to the same person. To do this, we collect a sample of MiFID questionnaires belonging to three Italian banks[23]. All the three questionnaires are suitability questionnaire addressed to retail clients. For each of them we also collected the scoring method that is used to calculate the profile of the client that fulfils the questions[24]. The three anonymous questionnaires (hereafter A, B and C) are submitted to a sample of 100 potential investors in order to verify the consistency of their profiles[25]. The sample is chosen according to a totally random criterion; we do not face any sampling problems as each person represents a result by himself or herself through the comparison of the three different profiles.

Because each of the three banks provides a different structure of profiles, we are forced to subjectively match them according to the description of each classification that is offered. In this way, before comparing the profiles, we make them comparable. In particular, Bank A classifies clients as conservative, balanced and enterprising; Bank B as safe, income, balanced, growth and dynamic and Bank C distinguishes among cautious, moderate and dynamic. Each of the questionnaires provides a detailed explanation of the characteristics that feature each of the profiles as shown in tables 4, 5, and 6. The way the profiles are described changes across the questionnaires; questionnaire A and B provide three and five categories respectively, and describe in words the main features that investor must have to be included in each profile. On the contrary, questionnaire C provides three risk profiles that are described in terms of the percentage of the capital that should be allocated among liquidity, bonds and stocks for each profile. In this way, any attempt at matching the profiles requires a certain level of subjectivity. Table 7 illustrates how the different profiles are matched across the three banks in the following analysis.

Table 4 Description of profiles for bank A

[insert table 4 here]

Table 5 Description of profiles for bank B

[insert table 5 here]

Table 6 Description of profiles for bank C

[insert table 6 here]

Table 7 Matching of profiles for banks A, B and C

[insert table 7 here]

In the experiment, each of the subjects is requested to fill out all of the three questionnaires. Once this step is completed, the three profiles for each subject are calculated and compared in order to assess their consistency.

5.1 Results for the empirical analysis

Table 8 illustrates the results; in particular, it shows the percentage of cases the profiles of single subjects are consistent throughout the sample[26]. The first column from the left shows that in the 77 per cent of cases, the same subject obtains profiles that are different across the three banks. In particular, in 14 per cent of the cases, the profiles are totally different as they range from the highest to the lowest profile across the three banks for the same subject. Moreover, in attempting to understand whether a questionnaire causes the inconsistency of the profiles more than the other two, we provide the percentage of inconsistency of profiles for each couple of questionnaires. The analysis shows that the inconsistency is 51 per cent between questionnaires A and B, 60 per cent between A and C and finally is 53 per cent between B and C.

Table 8 Percentage of consistency of profiles across questionnaires

[insert table 8 here]

In this sense, we cannot maintain that any of the three questionnaires is 'bad' because the couples of questionnaires show almost the same degree of inconsistency. More precisely, we should recognise that the questionnaires are strongly different as far as their structures and scoring methods are concerned. First of all, the range of questions that are asked to the client varies from eight in questionnaire A, to sixteen in questionnaire B and nine in questionnaire C as shown in table 9.

Table 9 Number of questions in the questionnaires

[insert table 9 here]

This evidence suggests that questionnaire B could be more precise and complex than the others. Besides, by following the methodology that we already used in the descriptive approach we briefly analyse the contents of the three questionnaires in order to obtain any difference that could help explain the relevant inconsistency of the profiles that a single person obtains when he or she is analysed by one bank or another. We first investigate the level of compliance to the MiFID suitability provisions in terms of the number of items that are included in the three questionnaires with respect to the 13 that are suggested in the Directive. Figure 6 shows that none of the three questionnaires is perfectly compliant to the number of items suggested (with B covering ten, A covering seven and C only five out of thirteen items).

Figure 6 Number of MiFID suggested items covered

[insert figure 6 here]

As far as the similarities are concerned, the items that are present in all of the three questionnaires are those related to the purpose of the investment (within the 'investment objectives' section), the source and extent of regular income ('financial capability' section) and the types of services and products the client is familiar with ('financial experience and knowledge' section). In this way, at least one of the items belonging to each of the main three sections is present in all of the questionnaires. As a further similarity, the period over which the investments were carried out is absent in all the questionnaires, as table 10 shows.

Table 10 Similarities in the three questionnaires

[insert table 10 here]

The main differences deal with the risk profile and risk preferences together with the level of education and profession. In fact, only questionnaire C investigates the investor's preferences for risk taking and only A includes a question on the risk profile. Moreover, questionnaire B is the only one interested in the level of education and current profession of the subject. All the other items are included by two banks out of the three. Table 11 summarises the main findings in terms of differences among the three questionnaires.

Table 11 Difference in the three questionnaires

[insert table 11 here]

This analysis mainly confirms the results we already obtained in the descriptive analysis. In fact, by observing the information provided in tables 10 and 11, all of the three banks seem to be mostly interested in the *objective parameters* (purpose of the investment, source and extent of regular income, services and products the client is familiar with, length of time of the desired investment, regular financial commitments, and so on). On the contrary, very little is asked in terms of the level of education, profession, risk profile and also of the preferences of the investor about risk taking, as already maintained in Linciano (2010). At the end of the descriptive analysis we already focused the attention on the possible reasons that could explain the huge differences in the content of the questionnaires and in the scoring methods. The results of this analysis let us maintain that those differences, together with the scarce attention to the *subjective characteristics* of the client, seem to provide good explanations for the variety and inconsistency of profiles that an investor can obtain by applying to different banks.

6. CONCLUSIONS

The MiFID has formalised the need for financial firms to acquire information about the features and preferences of their clients before selling investment product or services to them (the so called "suitability" and "appropriateness" requirements). Many firms were already used to this habit but the MiFID has made it

compulsory and has recommended the sections and items to be included in the suitability and appropriateness assessment. Still, this recommendation is only general and firms are allowed to comply to this obligation by developing the assessment tool (generally a questionnaire) on their own; as a result, a multitude of questionnaires about investors is now available to the public, depending on the financial firm they are clients of.

The aim of this paper is to analyse to what degree the questionnaires actually used by the major Italian intermediaries diverge from each other and if the differences are able to produce any impact on the profiles that investors obtain and on the consequent suitability of the products that are offered to them .To do this we carry out both a descriptive and an empirical analysis on a sample of questionnaires belonging to the major Italian financial firms (14 for the descriptive analysis and 3 involved in the empirical approach). In the descriptive analysis, we demonstrate that questionnaires largely diverge as far as their structure and content are concerned; the number of questions included in each questionnaire is very different from one questionnaire to another, as well as the specific items to be investigated. Besides, we also stress that Italian suitability questionnaires seem to be developed mainly with the purpose of deriving objective parameters for the implementation of traditional asset allocation strategies rather than with the aim of making a more in depth analysis of the subjective characteristics of clients. This is particularly true for the risk assessment item. In fact, Italian financial intermediaries do not seem to be particularly accurate at evaluating their clients' risk tolerance; they mainly focus on the desired risk-return combination of future investments (objective risk) rather than on the individual behaviour towards risk (subjective risk). However, it has to be pointed out that since the individual behaviour towards risk is a psychological construct, including this item into the questionnaire without a valid and reliable assessment tool can result in misleading choices. Future research should further study this critical issue, as it is crucial to derive complete, but also reliable, customer's profile.

The empirical analysis allows us to demonstrate that the actual differences and shortcomings in the suitability questionnaires may produce dramatic effects on investors: they could be profiled as 'cautious' by one financial firm and 'dynamic' by another. The differences that do exist may stem from the fact that supervisors give only general rules for the development of the suitability assessment tool without providing a standard format. As a consequence, each intermediary may develop its own suitability questions according to the business model it holds, the conduct of the compliance function in decoding the MiFID provisions, the competence and relationship skills of the front-office employees, and so on.

This evidence paves the way for a debate about the opportunity for the European Regulator to impose a single and standardised format for the questionnaire for all of the intermediaries whom the MiFID is addressed to. On the one hand, such a questionnaire could solve the actual weaknesses with reference to the incompleteness of the information required and to the inconsistency of the profiles obtained; however, on the other hand, this may contrast with the intrinsic nature of the suitability itself.

In order to discuss this point in depth, it is useful to recall the distinction between the "suitability" and the "best interest" obligation, already mentioned in paragraph 3 with reference to US legislation where these concepts were originally introduced. Strictly speaking, the suitability implies matching the individual investor's characteristics and one or more of the products supplied by the intermediary; in this sense, the suitability is typical of an advisory process that starts from the range of investment opportunities the intermediary actually provides and ends with their connection to the characteristics of the client (*investment advisory).* Hence, the suitability implies a "relative knowledge" of the client (relative to the range of

products supplied by the intermediary). Thus far, it may be viewed as more appropriate for a "non-independent financial advisory" process, where the range of products to sell is defined.

On the contrary, the best interest has been originally introduced as a broader concept that implies matching the individual investor's characteristics and the universe of products available in the market; in this case, the underlying advisory process starts from the characteristics of the client and, according to them, it addresses the selection of the best investment opportunities among those available in the market (*investor advisory).* Thus, the best interest standard implies an "absolute knowledge" of the client (absolute because it is not conditioned by the range of products the intermediary is supposed to sell). Thus far, it seems more appropriate for an "independent financial advisory" process, where the knowledge of the client is the core of any selling politics and there is not a defined range of products to be offered to customers.

With this distinction in mind, we might conclude that the actual framework based on different suitability questionnaires for different intermediaries might be proper for a non-independent financial advisory context; here, questionnaires need to be customised to the specific features of the intermediary in terms of product supply and business model. What may be proposed in this area to enhance customer protection and reduce the conflicts of interest may be the development of incentive systems for advisors more aligned to customer objectives and needs. On the contrary, an independent financial advisory framework, where there is not a defined range of products to sell, may offer the right context to test a standardised format for the questionnaire; in this case, the natural focus on the knowledge of the client, the different approach to selling practices and the lack of a financial membership seem to make the shortcomings of a single questionnaire less arguable.

REFERENCES:

Alba, J.W., Hutchinson, J.W., 1987. Dimensions of customer expertise. Journal of Consumer Research 13(3), 411-454.

Anderson, K., Kerr, C., 2002. Customer Relationship Management. McGraw-Hill: New York (USA).

Assogestioni, 2009. Mappa del risparmio gestito, third quarter 2009, 1–59.

Bank for International Settlement (BIS), 2008. Customer suitability in the retail sale of financial products and services. Basel Committee on Banking Supervision.

Brighetti, G., Lucarelli, C., 2010. Risk tolerance in the financial decision making. Palgrave McMillan: Basingstoke (UK).

Brucks, M., 1985. The effect of product class knowledge on search behaviour. Journal of Consumer Research 12(1), 1-16.

Channon, D.F., 1985. Bank Strategic management and marketing. John Wile and Sons: Chichester (UK).

Cordell, D.M. Risk Tolerance in Two Dimensions. Journal of Financial Planning, May 2002, 30-36.

Dhar, R., Zhu, N., 2006. Up Close and Personal: Investor Sophistication and the Disposition Effect.. Management Science 52(5), 726-40.

Graham, J. R., Harvey, C. R., Huang, H., 2009. Investor Competence, Trading Frequency, and Home Bias. Management Science 55(7), 1094-106.

Guiso, L., Jappelli, T., Terlizzese, D., 1996. Income risk, borrowing constraints and portfolio choice. American Economic Review 86(1), 158-172.

Harrison, T., 1994. Mapping customer segments for personal financial services. International Journal of Bank Marketing 12(8), 17-26.

Heaton, J., Lucas, D., 2000. Portfolio choice in the presence of background risk. Economic Journal 110(460), 1-26.

Heckman, J. J., 2001. Micro Data, Heterogeneity, and the Evaluation of Public Policy: Nobel Lecture. Journal of Political Economy 109(4), 673-748.

Jansen, C., Hackethal, A., 2008. How to Meet Private Investors' Advisory Needs. 20th Australasian Finance & Banking Conference 2007 Paper. Available at SSRN: http://ssrn.com/abstract=1 009194.

Lee, H.J., Park, J., Lee, Y.J., Wyer, R.S., 2008. Disposition Effects and Underlying Mechanisms in E-Trading of Stocks. Journal of Marketing Research 45(3), 362-78.

Linciano, N., 2010. Errori cognitivi e instabilità delle preferenze nelle scelte di investimento dei risparmiatori retail: le indicazioni di policy della finanza comportamentale. Quaderno di Finanza CONSOB 66, 1–46.

Loker, L.E., Perdue, R.R., 1992. A Benefit-Based Segmentation of a Non resident Summer Travel Market. Journal of Travel Research 31(1), 30-35.

Market in Financial Instruments Directive (MiFID) Level 1 Directive 2004/39/EC.

Market in Financial Instruments Directive (MiFID) Level 2 Commission Directive 2006/73/EC.

McDougall, H.G., Levesque, T.J., 1994. Benefit Segmentation Using Service Quality Dimensions: An Investigation in Retail Banking. International Journal of Bank Marketing 2, 15-23.

Minhas, R.S., Jacobs, E.M., 1996. Benefit Segmentation by Factor Analysis: An Improved Method of Targeting Customers for Financial Services. International Journal of Bank Marketing 3, 3-13.

Mishra, S., Umesh, U.N., Stem, D.E., 1993. Antecedents of the attraction effect: an information-processing approach. Journal of Marketing Research 30(3), 331-349.

Moschis, G., Bellenger, D., Curasi, C.F., 2003. Financial service preferences and patronage motives of older consumers. Journal of Financial Services Marketing 7(4), 331-340.

Pan, C.H., Statman, M., 2010. Beyond Risk Tolerance: Regret, Overconfidence, and Other Investor Propensities, Available at SSRN: http://ssrn.com/abstract=1549912.

Peelen, E., 2005. Customer Relationship Management. Pearson Education Limited: Harlow (UK).

Pennings, J. M., Garcia, P., 2009. Risk & Hedging Behavior: The Role and Determinantsof Latent Heterogeneity. The Journal of Financial Research, Forthcoming.

Roszkowski, M.J., Davey, G., Grable, J.E., 2005. Insights from psychology and psychometrics on measuring risk tolerance. Journal of Financial Planning 18(4), 68-76.

Shum, P., Faig, M., 2006. What explains household stock holdings. Journal of Banking and Finance 30(9), 2579-2597.

Speed, R., Smith, G., 1992. Retail financial services segmentation. The Service Industries Journal 12, 368-83.

Tynan, A.C., Drayton, J., 1987. Market segmentation. Journal of Marketing Management 2 (3), 301-335.

Violano, M., Collei, S.C., 1990. Prospettive del retail banking negli anni novanta. Edibank: Milano (ITALY).

Weber, E.U., Blais, A.R., Betz, N.E., 2002. A domain-specific risk-attitude scale: Measuring risk perceptions and risk behaviors. Journal of Behavioral Decision Making 15, 263–290.

[1] Investment services and activities are defined in art. 4 of MiFID Level 1 Directive 2004/39/EC and refer in particular to a list of activities in MiFID Annex I-A (reception and transmission of orders, execution of orders, dealing on own account, portfolio management, investment advice, underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis, placing of financial instruments without a firm commitment basis, operation of Multilateral Trading Facilities) related to financial instruments listed in MiFID Annex I-C.

[2] These questionnaires are different from those we employ in the descriptive analysis and are the only ones for which we were able to collect the scoring method that is used to calculate the profiles.

[3] The rule was proposed on August 13, 2010.

[4] See MiFID, art. 19 (5). For a more in depth understanding of the main differences between "suitability" and "appropriateness" requirements, we refer the reader to Marinelli and Mazzoli (2010), in Lucarelli and Brighetti (2010).

[5] In general, the term 'retail customer' is not defined; instead, anyone who is not a 'professional' investor (for example, financial intermediaries authorised to operate in the financial markets, companies meeting specific size requirements, some public organisations and, on request, private individual investors meeting certain minimum net worth levels or experience standards) is generally treated as a retail customer. For a complete definition of 'professional client', see MiFID Level 1 Directive 2004/39/EC, Annex II.

[6] The MiFID Level 2 Commission Directive 2006/73/EC, art. 35 (2) - 36.

[7] Note that a sub-group of 'professional clients' are the so called 'eligible counterparties', who typically comprise those subjects professionally operating in the financial markets. When executing orders on behalf of an eligible counterparty and/or dealing on own account and/or receiving and transmitting orders with eligible counterparties, the investment firm may provide the service without being obliged to comply with the suitability and appropriateness obligations, as outlined in the art. 24, section 1 of the MiFID Level 1 Directive 2004/39/EC. For a more in depth understanding of the inclusion into the 'eligible counterparty' category, we refer the reader to the art. 24 of the MiFID Level 1 Directive 2004/39/EC.

[8] FINRA Rule 2111 (b).

[9] For a more in depth analysis of the MiFID suitability application in the insurance sector, we refer the reader to Marinelli and Mazzoli (2010), in Lucarelli and Brighetti (2010).

[10] In a series of enforcement actions and Notice to Members, the NASD has specifically emphasised that NASD Rule 2310 on suitability applies to the sale of variable life insurance and annuities; see NASD Notices to Members 00-44 (July 2000), 99-35 (May 1999), and 98-86 (December 1996). Also some states have developed express suitability requirements in insurance by statute or rule (see Engel and McCoy, 2002). In the meantime, one industry trade association, the Insurance Marketplace Standards Association (IMSA), has imposed a suitability requirement on its member for life insurance and annuities.

[11] Brokers are defined under the Securities Exchange Act (SEA) as *any person engaged in the business of effecting transactions in securities for the account of others.* The core role of a broker is to execute transactions for customers. Brokers may provide a wide range of services for their clients related to the securities transactions, such as research and advice prior to effectuating a trade, but for the most part, their function is execution of trade (Rickert, 2007).

[12] Investment advisors are defined in the Investment Advisors Act (IAA) as *any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling business, issues or promulgates analyses or report concerning securities.*

[13] The SEC is in the process of studying the need for harmonisation of the standard applicable to brokers and investment advisers in accordance with the requirement of the Dodd-Frank Wall Street Reform and Consumer Protection Act. That law requires SEC to consider whether brokers should be subject to the same standards as investment advisers and whether investment advisers should be subject to an explicit requirement to act in their customers' "best interest".

[14] See the MiFID Level 1 Commission Directive 2004/39/EC, art. 19.

[15] See Assogestioni, 2009.

[16] Questionnaires for institutional investors and those addressed to the provision of services that require only an appropriateness evaluation are not part of this survey, as they may be considered a portion of the wider suitability questionnaire.

[17] We refer to the CONSOB Communication n. 9019104 of the 2 March 2009. This communication has been followed by inter-associative guidelines for the application of L3 measures promoted by the category associations in 14 July 2009.

[18] See the MiFID Level 2 Commission Directive 2006/73/EC, art. 35 and 37.

[19] For the purpose of clarity, we classified questions of the form: *'Which of the following investment results fits better your preferences regarding risk taking? A- A low expected return with a low risk of loss; B- A medium expected return with a limited risk of loss; C- A high expected return accepting a high risk of loss'* as belonging to the 'preferences regarding risk taking' item, whereas questions like *'Suppose that you have made an investment in a long term stock fund. A month after your investment, the value of your fund drops by 15 per cent. What is your reaction? A- I sell my investment in order to avoid further panic if the market continues to go down; B- I try to keep a cool head and I wait*

until when my investment recoups its value over the planned time horizon; C- I buy some more in order to take advantage of low prices' as belonging to the 'risk profile' item.

[20] The neglecting of investor's borrowing is also confirmed by the results of Cavezzali and Rigoni (2007).

[21] One may observe that each intermediary is able to know the portfolio composition of the client, without explicitly asking him or her, by looking at their internal source of information and databases. Nevertheless, if this is true for the assets held at that intermediary, this is not possible for the part of the financial portfolio managed by other intermediaries. As a consequence, an explicit question is needed.

[22] This finding is coherent with the implementation of L3 that requires a set of controls for the complexity, the risk profile and the liquidity of the products.

[23] Names are not revealed for privacy reasons. The questionnaires we employ in this study are different from those we used in the descriptive analysis.

[24] Obtaining the scoring method was quite difficult because of the opposition of banks to reveal this information. This is the reason why we were able to collect only three questionnaires.

[25] In this way, we submitted 300 questionnaires as a whole.

[26] A full description of the results is provided on request.