Choosing A Financial Advisor: Suitability Vs. Fiduciary Standards

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ARTICLE HIGHLIGHTS

- There are two parties in the investment field: investment advisors and brokers.
- Investment advisors are bound to a fiduciary standard.
- Brokers are regulated by the Financial Industry Regulatory Authority.

In the investment field, there are two primary parties who are able to offer investment advice to individuals, as well as institutional clients such as pension funds, non-profit organizations and corporations. These parties are investment advisors and investment brokers who work for brokers-dealers. Many clients may consider the investment advice they receive from each party as similar, but there is a key difference that may not be completely understood by the investing public. The difference pertains to two competing standards that advisors and brokers must adhere to, and the distinction has important implications for individuals who hire outside financial assistance. Below is an overview of both parties, the standards each must follow and how the standards that brokers follow can create conflicts between themselves and their underlying customer base. (To learn more, see *Paying Your Investment Advisor - Fees Or Commissions?*)

Investment Advisors

According to the Securities and Exchange Commission (SEC), investment advisors provide many services, including assisting individuals and institutions in making financial decisions pertaining to planning for retirement, saving up for a child's college education or planning and developing investment strategies to manage assets and portfolios. They can charge fees for their services, which can be on an hourly basis or a percentage of the assets they manage for clients. Instead, some advisors charge commissions on trades they make for their customers. They may manage individual portfolios, divided up by separate clients, or pooled investments such as hedge funds, pension funds and other related commingled assets. (To learn more about the SEC, read *Policing The Securities Market: An Overview Of The SEC*.)

Broker-Dealers

Broker-dealers serve many of the same functions as investment advisors in that they help individuals and institutions make important financial decisions. The SEC does make certain distinctions though, such as considering them financial intermediaries who help connect investors to individual investments. It details that a key role is to enhance market liquidity and efficiency, by linking capital with investment products that range from common stocks, mutual funds and other more complex vehicles, such as variable annuities, futures and options.

The SEC defines a broker as someone who acts as an agent for someone else, and a dealer as someone who acts as a principal for their own account. An example of an activity a dealer may carry out is selling a bond out of his or her firm's inventory of fixed income securities. The primary income for a broker-dealer are commissions earned from making transactions for the underlying customer.

The Fiduciary Standard

Investment advisors are bound to a fiduciary standard that was established as part of the Investment Advisors Act of 1940. They can be regulated by the SEC or state securities regulators, both of which hold advisors to a fiduciary standard that requires them to put their client's interests above their own. The act is pretty specific in defining what a fiduciary means, and it stipulates that an advisor must place his or her interests below that of the client. It consists of a duty of loyalty and care, and simply means that the advisor must act in the best interest of his or her client. For example, the advisor cannot buy securities for his or her account prior to buying them for a client, and is prohibited from making trades that may result in higher commissions for the advisor or his or her investment firm. (To learn more, see *The Rise Of The Modern Investment Bank*.)

It also means that the advisor must do his or her best to make sure investment advice is made using accurate and complete information, or basically, that the analysis is thorough and as accurate as possible. Avoiding conflicts of interest is important when acting as a fiduciary, and it means that an advisor must disclose any potential conflicts to placing the client's interests ahead of the advisor's. Additionally, the advisor needs to place trades under a "best execution" standard, meaning he or she must strive to trade securities with the best combination of low cost and efficient execution. (For more, read *Meeting Your Fiduciary Responsibility*.)

The Suitability Rule

Broker-dealers only have to fulfill a suitability obligation, which is defined as making recommendations that are consistent with the best interests of the underlying customer. Broker-dealers are regulated by the Financial Industry Regulatory Authority (FINRA) under standards that require them to make suitable recommendations to their clients. Instead of having to place his or her interests below that of the client, the suitability standard only details that the broker-dealer has to reasonably believe that any recommendations made are suitable for clients, in terms of the client's financial needs, objectives and unique circumstances. A key distinction in terms of loyalty is also important, in that a broker's duty is to the broker-dealer he or she works for, not necessarily the client served. (For more on FINRA's role in the financial industry, read *FINRA: How It Protects Investors*.)

Other descriptions of suitability include making sure transaction costs are not excessive or that are recommendation is not unsuitable for a client. Examples that may violate suitability include excessive trading, churning the account simply to generate more commissions or frequently switching account assets to generate transaction income for the broker-dealer. Also, the need to disclose potential conflicts of interest is not as strict a requirement for brokers; an investment only has to be suitable, it doesn't necessarily have to be consistent with the individual investor's objectives and profile.

Potential Conflicts

The suitability standard can end up causing conflicts between a broker-dealer and underlying client. The most obvious conflict has to do with fees. Under a fiduciary standard, an investment advisor would be strictly prohibited from buying a mutual fund or other investment, because it would garner him or her a higher fee or commission. Under the suitability requirement, this isn't necessarily the case, because as long as the investment is suitable for the client, it can be purchased for the client. This can also incentivize brokers to sell their own products ahead of competing products that may be at a lower cost.

The broker-dealer model also has other motivations in addition to serving its underlying client base. In early 2011, "Fortune" magazine described the combination of brokers and a firm with investment banking capabilities as an "engine to distribute product brought to market by the investment bank," through the brokers selling suitable investments to clients. For better or for worse, it is a condition that clients must be aware of when employing the services of a broker for investment services and advice.

The Bottom Line

With cost being one of the primary determinants of investment performance over the long term, the fiduciary standard appears to have the upper hand in terms of providing a benefit for underlying clients. Given the more stringent stipulations for investment fiduciaries, there is little question that the fiduciary standard better protects individual and institutional investors, than the suitability standard. Federal securities laws consider investment advisors fiduciaries, but this does not apply to broker-dealers across the board. Overall, it is best for individuals to find an advisor who will place his or her interests below that of the client. An investment advisor has no choice to fulfill this fiduciary stipulation, and the client may also be able to find brokers willing to adhere to this higher standard. (For more on choosing an advisor, read *Shopping For A Financial Advisor*.)

http://www.investopedia.com/articles/08/fiduciary-responsiblity.asp#axzz1i2OuQePb