

FIDUCIARY STANDARDS vs. SUITABILITY STANDARDS

Explaining the difference, and what it means to be a Registered Investment Advisor.

Presented by Quantum Financial Planning
Houston Scrudder, CFP®, John Nord, CFP®, John James, CFP®, CDFATM,
and Eric Christiansen, CFP®

If you meet with a financial professional, be sure to ask a critical question. If you make an appointment with a financial consultant on behalf of yourself, your family or your company, make the following inquiry before the meeting ends:

“Are you held to a suitability standard or a fiduciary standard?”

This distinction is very important. You should be aware of the difference.

What is a suitability standard? Investment brokers are frequently asked to abide by suitability standards: when they recommend a financial product to a client, they are ethically bound to recommend a product which is “suitable” for that client.

As laid out in the manual of FINRA (the Financial Industry Regulatory Authority, formerly known as the NASD or National Association of Securities Dealers), the suitability standard has long demanded that a broker make “reasonable efforts to obtain information” on four aspects of a client’s financial life:

- Financial status
- Tax status
- Investment objectives
- Other information used or considered to be reasonable

These factors (and others) have a hand in determining whether a financial product or securities transaction is deemed “suitable” for a client.¹

Suitability standards emerged in response to an age-old Wall Street problem. Decades ago, stock brokers garnered all sorts of bad publicity for calling their clients up and recommending “hot” stocks or funds that were utterly inappropriate for them. The investors may have gotten burned, but the brokers got their sales commissions.

Suitability standards are good, make no mistake. The problem is that they could be even better.

Even with a suitability standard, a broker has no specified duty to act in a client’s best interest. So while that broker may recommend a “suitable” fund, stock or other financial product to you, he is not prohibited from recommending an investment that will result in a bigger commission for him or higher costs for you.

If a broker has a proprietary security that seems “suitable” for you, the broker may promote it ardently to you even though better-performing securities might be available.

In 2005, the SEC determined that “broker-dealers will not be deemed to be investment advisers” and therefore are not subject to the same fiduciary standards as Registered Investment Advisors (RIAs) when recommending investments to clients.²

In 2011, FINRA Rules 2090 and 2111 expanded the existing suitability obligations while creating new ones. Any recommendations of “investment strategies” and any recommendations to hold securities within an investment strategy must now be “suitable” for the particular client, and the investor profile compiled by the broker to judge suitability must consider additional factors.³

What is a fiduciary standard? This is the standard that Registered Investment Advisors must uphold. An RIA is a financial firm. The “Registered” adjective refers to being registered with either the Securities & Exchange Commission (SEC) or a state securities agency. The individual who represents the firm is an Investment Advisor Representative (IAR).

The IAR has a fiduciary duty (a legal requirement) to act in the client’s best interest regardless of the level of compensation the advisor may receive as a result of recommendations or actions. Fundamentally, this comes down to two points as stated by the SEC:

- The advisor must avoid conflicts of interest.
- The advisor is prohibited from overreaching or taking unfair advantage of a client’s trust.

An Investment Advisor is not supposed to pitch products, strategies or securities transactions with the idea that “this will be a win-win for both of us.” The client’s best interest comes first and it is the only interest that matters.⁴

Retirement plan sponsors must also meet fiduciary standards. If you sponsor a retirement plan for your workers, then you are by definition a fiduciary. So says the Department of Labor. If you violate fiduciary standards, you may be found personally liable and responsible for restoring any losses to the plan or profits from improper use of plan assets.⁵

If you hire a third-party administrator (TPA) to help you with your plan, you need to understand whether or not that TPA will assume any share of fiduciary responsibilities. Most TPAs will not.^{6,7}

How can you tell if a TPA will? Look at the contract you sign. Look for language (in the fine print) stating that the individual or firm recognizes that it will act as a fiduciary under ERISA and the Advisers Act when offering advice to plan participants. If the TPA

exercises discretion and control over the retirement plan or some aspect of it, then it could be defined as a fiduciary.⁶

Seek strong standards. When you enter an advisory arrangement with a financial professional or financial consulting firm, the agreement you sign should tell you whether the advisor is held to a suitability standard or a fiduciary standard. In the opinion of many investors and financial professionals, a fiduciary standard clearly amounts to a higher standard.

Houston Scudder, CFP®, John Nord, CFP®, John James, CFP®, CDFP™, or Eric Christiansen, CFP® may be reached at 509-328-6653, or more information can be found at www.quantumplanning.com.

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Citations.

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- 3 - www.wnj.com/Publications/New-FINRA-Rules-on-Knowing-Your-Customer-and- [2/1/11]
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