

How the Fiduciary Standard Protects You

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Highlights

Investors should pay attention to the regulations surrounding the fiduciary standard.

Some financial planners or advisers do not have to put their client's best interest before their own.

Find out if your adviser operates under the fiduciary standard and which licenses he or she has.

Nearly four years after Lehman Brothers' collapse, systemically important financial institutions still engage in excessively risky trading and firms continue to exploit unsophisticated investors. Goldman Sachs was singled out in March for just such sins by a departing employee in a widely publicized op-ed in the New York Times.

Yet many at high levels continue to rail against meaningful financial reform, most famously Jamie Dimon, CEO of JPMorgan Chase, who has loudly opposed proprietary trading rules, even as JPMorgan Chase lost \$2 billion on a big bet on corporate bond derivatives.

What's behind the resistance? Some financial firms don't want change because they believe it would impact their profits. And realistically, those who benefit from the status quo are rarely happy to embrace change.

So what will it take to reign in Wall Street excesses? Possibly rebuilding ethics from the ground up, starting with the way brokers treat retail clients. Read on to learn how you can be streetwise when you deal with these crafty Wall Street types.

The fiduciary standard -- What is that?

When it comes to financial reform, individuals should pay the most attention to the regulations surrounding the fiduciary standard. It sounds complicated, but it essentially refers to the guidelines that spell out the obligations financial services professionals have to their clients.

Currently, there are two standards that advisers and financial planners are held to -- the suitability standard and the fiduciary standard. The suitability standard gives advisers the most wiggle room: It simply requires that investments must fit clients' investing objectives, time horizon and experience.

"You can satisfy the suitability standard by recommending the least suitable of the suitable options, as long as it falls within the general suitability test," says Barbara Roper, director of investor protection for the Consumer Federation of America.

The suitability standard invites conflicts of interest pertaining to compensation, which can vary greatly from one product to another.

"And you don't have to disclose your conflicts of interest. You don't have to appropriately manage your conflicts of interest or minimize your conflicts of interest. So what that means is often the products that are best for the broker have higher costs for the investor," Roper says.

The other standard of care, the fiduciary standard, basically charges advisers with putting their clients' best interest ahead of their own. For instance, faced with two identical products but with different fees, an adviser under the fiduciary standard would be compelled to recommend the one with the least cost to the client, even if it meant fewer dollars in the company's coffers -- and his or her own pocket.

Unfortunately, many investors can't distinguish among financial planners and advisers. Studies have shown that individual investors don't know who is a fiduciary or what a fiduciary actually is.

How to discern among financial advisers

The majority of investment advice providers are not trying to rip people off. But it's hard for average investors to know which type of adviser is held to what type of standard -- suitability or fiduciary.

For broker-dealers that are held to a suitability standard, the compensation system is set up in a way that can lead to conflicts of interest. But TV advertising suggests otherwise.

"You can never educate investors to understand that their financial adviser is a salesperson who doesn't have to act in their best interest when multimillion dollar marketing campaigns are designed to lead them to exactly the opposite conclusion," says Roper. "The titles and the descriptions of the services are designed to make them think they are in a trusted advisory relationship."

Increasing investors' education would go a long way toward unveiling the information gaps that currently exist between professionals and their clients. Many times investors don't know a lot about the products they are sold, but they should, at the very least, know what kind of adviser they're working with.

Questions to ask your adviser:

- Are you acting under the fiduciary standard? Can you put that in writing?
- Which licenses do you have?
- Are you a registered investment adviser? Can I get a copy of your form ADV (SEC/state regulators registration form)?
- If you are not acting as a fiduciary, are you willing to fully disclose all conflicts of interest and the amount of compensation received from advice and products recommended?

There is an easy way for them to find out an adviser's level of accountability.

"Ask one simple question: 'Are you acting under the fiduciary standard, and will you put that in writing?'" says Tim Hatton, president and founder of Hatton Consulting and author of "The New Fiduciary Standard: The 27 Prudent Investment Practices for Financial Advisers, Trustees and Plan Sponsors."

Investors should also ask which licenses the adviser has: the Series 7 or Series 65. The former allows brokers to sell securities.

Registered investment advisers are fiduciaries and they must have the Series 65 license. Some advisers may have both.

"I am a registered investment adviser with the (Securities and Exchange Commission), and that means that I cannot legally collect a commission, and I am not what's called dually registered (under both licenses). So I can't even legally collect a commission when I make a recommendation on any type of product or service," Hatton says.

Whether or not commissions inherently create conflicts of interest is a contentious topic.

If and when the SEC comes out with a rule extending the fiduciary standard to all financial advisers, it's most likely to require disclosure of payments as a way of minimizing the conflict.

It's not just investors who need an education in financial literacy; the industry could use a little schooling as well.

"Financial services executives and reps really need to raise their *ethical* literacy because right now a true professional has an obligation to serve the best interest of their clients. A professional also has an obligation to other members of their profession. And they also have an obligation to society, and all of those things are important," says Blaine Aikin, president and CEO of fi360, a fiduciary education and consulting firm.

Why is regulation necessary?

The Dodd-Frank Act gave the SEC the leeway to decide if broker-dealers should be regulated under the fiduciary standard. The SEC found that a higher standard of care for clients is needed, and it's currently in the process of hashing out the details.

But there is another regulatory movement afoot from the Department of Labor. It's working to change the definition of who is a fiduciary under the Employee Retirement Income Security Act, or ERISA, which is a complex set of regulations governing workplace retirement plans.

"Currently there is a five-part definition of fiduciary. It's very hard to enforce because all five parts have to apply in order for someone to be deemed a fiduciary. There are two parts that are particularly important. One part is that advice given must be regular," says Aikin.

That can be something of a loophole. If a financial professional gives someone personalized advice once, or on anything other than on a regular basis, he or she escapes fiduciary accountability.

The other tricky part of the current definition is that for the adviser to be held to a fiduciary standard, the advice must be the primary source of decision-making.

"What the new definition would say is that as long as it's personalized advice, it's fiduciary. It also goes on to say that it doesn't matter if it is primary advice, the main consideration is that it's advice that was material to the decision," Aikin says.

It's a big change, especially because the definition would apply to IRAs, which are not covered under ERISA.

"This is huge because there is a lot of advice being given to individual investors that is not being held to high standards of objectivity and competence, and investors don't know it," Aikin says.

Conversely, there are stringent limitations on the types of advice plan providers can offer to participants in workplace retirement plans such as 401(k)s. Conflicts of interest are painstakingly minimized.

For instance, a retirement plan administrator giving advice to plan participants receives a level fee no matter which investments are chosen. Or the advice can come from a computer model, as long as it has been approved as unbiased.

As everyone agrees that advisers should not be able to unfairly enrich themselves at the expense of workers' employer-sponsored plans, should IRAs be treated differently?

In an ideal world, ethical behavior would not need to be enforced by regulation. But we are talking about Wall Street, where the bottom line can supersede all ethical considerations. If individuals voted with their wallets and demanded ethical and fair treatment from the financial services industry, everyone would benefit.