Suitability or Fiduciary Standard? - It's a Big Deal!

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The majority of the public does not understand the two different rules under which financial advisors operate. Failing to be aware of this difference can have negative financial impacts.

More specifically, broker dealers, insurance salespersons or any other financial company representative operate under the "Suitability Standard," which is:

- Know your client and their financial situation.
- Recommend products that are suitable for their situation.

Registered Investment Advisors (RIA) or an ERISA appointed Fiduciary must operate under the "Fiduciary Standard," which is:

- Put the client's best interest first.
- Act with prudence; that is, with the skill, diligence and good judgment of a professional.
- Do not mislead clients; provide full and fair disclosure of all important facts.
- Avoid conflicts of interest.
- Fully disclose and fairly manage, in the client's favor, unavoidable conflicts.

Fred Reish, a very well known ERISA attorney, summed up the differences this way: "With regard to the standard of care under current securities laws, a broker-dealer needs only to determine that an investment is suitable for the client. However, the fiduciary standard of care requires that the adviser take into account a number of considerations, such as whether the fees are reasonable, whether the investments are adequately diversified, whether there are conflicts of interest, whether the investments are consistent with the provisions of the trust or other governing document, and so on. Furthermore, the process that the adviser uses in developing the recommendation is measured by a prudent and reasonable hypothetical person who is knowledgeable about investments, about portfolio concepts and about the purpose of the investments."

General example of this difference: An "advisor" determines that an S&P Index 500 fund is suitable for the client. The advisor's firm has a proprietary fund that pays a 5% commission out of the sale amount with high ongoing annual fees. An identical fund from another company pays 2.5% commission. Or, the advisor could recommend that the client obtain the identical fund from Vanguard or Fidelity with no commissions at all and lower ongoing expenses. Under the suitability rule, the advisor can legitimately "sell" the high priced fund and the Suitability Standard has been satisfied. Under the Fiduciary Standard, the advisor would recommend the Vanguard or Fidelity because that is what is best for the client.

Specific 401k example of the difference: A firm wants the benefits of a 401k. They have seen an advertisement that John Hancock is a big player in this market and the name is well known. The Hancock plan salesperson comes out and recommends their plan. Here are some issues that are permitted under the Suitability Standard that can negatively impact the participants of the plan:

1. The advisor recommends a line up of funds out of the 622 that Hancock offers. The plan sponsor just wants a "good mix" and relies on the "advisor" for what he/she thinks would be good. Hancock, like others, offers up to 9 options of the same fund all with different level of fees. The advisor recommends a number of the Hancock funds that have fees on the higher end. Under the suitability rule, the advisor is under no duty to disclose this or to recommend the lowest cost options.

2. The Hancock Target Date Funds (TDF) are included in the lineup of options and the salesperson highly recommends this concept to the employees. Most of the participants pick the TDF's. The advisor does not disclose that these funds have been around less than 3 years so there is little ability for participants to adequately judge the managers' effectiveness. Nor did the advisor later disclose that Morningstar evaluated TDF's and found that the Hancock funds are among the worst of all the mixed funds offered. Nor was it disclosed to the plan sponsor that Target Date Analytics, a firm dedicated to benchmarking TDF's, rates the Hancock offerings an "F" in the area of fees, due to their high costs compared to others.

3. The advisor is not required to mention that the record keeping and TPA services could be obtained from a competitor for less cost. Nor would the advisor discuss the options of bundled, unbundled or alliance options for service providers. The advisor works for Hancock and that is where the loyalty lies.

On the other hand, a fiduciary works for the plan and its participants' best interest. The fiduciary's loyalty is to the plan and its participants not to any investment or insurance company. As a result, plan sponsors are more likely to meet their ERISA responsibilities. Two primary responsibilities are investments and fees. The fiduciary's investment choices will be from a variety of companies and will seek to avoid unnecessary costs such as finder's fees, commissions, 12(b)1 fees, agent transfer fees or revenue sharing. The fiduciary can also provide investment advice to the plan as far as model portfolios and or individual participant advice.

Reducing plan costs and increasing account performance can greatly increase the future retirement income from the 401k, which is the objective in the first place. A professional fiduciary can also assume some of the plan sponsor's ERISA responsibilities, which decreases the plan sponsor liability.

With increased awareness of the fiduciary standard and the obvious benefits, this approach is becoming more popular. To try to maintain their profit margins and stem the movement to the use of fiduciaries, some financial services companies are trying to convince plan sponsors that they operate as a co-fiduciary or under the fiduciary rules.

Again, take Hancock for example. In 2005 they claimed to offer a "Fiduciary Warranty" but when sued in court, they changed their tone. "Hancock argue(d) that it is not an ERISA fiduciary because it does not exercise discretionary authority or control over the disposition of Plan assets." They settled out of court for an undisclosed amount. It remains very apparent that these big companies operate under the suitability standard which continues to allow plan participants to be taken advantage of with high fees and questionable investment options.

It boils down to one question. **"Do I want the highest standard of care regarding my investment advice or retirement plan?"** If so, you want the Fiduciary Standard.

Since the Supreme Court ruling, LaRue vs. DeWolff, the answer to this question may be even more important. The court ruled that plan participants could sue the plan sponsors and others for fiduciary breaches. If breaches occurred and caused financial losses, those persons are PERSONALLY financially liable. When plan sponsors opt for the lower standard of protections of the suitability standard it could be argued it is a breach in itself since the plan sponsor had the option of a higher standard of safeguard, but failed to act in the best interest of the plan participants. Why would a plan sponsor gamble when the fiduciary standard is clearly the best option?

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