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The Difference Between Fiduciary and Suitability Standards

Most investors don't realize that there are two standards of care in the financial industry.

By Peter Lazaroff April 6, 2016

The fiduciary standard requires that an adviser put the clients interest first and is adhered to by Registered Investment Advisors and enforced by the Securities and Exchange Commission (SEC).

The suitability standard requires that a broker make recommendations that are suitable based on a client's personal situation, but the standard does not require the advice to be in the client's best interest. Brokers, also known as registered representatives, are held to this suitability standard, which is enforced through a self-regulatory organization called the Financial Industry Regulatory Authority (FINRA).

Fiduciary vs Suitability: What's The Difference?

Imagine you need a new car, but you don't know much about different options. You head to the closest car dealer, which happens to be a Ford dealership. The dealer asks you to describe what kind of car you need, and you begin listing features and attributes that are best described as a Toyota Highlander.

Under the suitability standard, the dealer could say, "A Ford Explorer would meet all of your needs and we have some of those right over here." The dealer makes the sale and gets the commission. You have a car that is suitable for your needs, but it isn't necessarily what's best for you. Since you don't have a great deal of knowledge about the auto market, you are in the dark.

Under the fiduciary standard, the dealer would be obligated to say, "It sounds like you are describing a Toyota Highlander. We don't sell those. In order to get exactly what you described, you would have to go down the street to Toyota and ask for a Highlander. I can sell you a similar model called a Ford Explorer, it's more expensive and it isn't exactly what you described." In this scenario, you have more information about your options and the conflicts driving the dealer.

The Ford dealer has a clear conflict of interest in this situation. He can only sell Fords and will lose the opportunity to earn a commission if the client buys a Toyota Highlander. Under the suitability standard, the client ends up with a product (Ford Explorer) that isn't the best fit given their situation and it costs more than the better-fitting product (Toyota Highlander). Worst of all, the client probably has no idea that they weren't given advice that put their own interests first.

New Rules From The Department of Labor

Rules governing retirement investment advice haven't changed since 1975, despite the dramatic shift away from defined benefit pension plans to consumer-controlled options such as an IRA or defined contribution plans such as a 401(k). The new rules from the Department of Labor help address some conflicts of interest by requiring fiduciary care when advising on retirement accounts.

There has been a negative response from Wall Street and the insurance industry, but this is a huge win for individual investors. There will still be room for improvement within the broader finance industry, but these new rules will eliminate some bad practices and make it easier for investors to make a successful legal claim against adviser malfeasance.

The biggest downside is that brokers still won't be required to exercise fiduciary care on all types of accounts and there is a long implementation timeline that could allow for some pushback – firms will be required to acknowledge their fiduciary status by April 2017 and they have until January 2018 to comply with the rules. (see note below.)

Is My Advisor A Fiduciary?

The best way to find out whether your adviser is a fiduciary or not is to ask if he or she is a Registered Investment Advisor. Registered Investment Advisors are required by law to act as a fiduciary and put their clients' interest first.

Note: here is an update:

DOL Extends Transition Period Until July 1, 2019

The Department of Labor (DOL) has announced an 18-month extension of the Transition Period for the Fiduciary Rule exemptions.

The final rule will extend the Transition Period from January 2018 to July 2019. The additional time will allow the DOL to complete the review mandated by the President's Executive Memorandum. In addition, the DOL's non-enforcement policy will be extended through July 1, 2019.

Keep in mind that a major reason here is that Wall Street and the insurance industry are pushing back hard on the new rules and so far, the new administration is listening. This new rule may never be fully implemented.