Why Your Financial Adviser Should Be a Fiduciary

Many do-it-yourself investors may wonder if this article is relevant to their situation.

But think about your life during retirement and your interest may change. As we age, it's common for even do-it-yourself investors to seek the services of a financial adviser, especially in our later years. Given that you may eventually engage a financial adviser, here are some guidelines on how to select one.

It's a big decision. You've worked hard all your life to build your savings and you want a financial adviser who cares as much about your financial situation as you do.

But how do you know who to hire? You've heard of the big investment firms and you walk in one. You've seen their TV commercials and it seems like it might be a good fit. The firm's reputation is sterling and their experts are frequently interviewed on TV. You walk inside and meet a financial adviser. Nice guy, sharp suit, good handshake—firm and dry. His philosophy makes sense and his materials are professional. Yes, this is the adviser for you. Or is it?
You may not realize some things about your new adviser and his blue-chip firm. Your adviser may:

1. Not always place your interests ahead of his own,
2. Have conflicts that influence the advice he gives, and
3. Collect fees on investments he selects for you that are much greater than you might expect.

How can this be possible? How can an adviser not put your interests first?

The Fiduciary Versus the Suitability Standard

Many financial advisers are not fiduciaries; they are essentially brokers who are subject to a "suitability" standard. For suitability, the Securities and Exchange Commission (SEC) says the financial adviser "must have a reasonable basis for believing that the recommendation is suitable for you." This is a lower standard than being a fiduciary, which demands that the adviser place the client's interests ahead of his or her own. This may not seem like much of a difference, but it can be very significant.

Here's a typical example: Suppose an adviser can either sell a high-commission product or recommend a no-commission fund, both of which are suitable for you. The fiduciary adviser will be required to recommend the no-commission fund because he or she always must put your interests ahead of their own. But the non-fiduciary adviser could go either way because both products are suitable. Of course, you will probably be worse off if the adviser selects the high-commission product, since the added costs, often in the 3% to 6% range, tend to reduce the product's total investment returns.

Think about it: You invest $1 million, your adviser makes $60,000 in an instant (based on a 6% commission), and you're worse off. Yet his or her conduct is just fine under the suitability standard since the investment was suitable for you.

That's why you should always invest your hard-earned money with an adviser who practices according to a fiduciary standard. Your interests should always come first.

Conflicts of Interest Cost Investors

The problem has become so large and widespread that the U.S. government has stepped in to try and fix the situation. In February 2015, President Obama directed the U.S. Department of Labor (DOL) to propose rules that "require retirement advisers to abide by a 'fiduciary' standard—putting their clients' interests before their own profits." According to the DOL, "A White House Council of Economic Advisers analysis found that these conflicts of interest result in annual losses of about one percentage point for affected investors—or about $17 billion per year in total."

The DOL proposal requires that "retirement advisers put the best interests of their clients above their own financial interests." The proposal also seeks to protect investors from conflicts of interest, particularly "backdoor payments and hidden fees often buried in fine print." Sounds like an ugly situation that needs fixing, right? Yet the government is facing heavy resistance from large investment firms who are against this proposal—they want to keep things just the way they are.

Watch Out for Dual Registrants

As with most things in the investment business, the term "fiduciary" can have shades of gray. A financial adviser may serve as a fiduciary for some transactions and "switch hats" to act as a broker on others (subject only to the suitability standard). Sounds crazy, but it's actually very common.

According to a FINRA study cited by the SEC (**www.sec.gov/news/studies/2011/913studyfinal.pdf**), 88% of investment adviser representatives are also registered as brokers. These are called dual registrants. They can engage in "hat switching," serving as a fiduciary on one transaction (typically a no-commission fund) and a broker on another (usually a commission product). As you can see, it can be difficult to tell which advisers always adhere to a fiduciary standard. Of course, simply because an adviser is dual-registered should not disqualify him or her from your search process, though it may raise questions in your mind as to whether the adviser will always act in your best interests.

The Client Should Come First

Regardless of what market the adviser serves—retirement plans or family portfolios—the client should always come first. So, do your homework.

- Ask your adviser: “Do you always act according to a fiduciary standard? Are you legally bound to act in my best interest?”
- Look at the adviser’s documents: Is the adviser’s adherence to a fiduciary standard clearly stated in writing?
- Look at your account statements: Make sure you are not invested in proprietary funds (created or sponsored by the adviser’s firm) or products that charge commissions when your objective could be just as effectively be met by non-commission funds.

How to Find a Fiduciary Adviser

Finding an adviser who operates as a fiduciary is not as easy as it sounds. As mentioned previously, a FINRA study revealed that 88% of investment adviser representatives are also registered as brokers.

Many of these dual-registered advisers are employed by broker-dealers, which include the big-name investment firms you see in print ads and TV commercials. While these large firms undoubtedly employ many high-quality advisers, they may also have advisers who are perhaps more focused on generating fees and commissions than they should be. Every adviser is different and it’s unrealistic to categorize. Nonetheless, you should be aware of the differences in various types of firms.

Registered Investment Advisor (RIA) firms are generally regulated by the Investment Advisers Act of 1940 (Advisers Act) and relevant state statutes, which stipulate that investment advisers must act in the best interests of their clients. The U.S. Supreme Court has interpreted the Advisers Act as binding investment advisers to a fiduciary duty in SEC v. Capital Gains Research Bureau Inc. As such, they must clearly know their clients and provide complete disclosure regarding fees and conflicts of interest. Section 206 of the Advisers Act specifically prohibits an RIA firm from using deceptive or manipulative tactics and from conducting fraudulent business activities. Of course, there are some RIA firms that offer products with commissions or develop their own products that have built-in fees, so you need to be aware of those potential conflicts of interest.

Even the U.S. government has become concerned with the quality of financial advice, especially with numerous surveys suggesting that large numbers of U.S. consumers are not prepared for retirement. The Labor Department is leading the charge on this front and offers a fact sheet called “How to Tell Whether Your Adviser Is Working in Your Best Interest: A Fiduciary Guide for Individual Consumers” (**www.dol.gov/ebsa/newsroom/fsfiduciaryoutreachconsumers.html**).

An easy way to find a fiduciary is to go to the Let's Make a Plan website (**www.letsmakeaplan.org**) and click on "Find a CFP Professional." All CFP professionals (certified financial planners) are required to adhere to a fiduciary duty when providing financial planning services. They are not allowed to engage in hat-switching either. To become a CFP professional, advisers must pass a rigorous test about various aspects of personal finance that is administered by the Certified Financial Planner Board of Standards. [Editor's note: The Financial Planning Association (**www.plannersearch.org**) and The National Association of Personal Financial Advisors (**www.napfa.org**) also have searchable databases for finding an adviser.]

The CFP Board, the Financial Planning Association and the National Association of Personal Financial Advisers are working closely to promote a fiduciary standard for financial advisers. These three organizations form the Financial Planning Coalition, which, among other things, supports the SEC in establishing a strong and uniform fiduciary standard of care for broker-dealers and investment advisers. This would be a major step in the right direction for the investment marketplace, assuring individual investors that their financial advisers place their clients' interests first. Unfortunately, some major investment firms have mounted strong opposition and the outcome of these proposals is uncertain.

Make an Informed and Prudent Choice

You've worked hard and long for your money. If and when you feel it's time to hire a financial adviser, make an informed and intelligent choice. Don't hand your future over to your relative or golfing buddy; your retirement savings are too important. Hire a financial adviser who places your interests ahead of their own.

Go in with your eyes wide open. Ask the right questions and probe deep. Be picky—there are plenty of quality professionals out there. Find an adviser who is both intelligent and experienced, and commits to a fiduciary responsibility to always place your interests first.

> *This article was adapted from* ***Larry Stein's*** *piece that appeared in the November 2015 issue of the* AAII Journal. For the unabridged version, including **Four Additional Questions to Ask** when choosing a financial adviser, see the **online version**.