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What Is a Fiduciary Financial Advisor?

Only fiduciary advisors are legally and ethically required to put your best interest before their own.

By Coryanne Hicks, Staff Writer |March 21, 2018

In April 2016, a new word entered many investors' vocabularies: fiduciary. Even for those who'd heard it before, the term took on a whole new meaning when the Department of Labor's Fiduciary Rule was released. All of a sudden financial advisors fell into two camps: fiduciaries and non-fiduciaries, adding a new level of confusion – and risk – to the advisor-client relationship for many investors.

Research by digital wealth manager Personal Capital found that nearly half of Americans falsely believe all advisors are legally required to always act in their clients' best interests. Not only is this inaccurate, but it can also be detrimental to investors who unwittingly expose themselves to biased and potentially costly advice from advisors who put their own interests before investors.

"Not all advisors are required to put you first," says Jay Shah, chief executive officer of San Francisco-based Personal Capital. "Only financial advisors who are fiduciaries are required to act in the best interests of their clients."

What is a fiduciary? A fiduciary is a person or legal entity, such as a bank or brokerage firm, that has the power and responsibility of acting for another (usually called the beneficiary or principal) in situations requiring total trust, good faith and honesty.

The most common example of a fiduciary is a trustee of a trust, but anyone can be a fiduciary. If you undertake to assist someone in a situation where they place total confidence and trust in you, you have a fiduciary duty to that person. Corporate officers are fiduciaries for their shareholders, as are attorneys and real estate agents for their clients. Some, but not all, financial advisors are fiduciaries.

When you're the beneficiary of a fiduciary relationship, you give that fiduciary discretionary authority over your assets. So a fiduciary financial advisor can buy and sell securities in your account on your behalf without needing your express consent before each trade. Because fiduciaries have this discretionary authority, they're held to a higher standard than non-fiduciary advisors.

The fiduciary duty is the highest standard of care. According to the Cornell Law Dictionary, "A fiduciary duty is the highest standard of care." It entails always acting in your beneficiary's best interest, even if doing so is contrary to yours. For a financial advisor, this may mean recommending a product that results in reduced or no compensation because it's the best option for the client.

According to the Securities and Exchange Commission, which regulates registered investment advisors as fiduciaries, the fiduciary duty also entails:

- Acting with undivided loyalty and utmost good faith
- Providing full and fair disclosure of all material facts, defined as those which "a reasonable investor would consider to be important"
- Not misleading clients

- Avoiding conflicts of interest (such as when the advisor profits more if a client uses one investment instead of another or trades frequently) and disclosing any potential conflicts of interest
- Not using a client's assets for the advisor's own benefit or the benefit of other clients

The commission concludes by stating that "departure from this fiduciary standard may constitute 'fraud' upon your clients," which could result in the firm's or investment advisor's registration being revoked, the advisor getting barred from the industry or multi-million dollar disgorgements, among other penalties.

Fiduciaries have a "duty to care." That means these obligations extend beyond the first meeting. A fiduciary will continually monitor a client's investments and financial situation and adhere to best practices of conduct for the duration of the relationship.

"I think most investors would expect their advisors are doing that anyway, but that's not always the case," says Shelby George, senior vice president of advisor services at Manning & Napier, an investment manager in Fairport, New York. Non-fiduciaries are held to the suitability standard, a lower standard of care.

Fiduciary standard versus suitability standard. For advice to be considered merely "suitable," the financial professional must only have an adequate reason to believe a recommendation fits the client's financial situation, needs and other investments. For that to be the case, an advisor must obtain adequate information about the investment as well as the customer's financial situation before making the recommendation.

The most common difference between "a fiduciary and an advisor acting under a suitability standard is the decision-making process," George says. Before making a recommendation, fiduciaries undergo a prudent process designed to determine their client's best interest. After making a recommendation, they discuss it thoroughly with the client to ensure there's no misunderstanding about the recommendation and the fiduciary's rationale for making it.

"Advisors acting under the suitability standard may, but are not required, to have the same depth of discussion," George says. As a result, their duty to a client's investments and financial situation ends once the trade is placed. These advisors aren't obligated to monitor client accounts or financial situations on an ongoing basis.

Instead, the suitability standard only calls for fair dealing and best execution, which means the advisor must do the following:

- Execute orders promptly and at the most favorable terms available, determined through "reasonable diligence"
- Disclose material information
- Charge prices reasonably related to the prevailing market
- Fully disclose any conflicts of interest

The suitability standard does not require advisors to put their clients' best interests before their own, nor must they avoid conflicts of interest.

"If your advisor isn't a fiduciary, he can steer you into products that put more money into his pocket, as long as they're considered suitable for you," Shah says. For instance, when faced with two comparable investments, one of which has a higher commission, a fiduciary couldn't recommend the pricierinvestment because paying more in fees isn't in the client's best interest. An advisor held to the suitability standard, however, could recommend the more expensive product provided it's "suitable" for the client.

"Of course, not all non-fiduciaries are bad guys hoping to eat your financial lunch, but it's important to understand that, legally, they can," Shah says. "What's more, their compensation structure could inherently make it difficult for them to act without conflicts of interests."