Find a financial adviser who will put your interests first

By Barry Ritholtz Columnist October 25, 2014

Today's column is going to be on the wonky side, but stay with me — it is very important stuff. For investors seeking some help, it can be crucial.

If you want financial advice, there are two things you should be aware of: First, the quality of advice you receive varies widely. You probably knew this already. The quality of everything you buy varies widely. It is as true for financial advice as it is for any product or service you may buy or otherwise consume. You can buy a Yugo or a Mercedes-Benz. They may both be automobiles, but they vary dramatically.

Regardless, everywhere these cars are sold, they each must meet the same government rules. Safety regulations, crash worthiness standards, fuel economy, consumer warranties, etc., apply equally to both vehicles.

This is decidedly not true of the people who provide you with financial advice. So we come to the second point: There are two completely different standards for these people — they are governed by two wholly different sets of regulations. The two standards are "suitability" and "fiduciary."

People who operate under the suitability standard typically are called "brokers," but they also go by the name registered representative — or, on their business cards, vice president. (On Wall Street, no one ever has a title below VP.). People who adhere to the fiduciary standard are called registered investment advisers, or RIAs.

Fiduciaries have a much stricter duty and legal obligation than do those who operate under suitability rules.

In 2011, the Securities and Exchange Commission published its "Study on investment advisers and broker-dealers. It recommended that all financial advisers should be placed under a uniform fiduciary standard. Wall Street was not happy about this, and spent tens of millions of dollars lobbying to prevent the higher standard from becoming the law of the land.

Why do you think they did that?

The fiduciary legally obligates the registered investment adviser to act at all times for the sole benefit and interest of the client. That straightforward, cut-and-dried standard has enormous ramifications.

The standard is simple. There is zero wiggle room. Any advice, product or service offered to a client must meet the test of “Is this in the client’s best interest?” If the answer is “No,” then it cannot be performed by a fiduciary. It is against the law.

In contrast, the suitability standard is far more complicated — and offers much less protection to investors.

The simplest way to describe this standard is “Don’t sell AliBaba IPO to Grandma.” In other words, all that matters is the investor is “suitable” for a particular product. This is true regardless of how expensive that product might be or how much of a dog the investment is. There are lots of wrinkles and permutations, but the bottom line is that the client’s best interest is not part of the equation.

How they charge

The RIAs operating under the fiduciary standard charge fees — typically, a percentage of assets under management. These range from 25 basis points up to 2 percent per year.

The brokers governed by suitability rules typically charge commissions. This is a transactional rate, and ranges from the online broker who gets $8 a trade to the full- service operation that charges thousands of dollars per trade.

There is nothing inherently wrong with commission-based compensation. However, it seems to work best with institutional investors. Hedge funds, mutual funds, endowments and the like are in the business of understanding the details of financial products. They have the financial wherewithal and technical expertise to understand what the brokers are advising them to buy, what it will cost them, and the associated risks. Paying commissions to a sales person is simply one of their costs of doing business.

Unlike the big firms, mom-and-pop investors don’t have a sophisticated staff on the payroll. They are rarely in a strong position to judge the value of what is being sold to them. They are very easily hoodwinked into buying expensive, poorly designed products that fail to perform as promised.

My personal observations and experiences indicate that over the course of a year, brokers charge from five to 10 times (or more) what an investment adviser will charge per account. So long as it is for “suitable” investments, it is all perfectly legal.

So the ordinary individual investor has three problems with the suitability standard:

1. It favors the brokerage firm and its employees over the investor.

2. It costs much more than services provided under other standards.

3. And it creates an inherent conflict of interest between the adviser and the investor.

The last one is perhaps the most important. Any conflict of interest between an investor and their adviser is extremely problematic.

Any time the client's best interest is not the focus, what occurs instead is the opportunity to "max out" the revenue each client generates. Brokers under the suitability standard are allowed to do this, yet remain within their rules. Since "maxing out fees" is not in the client's best interest, fiduciaries cannot.

Why two standards?

How did we come to have such wildly different standards of acceptable behavior for investment professionals?

The short answer is that the SEC enforces the standards for fiduciaries — but brokers, aiming to head off more regulations, created the suitability rules themselves. They did this through self-regulatory organizations called the National Association of Securities Dealers, or NASD, and its modern successor, the Financial Industry Regulatory Authority or FINRA.

Investors rarely come out on top when a self-regulating entity is involved. Any system where brokerage firms police themselves are not nearly as strict as a third-party regulator operates free from conflicts of interest.

You can find information on the suitability standard on FINRA's Web site. It's a fairly technical legalistic standard, saying in part that a broker must have "a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation."

And that's the *short* version. The longer version runs for many, many pages and involves the opinions of lawyers and compliance officers and arbitration judges. It is a mess to follow. And it does exactly the sort of job you might expect.

To be fair, FINRA occasionally nabs bad brokers or others engaging in unethical behavior. They also shut down firms that are engaging in fraud. They are pretty good with the very visible blatant crimes.

But in my observations, the suitability standard serves more of a public-relations role for brokers than a protection function for investors. I have jokingly said that the next lower standard of care below suitability is "grifting." I wish that was more of an exaggeration.

Any mention of the word "fiduciary" generates a furious lobbying campaign by Wall Street. That ought to give you an idea of exactly how loose and lucrative the suitability standard is.

Over the years, I have worked for firms that were governed by each of these standards. Both sets require sitting for a licensing exam and regularly taking continuing education every two or three years.

But fiduciary rules protect investors from adviser malfeasance, while suitability rules protect brokers from investor lawsuits.

When seeking out advice, do yourself this favor: Find an adviser who is legally obligated to put your interests first. When you are retired and living comfortably off of your investments, you will thank me.