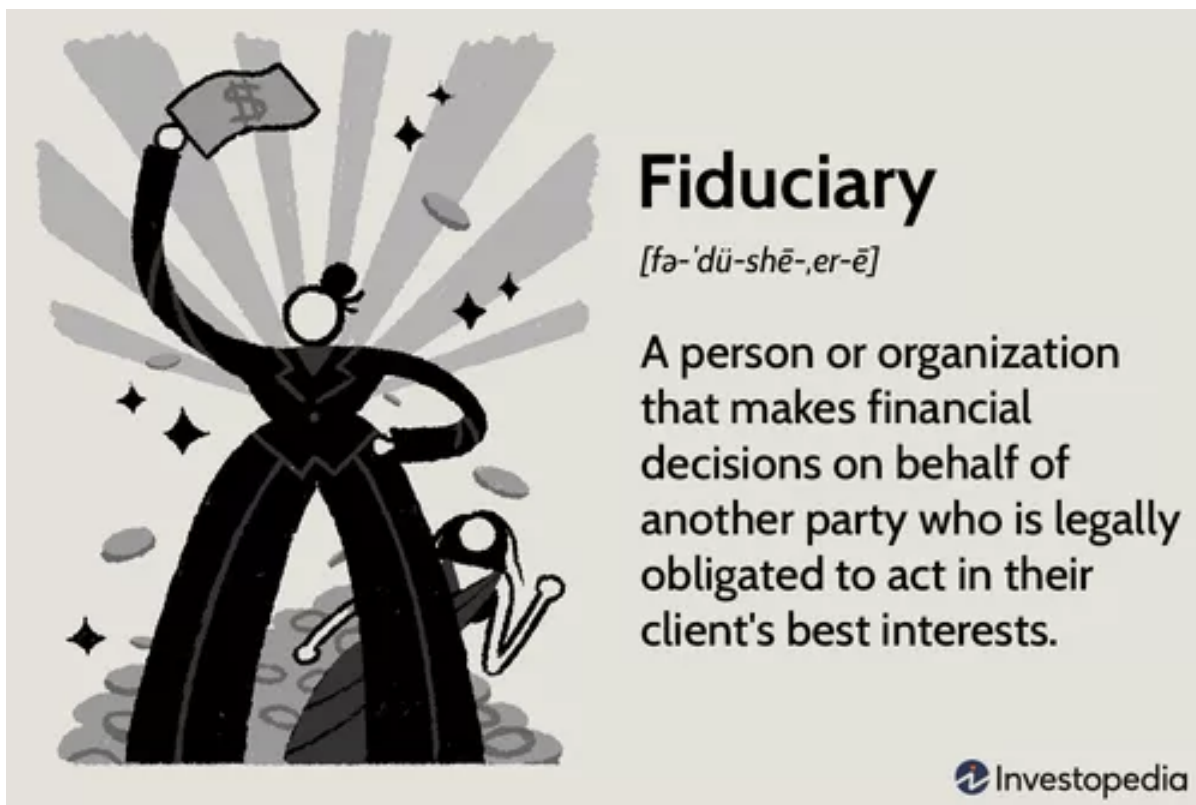


# Fiduciary Definition: Examples and Why They Are Important

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## What Is a Fiduciary?

A fiduciary is a person or organization that acts on behalf of another person or persons, putting their clients' interests ahead of their own, with a duty to preserve [good faith](#) and trust. Being a fiduciary thus requires being bound both legally and ethically to act in the other's best interests.

A fiduciary may be responsible for the general well-being of another (e.g. a

child's legal guardian), but often the task involves finances; managing the assets of another person, or a group of people, for example. Money managers, financial advisers, bankers, insurance agents, accountants, executors, board members, and corporate officers all have fiduciary responsibility.

## KEY TAKEAWAYS

- A fiduciary is legally bound to put their client's best interests ahead of their own.
- Fiduciary duties appear in a range of business relationships, including a trustee and a beneficiary, corporate board members and shareholders, and executors and legatees.
- An investment fiduciary is anyone with legal responsibility for managing somebody else's money, such as a member of the investment committee of a charity.
- Registered investment advisers and insurance agents have a fiduciary duty to clients.
- Broker-dealers just have to meet the less-stringent suitability standard, which doesn't require putting the client's interests ahead of their own.

## How the Fiduciary Rule Can Impact You

### Understanding Fiduciaries

A fiduciary's responsibilities and duties are both ethical and legal. When a party knowingly accepts a [fiduciary duty](#) on behalf of another party, they are required to act in the best interest of the principal, i.e. the client or party whose assets they are managing. This is what is known as a "prudent person standard of care;" a standard that originally stems from an 1830 court ruling. This formulation of the [prudent-person rule](#) required that a person acting as fiduciary was required to act first and foremost with the needs of beneficiaries in mind. Strict care must be taken to ensure no [conflict of interest](#) arises between the fiduciary and their principal.

In many cases, no profit is to be made from the relationship unless explicit consent is granted at the time the relationship begins. As an example, in the United Kingdom, fiduciaries cannot profit from their position, according to an English High Court ruling, *Keech vs. Sandford* (1726). If the principal provides consent, then the fiduciary can keep whatever benefit they have received; these benefits can be either monetary or defined more broadly as an "opportunity."

Fiduciary duties appear in a wide variety of common business relationships, including:

- Trustee and beneficiary (the most common type)
- Corporate board members and shareholders
- Executors and legatees
- Guardians and wards
- Promoters and stock subscribers
- Lawyers and clients
- Investment corporations and investors
- Insurance companies/agents and policyholders

#### **FAST FACT**

*Fiduciary negligence is a form of professional malpractice when a person fails to honor their fiduciary obligations and responsibilities.*

## **Fiduciary Relationship Between Trustee and Beneficiary**

Estate arrangements and implemented trusts involve both a trustee and a beneficiary. An individual named as a trust or estate [trustee](#) is the fiduciary, and the beneficiary is the principal. Under a trustee/beneficiary duty, the fiduciary has legal ownership of the property or assets and holds the power necessary to handle assets held in the name of the trust. In estate law, the trustee may also be known as the estate's [executor](#).

Note that the trustee must make decisions that are in the best interest of the beneficiary as the latter holds equitable title to the property. The

trustee/beneficiary relationship is an important aspect of comprehensive estate planning, and special care should be taken to determine who is designated as trustee.

Politicians often set up [blind trusts](#) in order to avoid real or perceived conflict-of-interest scandals. A blind trust is a relationship in which a trustee is in charge of all of the investment of a beneficiary's [corpus](#) (assets) without the beneficiary knowing how the corpus is being invested. Even while the beneficiary has no knowledge, the trustee has a fiduciary duty to invest the corpus according to the prudent person standard of conduct.

## **Fiduciary Relationship Between Board Members and Shareholders**

A similar fiduciary duty can be held by [corporate directors](#), as they can be considered trustees for stockholders if on the board of a corporation, or trustees of depositors if they serve as the director of a bank. Specific duties include the following:

### **The Duty of Care**

[Duty of care](#) applies to the way the board makes decisions that affect the future of the business. The board has the duty to fully investigate all possible decisions and how they may impact the business. If the board is voting to elect a new CEO, for example, the decision should not be made based solely on the board's knowledge or opinion of one possible candidate; it is the board's responsibility to investigate all viable applicants to ensure the best person for the job is chosen.

### **The Duty to Act in Good Faith**

Even after it reasonably investigates all the options before it, the board has the responsibility to choose the option it believes best serves the interests of the business and its shareholders.

### **The Duty of Loyalty**

[Duty of loyalty](#) means the board is required to put no other causes, interests, or

affiliations above its allegiance to the company and the company's investors. Board members must refrain from personal or professional dealings that might put their own self-interest or that of another person or business above the interest of the company.

If a member of a board of directors is found to be in breach of their fiduciary duty, they can be held liable in a court of law by the company itself or its shareholders.

#### **FAST FACT**

*Contrary to popular belief, there is no legal mandate that a corporation is required to maximize shareholder return.*

## **More Examples of Fiduciaries**

### **Fiduciary Relationship Between Executor and Legatee**

Fiduciary activities can also apply to specific or one-time transactions. For example, a fiduciary deed is used to transfer property rights in a sale when a fiduciary must act as an executor of the sale on behalf of the property owner. A fiduciary deed is useful when a property owner wishes to sell but is unable to handle their affairs due to illness, incompetence, or other circumstances, and needs someone to act in their stead.

A fiduciary is required by law to disclose to the potential buyer the true condition of the property being sold, and they cannot receive any financial benefits from the sale. A fiduciary deed is also useful when the property owner is deceased and their property is part of an estate that needs oversight or management.

### **Fiduciary Relationship Between Guardian and Ward**

Under a guardian/ward relationship, the legal guardianship of a minor is transferred to an appointed adult. As the fiduciary, the guardian is tasked with ensuring the minor child or ward has appropriate care, which can include deciding where the minor attends school, that the minor has suitable medical care, that they are disciplined in a reasonable manner, and that their daily

welfare remains intact.

A guardian is appointed by the state court when the natural guardian of a minor child is not able to care for the child any longer. In most states, a guardian/ward relationship remains intact until the minor child reaches the age of majority.

## **Fiduciary Relationship Between Attorney and Client**

The attorney/client fiduciary relationship is arguably one of the most stringent. The U.S. Supreme Court states that the highest level of trust and confidence must exist between an attorney and client—and that an attorney, as fiduciary, must act in complete fairness, loyalty, and fidelity in each representation of, and dealing with, clients. <sup>[1]</sup>

Attorneys are held liable for breaches of their fiduciary duties by the client and are accountable to the court in which that client is represented when a breach occurs.

## **Fiduciary Relationship Between Principal and Agent**

A more generic example of fiduciary duty lies in the [principal/agent relationship](#). Any individual person, corporation, partnership, or government agency can act as a principal or agent as long as the person or business has the legal capacity to do so. Under a principal/agent duty, an agent is legally appointed to act on behalf of the principal without conflict of interest.

A common example of a principal/agent relationship that implies fiduciary duty is a group of shareholders as principals electing management or [C-suite](#) individuals to act as agents. Similarly, investors act as principals when selecting investment fund managers as agents to manage assets.

## **Investment Fiduciary**

While it may seem as if an investment fiduciary would be a financial professional (money manager, banker, and so on), an "investment fiduciary" is actually any person who has the legal responsibility for managing somebody else's money.

That means if you volunteered to sit on the investment committee of the board of your local charity or other organization, you have a fiduciary responsibility. You have been placed in a position of trust, and there may be consequences for the betrayal of that trust. Also, hiring a financial or investment expert does not relieve the committee members of all of their duties. They still have an obligation to prudently select and monitor the activities of the expert.

## The Suitability Rule

Broker-dealers, who are often compensated by commission, generally only have to fulfill a [suitability](#) obligation. This is defined as making recommendations that are consistent with the needs and preferences of the underlying customer. Broker-dealers are regulated by the Financial Industry Regulatory Authority (FINRA) under standards that require them to make suitable recommendations to their clients.

Instead of having to place their interests below that of the client, the suitability standard only details that the broker-dealer has to reasonably believe that any recommendations made are suitable for the client, in terms of the client's financial needs, objectives, and unique circumstances. A key distinction in terms of loyalty is also important: A broker's primary duty is to their employer, the broker-dealer for whom they work, not to their clients.

Other descriptions of suitability include making sure transaction costs are not excessive and that their recommendations are not unsuitable for the client. Examples that may violate suitability include excessive trading, churning the account simply to generate more commissions, and frequently switching account assets to generate transaction income for the broker-dealer.

Also, the need to disclose potential conflicts of interest is not as strict a requirement for brokers; an investment only has to be suitable, it doesn't necessarily have to be consistent with the individual investor's objectives and profile.

The suitability standard can end up causing conflicts between a broker-dealer

and a client. The most obvious conflict has to do with compensation. Under a fiduciary standard, an investment adviser would be strictly prohibited from buying a mutual fund or other investment for a client because it would garner the broker a higher fee or commission than an option that would cost the client less—or yield more for the client.

**Important:** Under the suitability requirement, as long as the investment is suitable for the client, it can be purchased for the client. This can also incentivize brokers to sell their own products ahead of competing for products that may cost less.

## Suitability vs. Fiduciary Standard

If your investment adviser is a [Registered Investment Adviser \(RIA\)](#), they share fiduciary responsibility with the investment committee. On the other hand, a broker, who works for a broker-dealer, may not. Some brokerage firms don't want or allow their brokers to be fiduciaries.

Investment advisers, who are usually fee-based, are bound to a fiduciary standard that was established as part of the [Investment Advisers Act of 1940](#). They can be regulated by the SEC or state securities regulators. The act is pretty specific in defining what a fiduciary means, and it stipulates a duty of loyalty and care, which means that the adviser must put their client's interests above their own. <sup>[2]</sup>

For example, the adviser cannot buy securities for their account prior to buying them for a client and is prohibited from making trades that may result in higher commissions for the adviser or their investment firm.

It also means that the adviser must do their best to make sure investment advice is made using accurate and complete information—basically, that the analysis is thorough and as accurate as possible. Avoiding conflicts of interest is important when acting as a fiduciary, and it means that an adviser must disclose any potential conflicts to placing the client's interests ahead of the adviser's.

Additionally, the adviser needs to place trades under a "best execution"



Additionally, the adviser needs to place trades under a "best execution" standard, meaning that they must strive to trade securities with the best combination of low cost and efficient execution.

## The Short-Lived Fiduciary Rule

While the term "suitability" was the standard for transactional accounts or brokerage accounts, the [Department of Labor Fiduciary Rule](#), proposed to toughen things up for brokers. Anyone with retirement money under management, who made recommendations or solicitations for an IRA or other tax-advantaged retirement accounts, would be considered a fiduciary required to adhere to that standard, rather than to the suitability standard that was otherwise in effect.

The fiduciary rule has had a long and yet unclear implementation. Originally proposed in 2010, it was scheduled to go into effect between April 10, 2017, and Jan. 1, 2018. After President Trump took office it was postponed to June 9, 2017, including a transition period for certain exemptions extending through Jan. 1, 2018.

Subsequently, the implementation of all elements of the rule was pushed back to July 1, 2019. Before that could happen, the rule was vacated following a June 2018 [decision](#) by the Fifth U.S. Circuit Court. <sup>[3]</sup>

In June 2020, a new proposal, Proposal 3.0, was released by the Department of Labor, which "reinstated the investment advice fiduciary definition in effect since 1975 accompanied by new interpretations that extended its reach in the rollover setting, and proposed a new exemption for conflicted investment advice and principal transactions." <sup>[4]</sup>

It remains to be seen if it will be approved under President Biden's administration.

## Risks of Being a Fiduciary

The possibility of a trustee/agent who is not optimally performing in the beneficiary's best interests is referred to as "fiduciary risk." This does not

necessarily mean that the trustee is using the beneficiary's resources for their own benefit; this could be the risk that the trustee is not achieving the best value for the beneficiary.

For example, a situation where a fund manager (agent) is making more trades than necessary for a client's portfolio is a source of fiduciary risk because the fund manager is slowly eroding the client's gains by incurring higher transaction costs than are needed.

In contrast, a situation in which an individual or entity who is legally appointed to manage another party's assets uses their power in an unethical or illegal fashion to benefit financially, or serve their self-interest in some other way, is called "fiduciary abuse" or "fiduciary fraud."

## **Fiduciary Insurance**

A business can insure the individuals who act as fiduciaries of a qualified retirement plan, such as the company's directors, officers, employees, and other natural person trustees.

Fiduciary [liability insurance](#) is meant to fill in the gaps existing in traditional coverage offered through employee benefits liability or director's and officer's policies. It provides financial protection when the need for litigation arises, due to scenarios such as purported mismanaging of funds or investments, administrative errors or delays in transfers or distributions, a change or reduction in benefits, or erroneous advice surrounding investment allocation within the plan.

## **Investment Fiduciary Guidelines**

In response to the need for guidance for investment fiduciaries, the nonprofit Foundation for Fiduciary Studies was established to define the following prudent investment practices:

### **Step 1: Organize**

The process begins with fiduciaries educating themselves on the laws and rules that will apply to their situations. Once fiduciaries identify their governing rules,

they then need to define the roles and responsibilities of all parties involved in the process. If investment service providers are used, then any service agreements should be in writing.

## **Step 2: Formalize**

Formalizing the investment process starts by creating the investment program's goals and objectives. Fiduciaries should identify factors such as investment horizon, an acceptable level of risk, and expected return. By identifying these factors, fiduciaries create a framework for evaluating investment options.

Fiduciaries then need to select appropriate asset classes that will enable them to create a diversified portfolio through some justifiable methodology. Most fiduciaries go about this by employing the [modern portfolio theory](#) (MPT) because MPT is one of the most accepted methods for creating investment portfolios that target a desired risk/return profile.

Finally, the fiduciary should formalize these steps by creating an investment policy statement that provides the detail necessary to implement a specific investment strategy. Now the fiduciary is ready to proceed with the implementation of the investment program, as identified in the first two steps.

## **Step 3: Implement**

The implementation phase is where specific investments or investment managers are selected to fulfill the requirements detailed in the investment policy statement. A [due diligence](#) process must be designed to evaluate potential investments. The due diligence process should identify criteria used to evaluate and filter through the pool of potential investment options.

The implementation phase is usually performed with the assistance of an investment advisor or adviser because many fiduciaries lack the skill and/or resources to perform this step. When an advisor or adviser is used to assist in the implementation phase, fiduciaries and advisors or advisers must communicate to ensure that an agreed-upon due diligence process is being used in the selection of investments or managers.

## Step 4: Monitor

The final step can be the most time-consuming and also the most neglected part of the process. Some fiduciaries do not sense the urgency for monitoring if they got the first three steps correct. Fiduciaries should not neglect any of their responsibilities because they could be equally liable for negligence in each step.

In order to properly monitor the investment process, fiduciaries must periodically review reports that benchmark their investments' performance against the appropriate index and peer group, and determine whether the investment policy statement objectives are being met. Simply monitoring performance statistics is not enough.

Fiduciaries must also monitor qualitative data, such as changes in the organizational structure of investment managers used in the portfolio. If the investment decision-makers in an organization have left, or if their level of authority has changed, investors must consider how this information may impact future performance.

In addition to performance reviews, fiduciaries must review expenses incurred in the implementation of the process. Fiduciaries are responsible not only for how funds are invested but also for how funds are spent. Investment fees have a direct impact on performance, and fiduciaries must ensure that fees paid for investment management are fair and reasonable.

## Fiduciary Rules and Regulations

*A Department of the Treasury agency, the [Office of the Comptroller of the Currency](#), is in charge of regulating federal savings associations and their fiduciary activities in the U.S. Multiple fiduciary duties may at times be in conflict with one another, a problem that often occurs with real estate agents and lawyers. Two opposing interests can at best be balanced; however, balancing interests is not the same as serving the best interest of a client.*

*Fiduciary certifications are distributed at the state level and can be revoked by the courts if a person is found to neglect their duties. To become certified, a fiduciary is required to pass an examination that tests their knowledge of laws, practices, and security-related procedures, such as background checks and screening. While board volunteers do not require certification, due diligence includes making sure that professionals working in these areas have the appropriate certifications or licenses for the tasks they are performing.*

## **What Is a Fiduciary?**

A fiduciary must place the interest of their clients first, under a legal and ethically binding agreement. Importantly, fiduciaries are required to prevent a conflict of interest between the fiduciary and the principal. Among the most common forms of fiduciaries are financial advisers, bankers, money managers, and insurance agents. At the same time, fiduciaries are present across many other business relationships, such as corporate board members and shareholders.

## **What Are the 3 Fiduciary Duties to Shareholders?**

Since corporate directors can be considered fiduciaries for shareholders, they possess the following three fiduciary duties. Duty of Care requires directors to make decisions in good faith for shareholders in a reasonably prudent manner. Duty of Loyalty requires that directors should not put other interests, causes, or entities above the interest of the company and its shareholders. Duty to Act in Good Faith, finally, requires that directors choose the best option to serve the company and its stakeholders.

## **What Is an Example of Fiduciary Duty?**

There are [many examples of fiduciary duty](#). Consider the examples of a trustee and beneficiary, the most common form of a fiduciary relationship. The trustee is an organization or individual that is responsible for managing the assets of a third party, often found within estates, pensions, and charities. A trustee is bound under a fiduciary duty to put the interests of the trust first, ahead of their

## Why Does Someone Need a Fiduciary?

Working with a fiduciary means that you can be assured that a financial professional will always be putting your interests first, and not their own. This means that you don't have to worry about conflicts of interest, misplaced incentives, or aggressive sales tactics.

### ARTICLE SOURCES ▲

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1. Library of Congress. "U.S. Reports: Stockton v. Ford, <https://tile.loc.gov/storage-services/service/l/usrep/usrep052/usrep052232/usrep052232.pdf>," Page 247.
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