September 24, 2016

Excessive Compensation Prohibition

No Exceptions

The DoL Fiduciary Rule ("Rule") prohibits advisors from receiving excessive compensation from any IRA or ERISA Plan for both existing and new business!

While there are many exemptions and exceptions built into the Rule, there is one common mandate:

> **No compensation in excess of what is reasonable for the services provided.**

Prohibition of Excessive Compensation of the Rule applies to:

- Existing and new business	- No-conflict arrangements
- Best Interest Contracts	- Level Fee Arrangements
- Annuity Products	- Robo Advisors

Resolving excessive compensation can be a lengthy process and must be started immediately to achieve the applicability date of April 10, 2017.

Meeting Requirements with Minimum Harm

Every advisor has the potential to receive excessive compensation from one or more accounts.

Identifying and resolving the cases of excessive compensation requires a three immediate actions:

1. Select a method of determining what is reasonable
2. Identify accounts that are in violation
3. Resolve accounts that are in violation

The Fiduciary Rule has not defined what reasonable levels are and instead has left it up to each advisor and financial institution to arrive at their own conclusions that will be tested in courts at a later time. While this approach creates uncertainty, it also creates the opportunity to use a definition that most likely to prevail in court and is least harmful to current and future business.

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Defining What Is Reasonable

In 2010 the US Supreme Court unanimously affirmed that five factors determine if an RIA's fees are excessive. The four determinants of excessive fees are:

- **Services**
  The nature, extent, and quality of the services to be provided by the investment adviser;
- **Performance**
  the investment performance of the investment and the investment adviser;
- **Costs and Profits**
  the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates;
- **Economies of Scale**
  the extent to which economies of scale would be realized as the investment grows; and
- **Benefit to Investors**
  whether fee levels reflect these economies of scale for the benefit of investors.

In its decision, the Supreme Court pointed out that in order to be excessive:

> *"…an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."*

Compensation benchmarks are most easily implemented but the Supreme Court warned against placing too much emphasis on them and they have devastating effect on overall revenue. More meaningful profit based or value based evaluations preserve the compensation in a more reasonable way.

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Service Is the New Cornerstone

The Rule's prohibition is not focused on any individual investment class or types of advisor. The focus is on the individual account and the total compensation paid by the account for the services received. As a result, excessive compensation violations occur in underserved accounts and can be resolved by increasing the range or quality of services.

The effect is that constraints are placed on the underserved accounts of all products and all advisors.

Affected Accounts

The number of an advisor's accounts that are classified as paying excessive compensation depend on the method used to determine what is reasonable. Two methods were evaluated based on a high service advisor with a wide range of investments:

- Benchmark of comparable advisors 22.0% affected
- Profit based evaluation 1.5% affected

Abandoned accounts (no broker of record) are particularly problematic and a high volume could change the statistics.

High Expense Products

A violation is more likely to occur when products with high expenses are used in accounts that receive low levels of service. The Rule is blind to the products expense, if it can be shown that the cost is reasonable for the level of account services.

Clients Desiring Low Service

One course of action for an account found to be paying excessive fees is to increase the services being provided. The added services (such as more frequent visits, additional reporting, tracking a wider range of investments) then support the compensation.

This alternative is not feasible for clients who elect not to use additional services. In this case it may be necessary for the advisor to recommend lower cost alternatives.

Surrender Charges

In addition to receiving only reasonable compensation, the Rule requires advisors to act in the client's best interest.

This creates a dilemma for the advisor with an excessive fee account that also has a surrender charge. The advisor is required to recommend the surrender and notify the client of the cost.

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Saving the Account

The Rule prohibits excessive compensation from the account but does not suggest any guidelines for what to do about them. Note that resolutions described here should only be attempted when there are very few violations.

The first course of action is to check on reasonableness of compensation to determine its validity for the account.

The next possible course is to offer additional services to the account and failing this, recommend changes that lower the compensation paid.

If these measures fail to resolve the excess, the remaining unpleasant alternative is to terminate the account.

Resolving the Validity of the Excess

Validation begins with the advisor examining the circumstances applicable to the account in relation to the corresponding circumstances of the comparative reasonable level.

If a benchmark is being used, the breakdown of the composition of the benchmark is examined.

If a profit based calculation is used, the estimates of hours spent, scope, weighting of services and profit margins are reviewed and revised if necessary.

Adding Services

Most clients are delighted at the additional services that are of value to them. Suggestions for additional services should therefore be carefully selected and presented based on how desirable they are to the particular client.

Of equal importance is the cost and time required for the advisor to provide the service. Additional services can often be performed at relatively low cost.

Lowering the Compensation

When compensation from the account cannot be resolved in another way, it will be necessary to change investments, share classes or rates/amounts in the case of direct fees.

These changes have other consequences that must also be evaluated.

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The History

DALBAR has used the method of evaluation based on cost and profit in the context of service providers to ERISA plans for several years. This work has successfully undergone the scrutiny of the DoL without complaint. The result has been that several seemingly overpriced plans were found to be reasonable after considering services and quality factors.

This proven method has now been applied to the Rule to determine qualification for grandfathering of existing accounts as well as for new business.

Availability

The DALBAR Solutions described below are available to investment and insurance product providers to support the advisor community.

Under such arrangements the DALBAR Solutions are fully supported:

- Online access and reporting
- Live advisor help line
- Development of marketing materials
- Wholesaler training
- Supporting materials and papers

Pre-Existing Exemption Test

DALBAR has created a system to find any accounts that fail to comply with compensation limits.

- Protects compensation from clients who pay above average fees for above average services
- Targets the recovery of costs and generation of a profit from each client, large and small, complex and simple
- Adds a premium for a superior standard of care, level of risk, skills required and the cost of tools needed to serve each client
- Evaluates the services delivered to each client for alignment with compensation as required by regulation

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Advisor's Certification of Reasonableness ("ACOR")

ACOR is a prudent approach to meeting the compensation requirement and provides an independent third party certification of compliance with the rule.

- Prevents erosion of compensation produced by benchmark comparisons and RFP bidding
- Targets the recovery of costs and generation of a profit from each client, large and small, complex and simple
- Adds a premium for a superior standard of care, level of risk, skills required and the cost of tools needed to serve each client
- Evaluates the services delivered to each client for alignment with compensation as required by regulation
- Certifies reasonableness or identifies instances where compensation is unreasonably low as well as instances where compensation is unreasonably high.

About DALBAR

DALBAR, Inc. is the financial community's leading independent expert for evaluating, auditing and rating business practices, customer performance, product quality and service. Launched in 1976, DALBAR has earned the recognition for consistent and unbiased evaluations of investment companies, registered investment advisers, insurance companies, broker/dealers, retirement plan providers and financial professionals. DALBAR awards are recognized as marks of a superior standard of care in the financial community.

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