**BRIEFING PAPER**

# THE NOT-SO-FREE LUNCH
## GRANDFATHERING UNDER THE DOL FIDUCIARY RULE


***Abstract***

It has been widely reported that advisors were given a free pass for existing accounts in the new DoL Fiduciary Rule but to qualify for this free lunch there is one very expensive detail. This detail has not had much coverage, but is burdensome and could force an advisor to take a severe cut in pay.

- Accounts that pay excessive compensation get no free pass.
- Advisors must find which accounts are excessive.
- Excesses must be resolved before rule goes into effect.

This paper lays out the challenge and offers alternatives to minimize the loss in compensation and avoid regulatory violations.




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## The Not-So-Free Lunch

The final DoL Fiduciary Rule applies to advisors serving:

(1) A participant or beneficiary of a Plan with authority to direct the investment of assets in his or her Plan account or to take a distribution;

(2) The beneficial owner of an IRA acting on behalf of the IRA; or

(3) A Retail Fiduciary with respect to a Plan or IRA.

Only certain accounts qualify for grandfathering relief as described in the *conditions* in Section VII(b).

The final DoL Fiduciary Rule ("Rule") gave advisors a big break by exempting existing accounts from many of the new requirements. However, existing accounts are subject to a new compensation limitation. The new limitation means that total compensation paid to the advisor and related financial institutions cannot exceed a reasonable level for the services provided to the account ("Excessive Compensation").

The 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 definitions. While this approach creates uncertainty, it also creates the opportunity to use a definition that is least harmful to current and future business.

Additionally, the Rule does not specify that advisors must examine every account to determine if the compensation is excessive, but it does say that any account that generates excessive compensation is prohibited. There is no plausible way to find an offending account without reviewing the compensation from each, so for most advisors it will be necessary to determine a reasonable level for each account individually. This may be a lengthy process. The prohibition starts on the applicability date (April 10, 2017) and remains in effect continuously thereafter!

This paper identifies ways to define reasonable levels but some are harmful to advisors. This paper also presents one alternative that avoids a severe loss of compensation for most.

### *Avoiding Compensation Limits*

The 408(g) Computer Model automates the advisor's decision making and provides the required evidence of prudence.

The 408(g) Computer Model is the humanized incarnation of a robo advisor.

The limits to compensation are imposed by the Best Interest Contract Exemption ("BICE") of the Rule. There are two business models in which the Rule imposes no compensation limits:

- Give No Advice: Limits the value an advisor can provide.
- 408(g) Computer Model: Advisor delivers advice through a certified computer model.

The most practical for most advisors is the 408(g) Computer Model. The advisor is required to implement an investment strategy in a computer model which is then certified. Instead of developing recommendations manually, the advisor enters key facts and the computer model uses the advisor's strategy to create them. (See article on this subject).



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BICE VII(b)(4)

The amount of the compensation paid, directly or indirectly, to the Adviser, Financial Institution, or their Affiliates or Related Entities in connection with the transaction is not in excess of reasonable compensation within the meaning of ERISA section 408(b)(2) and Code section 4975(d)(2)

### *Excessive Compensation Compliance*

To comply with the excessive compensation prohibition, advisors will need to identify prohibited accounts and complete corrective action before the applicability date.

Advisors will also need a process to monitor accounts for violations caused by changes in circumstances or increases or decreases in account value.

Circumstances include changes in product pricing, costs of doing business and the reference used to determine reasonableness. For clients under an AUM arrangement, account appreciation or contributions can move that account into a prohibited range. For flat fee arrangements, attrition due to retirement income payments could also cause a problem.

### *Resolving Excessive Compensation*

Regulations do not prescribe a course of action for accounts paying excessive compensation to the advisor. This condition is simply prohibited. It is therefore left to the advisor to make the necessary adjustments.

After identifying an Excessive Compensation Prohibition, there are three approaches to a resolution:

- Lower the compensation to a reasonable level
- Increase the services provided to the account
- Terminate the client

A single case of excessive compensation is not likely to be very damaging unless it reveals a pattern of excesses.

Such a pattern can quickly envelop an advisor’s entire business, and lead to an investigation of a financial institution’s practices and potentially the entire industry’s.

Lowering the compensation for fees charged directly to a client is painful but straightforward. Altering compensation that comes through product providers involves changing the holdings in the account. This may involve a share class change or may require replacing investments which could result in penalties for the client. If sufficiently large, these penalties could violate the requirement to act in the best interest of the client.

Increasing the services may also present problems if the client currently uses all the services offered by the advisor or has no use for other services available.

Terminating a client is clearly a last resort.

**Note**: *Unless it can be shown to be in the client’s best interest, it is not recommended to raise compensation in accounts that are not subject to the Fiduciary Rule in order to cover reductions in excess compensation accounts.*



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Averages of prevailing compensation are harmful since differences among clients may not be factored:

- Cost and effort to acquire
- Time spent servicing
- Compliance requirements
- Use of other resources
- Other services provided
- Cost of required skills
- Standard of care

Averages create a loss of compensation that only ends when all competitors have succumbed.

### *Reasonableness*

There are prudent and imprudent ways of determining which accounts are exposed to Excessive Compensation Prohibition.

The easiest way to determine what is reasonable is also the least prudent! That is to take the average compensation that an advisor's client pays and consider any account above that level to be excessive. The effect of this is simply an immediate and dramatic reduction in compensation.

The second imprudent way of assessing reasonableness is to use industry averages in the same way that the first option is used ("Benchmarking"). While the effect of Benchmarking is not as immediate, the reduced compensation is as certain. While advocated by regulators and consumer advocates, the Benchmarking method is not supported by actual regulation or case law.

The prudent approach is to base the assessment of what is reasonable on the cost to the advisor plus a reasonable profit. This profit based approach is by far the most frequently used in the business world, although it may be new for advisors. This approach is based on case law.

### *Case Law on Reasonableness of Investment Compensation*

While the Gartenberg case specifically applied to investment advice to mutual funds, it is generally accepted for investment advice to all types of clients.

The landmark Gartenberg case (Gartenberg v. Merrill Lynch Asset Management, Inc.) offers the most credible definition of what constitutes reasonable compensation. In Gartenberg the court found that excess compensation requires that it:

> *"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."*

This conclusion was affirmed in 2010 by the U. S. Supreme Court in the Jones v. Harris Associates decision, with the opinion that it had proved to be:

> *"workable for nearly three decades."*

The prudent profit based approach described above is consistent with the Gartenberg guidelines in that the cost of providing services at an acceptable margin of profit bears a "*reasonable relationship to the services rendered*".



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### *Effects of Profit Based Approach*

In almost all circumstances, when compensation is based on cost plus a reasonable profit, advisors will find only very few cases of excessive compensation. The reason is that extreme charges are detected and addressed by either the advisor or the client.

Using the profit based approach, there are two circumstances that produce an excessive compensation violation:

- Compensation paid to the advisor is out of line with the total cost of operating the service. In this circumstance the advisor is highly exposed to litigation under Gartenberg.
- A generic pricing structure causes certain accounts to over-pay. This may arise when an account pays for a comprehensive set of services but does not use them. Most notable is a wrap fee arrangement in which there is no trading!

Advisors receiving excessive compensation defined by the Gartenberg standard can usually recognize the problem without an analysis.

Profit based pricing will also identify accounts that are underpriced. These are typically high maintenance accounts that pay the same standard fee as other accounts.

### *The Process for Using Profit Based Approach*

Two tasks must be performed to adopt a profit based approach:

- Determine cost and desired profit margin to determine the total compensation needed
- Allocate compensation needed for each account to determine the reasonable compensation and compare this to the actual compensation

The profit based approach requires a diligent effort but the alternative is an immediate and continuing reduction in compensation.

The process can be facilitated by DALBAR's online calculators:

- Pre-Existing Exemption Test
- Advisor Certification of Reasonableness

The cost is the advisor's total annual expenditure. Profit margins are generally in the range of 10% to 50% and typically about 30%.

The allocation to each account is simple if all accounts receive the same service, use the same resources and are the same size. When accounts differ widely, it may be necessary to use an automated allocation tool.

There should only be very few accounts in which the actuals exceed the reasonable compensation by a material amount. A large number of accounts with excessive compensation probably indicates an error in the allocation to these accounts.

This process will also identify accounts that are paying too little compensation. These accounts are loss leaders and advisors should determine if the "investment of compensation" in them is worthwhile. Reasons for the lowered compensation should be examined and when necessary, the compensation increased.



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The first step is to calculate hourly rates (see next section) and then unbundle the rate to reflect the premium charged for each of the other categories.

In this way a premium can be charged to accounts that require extensive services while lowering the cost for less demanding accounts.

### *Determining Costs and Profit*

If the advisor's account base is varied, it will be necessary to break down costs and profit so as to properly allocate the compensation needed. Examples of such breakdowns:

- Resources (Hours and rate for each skill set used)
- Scope (Depth of analysis and range of investments)
- Services (IPS, financial planning, periodic reviews, education, etc.)
- Standard of Care (Co-fiduciary, fiduciary)
- Asset Size Ranges (Reflecting risk exposure)

These breakdowns are then used as the basis to calculate the reasonable compensation for each account.

### *Calculating Hourly Rates*

Example:

Total expenditure: $.5 m

Profit margin: 30%

Number on team: 2

Total hours: 2,000
(400 days @ 5 hours each)

Hourly calculation:
(500,000 + .30 * 500,000) / 2,000

Average hourly rate: $325

Role #1 rate: $425

Role #2 rate: $225

There is a simple method of finding hourly rates.

Start by calculating the average rate for the practice.

Total annual expenditures
(including all funds withdrawn and
broker/dealer portion of compensation)

PLUS

Profit
(profit margin %
TIMES
total annual expenditures) and

DIVIDE

the result by total hours worked
by all members in one year

For a one-person practice, this is the hourly rate.

If there are multiple team members, the average rate is raised or lowered in proportion to the compensation and skills required for each role. Principals and team members with special expertise are assigned higher rates while subordinates have lower rates.

The breakdown into multiple rates permits a reasonable allocation of cost and profit to client accounts (See next section).



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Separate service sets can be assigned to high maintenance accounts or accounts requiring moderate or low maintenance.

Accounts that required great effort to win the business can be in different service sets from accounts that took less effort/time.

### *Allocating Costs and Profit to Client Accounts*

Allocation is necessary when an advisor's client accounts differ in make-up and services. The process distributes the costs and profits based on these differences.

Allocation is most easily done by grouping accounts into service sets, each having a unique arrangement of features. The allocation may then be done by service set and the set applied to each account. Accounts that do not fit a service set will require an additional service set.

Each service set defines:

- Hours spent or planned for each skill or role used
- Depth of analysis such as needs analysis, IPS, risk assessment, financial planning, etc.
- Range of investments that reflects the complexity of recommendations and compliance
- Specific services used
- Standard of Care
- Asset range

Previously calculated rates are then applied to each account in a service set to determine the reasonable compensation.

The reasonable compensation is compared to the account's actual compensation. Actuals that exceed the reasonable compensation by more than the margin of error are considered excessive. The typical margin of error for advisors with less than 500 accounts is typically 10%.



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## Briefing Paper

### Has this paper raised questions that you need to answer?

DALBAR provides a double-check service to deliver answers including:

Exemptions Available

- Alternatives to BICE
- Contact Center Operation Under BICE

Impartial Conduct Standards

- Proof of Prudence

Risk Management

- Exposure to Class Action Litigation
- Effect on Liability Insurance Premiums

Marketplace Changes

- Compensation for Sales
- Effect on Rollovers

Product Incentives, Sales and Marketing

Learn more about:

**Fiduciary Double-Check**

### Do you have a compliance challenge with the new Fiduciary Rule?

The Wagner Law Group and DALBAR can help.

The Wagner/DALBAR standard is a uniform interpretation of the complex new fiduciary rules that are essential to compliance while also:

- Retaining current revenue and clients
- Remaining competitive to win new business
- Mitigating risks created by the new rules
- Operating within a "safe harbor" defined by consensus
- Avoiding potential anti-trust issues
- Using the Standard as a foundation to create your unique solution

Learn more about:

**Standardized Compliance for the New Fiduciary Era**

### Are you interested in an automated system for checking excess compensation?

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

Learn more about:

**Pre-Existing Exemption Test**



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