BRIEFING PAPER

ASSESSING COMPENSATION REASONABLENESS OF RETIREMENT INVESTMENT ADVISERS

September 20, 2016

Abstract

The 21st century has seen an escalation in the focus on retirement adviser compensation coming from a plethora of lawsuits, new laws from Congress, Regulatory action and even the President promising to cut $17 billion from adviser's pay.

This unprecedented activity has led many to conclude that compensation will be cut. The basis for all this activity is the firm belief that advisers are excessively compensated for the work they do. Such a belief may have been fueled by the high profile case of Bernie Madoff.

While it is entirely possible that unreasonable and excessive compensation exists, it is unreasonable to expect that such excesses are widespread.

Unfortunately the hunt for unreasonable compensation is being fueled by advisers and advisory firms that fail to see the threat to their own existence. Instead many carry out this destructive behavior by lowering their own compensation in an imprudent effort to avoid possible penalties.

This paper is intended to inform and to limit the damage to advisers who perform at a high level for reasonable compensation.

Supporting this initiative to limit the damage to good advisers, is the unanimous 2010 Supreme Court decision that stipulates that reasonable compensation must be based on factors of value described in the Gartenberg Standard.

The Gartenberg Standard incorporates the varied relationships and arrangements that exist between advisers and clients, developed from decades of understanding client needs and situations and molded into a framework of regulation and enforcement.

The Court warned about the use of benchmarks to compare advisers, limiting such tools to "arm's length benchmarks" that include only those arrangements derived from arm's length bargaining. The Court ordered that even "arm's length benchmarks" were unnecessary and only ancillary to the other Gartenberg factors.

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BICE II(c)(2) The recommended transaction will not cause the Financial Institution, Adviser or their Affiliates or Related Entities to receive, directly or indirectly, compensation for their services that is in excess of reasonable compensation within the meaning of ERISA section 408(b)(2) and Code section 4975(d)(2).

ERISA 408(g)(1)(b)(3) (B) Any investment advice takes into account investment management and other fees and expenses attendant to the recommended investments;

ERISA 408(b)(2)(c)(1) (i) General. No contract or arrangement for services between a covered plan and a covered service provider, nor any extension or renewal, is reasonable within the meaning of section 408(b)(2) of the Act and paragraph (a)(2) of this section unless the requirements of this paragraph (c)(1) are satisfied.

Introduction

The 21st century ushered in a witch hunt to find and punish advisers who take unfair advantage of consumers by charging unreasonable compensation. After three decades of largely failed efforts at pursuing fees charged by institutions, attention has turned to advisers.

There has been a history of success in reducing adviser compensation in the late 20th century. Of particular note are:

- Deregulation of brokerage commissions
- The demise of contractual plans by requiring refunding of commission advances
- Cutting sales charges from 8.5% to 5% by the action of the self-regulatory organization
- Reduction in retirement plan charges by the competitive onslaught of mutual funds
- Introduction of expense criteria in investment policy statements

Advisers are today faced with threats to retirement business from four directions.

- Litigation from Retirement Investors
- Limitations of the Best Interest Contract Exemption ("BICE")
- Reasonableness requirements of the Pension Protection Act Exemption 408(g)
- Fee Disclosure Regulation (ERISA 408(b)(2)

All of these seek to eradicate unreasonable fees, but it is the Supreme Court that provided the guidance of what a reasonable fee should be. It is up to the investment adviser community to adopt an appropriate standard of reasonableness that complies with this guidance.

Determining what is and is not reasonable for clients whose wealth ranges a thousand fold in a mosaic of relationships, services, products and compensation systems is complex. As the Court affirmed, simple comparisons of what others charge *"are problematic because [they] may not be the product of negotiations conducted at arm's length"*.

Assessment of reasonableness involves consideration of a host of factors that may be relevant to one situation but immaterial in another.

Answering these threats requires a course of action that recognizes and enhances the value that advisers provide so as to limit the exposure to massive compensation cuts.

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2010 -JONES ET AL. *v.* HARRIS ASSOCIATES L. P. (a) A consensus has developed regarding the standard *Gartenberg* set forth over 25 years ago: The standard has been adopted by other federal courts, and the Securities and Exchange Commission's regulations have recognized, and formalized, *Gartenberg*-like factors.

The Guidance on Excessive Fees

In 2010 the US Supreme Court affirmed (Jones[1]) the historical standard for determining when investment related fees and expenses are excessive. The Court also added further guidance for lower courts to apply in judging whether compensation is excessive.

The affirmed standard are the Gartenberg[2] Factors that require compensation be examined from multiple perspectives before a finding of excessiveness can be made, including at a minimum:

- **Services & Quality**
  The nature, extent, and quality of the services to be provided by the investment adviser;
- **Adviser Performance**
  the investment performance of the investment and the investment adviser;
- **Costs & 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 other circumstances increase efficiency;
- **Benefit to Investors**
  whether fee levels reflect these economies of scale for the benefit of investors.

[1] See Jones v. Harris Associates.
[2] See Gartenberg v. Merrill Lynch, etc.

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2010 -JONES ET AL. *v.* HARRIS ASSOCIATES L. P. "The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside." *Gartenberg*'s approach fully incorporates this understanding, insisting that all relevant circumstances be taken into account and using the range of fees that might result from arm's-length bargaining as the benchmark for reviewing challenged fees.

Conclusions of the Court

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."*

The Court also warned against placing too much emphasis on a comparison of one advisory fee against fees charged to others by other advisers (Statistical benchmarks). The Supreme Court wrote:

> *"These comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm's length."*
>
> *and*
>
> *"Gartenberg uses the range of fees that might result from arm's-length bargaining as the benchmark for reviewing challenged fees."*

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Arm's Length Benchmarks

The Supreme Court discouraged the use of benchmarks, ascribing only marginal usefulness to "arm's length benchmarks" that excluded many adviser arrangements in the market today. This lay to waste benchmarks that contain arrangements between parties who:

- Are family members
- Are employer/employee
- Have other material business relationship(s)
- Have controlling influence (Superior/subordinate)
- Have a significant knowledge advantage of the market
- Engage in bartering in which goods or services are exchanged
- Are referred in a quid pro quo arrangement
- Use temporary low pricing to capture market share

These exclusions make the collection and calculation of "arm's length benchmarks" difficult, expensive and unreliable.

The process is made difficult by the need to identify only those arrangements that are arm's length. The existence of these exclusions may only be known to the parties involved.

The process is expensive due to the slow manual process required to select the arrangements that qualify as "arm's length". The results are likely to be unreliable for the reliance on a manual process and the relatively small sample that can be obtained by this means.

A further consideration is that "arm's length benchmarks" can only be applied to arm's length arrangements.

Arm's Length

adj. the description of an agreement made by two parties freely and independently of each other, and without some special relationship, such as being a relative, having another deal on the side or one party having complete control of the other. It becomes important to determine if an agreement was freely entered into to show that the price, requirements, and other conditions were fair and real. Example: if a man sells property to his son the value set may not be the true value since it may not have been an "arm's length" transaction.

Why Regulators Pass the Buck

In considering regulation regarding fees, regulators have had to avoid being reversed in court, and in particular by the Jones and Gartenberg precedents. Regulations have therefore stayed away from defining what compensation is reasonable and therefore not excessive.

While the DoL and IRS have both expressed support for considering compensation in all vendor selection, they have generally been silent on what specific methods would be acceptable.

Endorsing benchmark comparisons would also contradict the Supreme Court decision that limits the use to "arm's length benchmarks".

DoL FAB 2007-01 With regard to the prudent selection of service providers generally, the Department has indicated that a fiduciary should engage in an objective process that is designed to elicit information necessary to assess the provider's qualifications, quality of services offered and reasonableness of fees charged for the service.

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Product Dependency

Unlike products that are generally cut from the same mold, advisers have evolved to meet a non-homogenous mix of client needs, preferences, fears and desires. Compensation for advisers based on products that are in the client's best interest will invariably yield over-compensation in some cases and under-compensation in others.

The imbedded compensation received from product manufacturers presents a further challenge to regulators seeking to curb excessive compensation.

The first issue is jurisdictional.

A dually registered adviser may be paid by an investment manager and insurance company for products held in a combination of taxable accounts, IRAs and ERISA plans. In this case the adviser may come under the Jurisdiction of the SEC, Finra and one or more insurance commissioners. The IRA business is in the jurisdiction of the IRS and ERISA is the responsibility of the Department of Labor.

So who will be holding the adviser accountable?

The second issue is complexity.

The payment of this compensation can take very intricate routes. Starting with the client the funds may come first to a broker/dealer, a bank for certain activities, an insurance agency or a payroll provider for payroll deductions. It may then flow to a number of product providers who distribute the funds as directed, including back to the broker/dealer.

Imagine trying to follow the money!

The third issue is conflicting laws.

This entangled system is further knotted up by the growing number of laws that sometimes contradict each other. The list of these are so long it would be impractical to attempt to list them here, but consider just the categories of State and Federal laws covering securities, insurance, taxes, money movements and consumer protection.

And excessive compensation could potentially violate any of them.

The Gartenberg Standard cuts across these jurisdictions, complexities and laws to provide a rational way to assess reasonableness.

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Why Rely on Gartenberg

Specifics of the case is fairly narrow but the principles of the Court's decision have wide application.

These principles can be summarized as follows:

- The reasonableness of Adviser's compensation cannot be determined by a single measure but require at least the five considerations embodied in the Gartenberg Standard in addition to other relevant facts.
- The compensation received by other advisers under similar circumstances may have no bearing on the reasonableness of another for several reasons, but in particular transactions are often not "arm's length" and involve other relationships and services.

These principles guide regulators and courts and are applicable to individual clients as well as institutions and large investment pools.

The Gartenberg Standard also addresses the variation in the portfolio mix that an adviser's client owns. Examining each adviser recognizes the difference in time and skill required to serve very simple portfolios (say indexed mutual funds) from portfolios that are more complex (with insurance products, alternative investments, etc.) as well as every possible combination. With Gartenberg, advisers with complex client portfolios are not penalized for the time it takes to serve them.

Employing these principles provides advisers with the greatest protection since they are based on a Supreme Court decision. In the event of a charge of excessive or unreasonable compensation the adviser can answer the plaintiff or regulator with a value argument. The value provided by the adviser is represented in the Gartenberg Standard which can often be demonstrated to exceed the compensation that the adviser receives.

Operating outside of these principles exposes advisers to excessive compensation penalties, regardless of other regulatory compliance. If a client should suffer a loss, and an adviser cannot show evidence of meeting the Gartenberg Standard, it is far more likely that the adviser or firm will be forced to restore losses or worse, pay penalties.

It becomes clear that while nothing is certain, the prudent choice for advisers is to operate under the Gartenberg Standard and the opinion of the Court.

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Applying the Gartenberg Standards to Various Situations

The four examples that follow show the misleading results that can be produced by using simple peer group averages without considering the Gartenberg factors.

Example 1: Reasonable above average compensation for an IRA

The client is retired and has only one account with assets of $700,000 to fund retirement in addition to Social Security. Investment requirements are to hold a substantial portion of assets in the energy sector but to avoid health care. The client requires quarterly reviews to monitor the IRA portfolio and update personal preferences and risk tolerance.

The adviser receives compensation of 95 basis points which is 50% higher than other similarly situated clients with other advisers.

This give the misleading impression that this client is overpaying for the adviser's services.

Applying Gartenberg, the finding is that this client should be paying more:

Exceptionally high service requirements.

- The first step is to calculate what the client is actually paying the adviser:

  $700,000 X 95 bps = $6,550

- Next is to determine the cost and profit of providing the services to this client. Adviser spends 24 hours per year servicing this client at an internal cost + profit of $350 per hour.

  $350 X 24 hours = $8, 400

- Additional factors are then considered and weighted. These may increase or decrease the hourly calculation to arrive at a "Reasonable" compensation.

  Adviser performance: + 10% ($840)

  Economies of scale: +0% ($0)

  Benefits to client: +25% ($2,100)

- Summing to a total reasonable compensation of:

  $11,340

The reasonable compensation in this case is far in excess of what the adviser earns.

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Example 2: Reasonable above average compensation for 401(k) Plan

This client is a 401(k) plan with $13 million and 300 participants. Participation rate is 93% of eligible employees and contributions average 7.5% of salaries. The average age of participants is 46. Plan asset allocation is rated at moderately aggressive. The adviser visits quarterly and provides regular training sessions with employees. The adviser is responsive to calls from participants 24 hours per day.

The adviser receives a net of 40 basis points as broker of record on the plan. This is nearly double the average for plans of this size.

Applying Gartenberg, the finding is that this client should be paying more, not less:

- The first step is to calculate what the client is actually paying the adviser:

  $13,000,000 X 40 bps = $52,000

- Next is to determine the cost and profit of providing the services to this client. Adviser spends 52 hours per year servicing this client at an internal cost + profit of $450 per hour. An analyst in the practice spends 45 hours per year at $150 per hour.

  $450 X 52 hours = $23,400

  $150 X 45 hours = $6,750

  Total $30,150

- Additional factors are then considered and weighted. These may increase or decrease the hourly calculation to arrive at a “Reasonable” compensation.

  Adviser performance: + 25% ($7,538)

  Economies of scale: +0% ($0)

  Benefits to client: +50% ($15,075)

- Summing to a total reasonable compensation of:

  $52,763

Exceptional adviser performance.

The reasonable compensation in this case is close to what the adviser earns.

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Not "arm's length" bargaining.

Example 3: Unreasonable below average compensation for large client

This client has total assets of $47 million with the adviser that includes a $100,000 IRA on a separate platform that pays the adviser 65 basis points. This account receives no services from the adviser and is considered a "convenience" for the client.

The average adviser compensation for IRAs of this size is 85 basis points, but this simple average does not consider the scale of the entire relationship.

Applying Gartenberg, the finding is that this client should be paying less:

- The first step is to calculate what the client is actually paying the adviser:

  $100,000 X 65 bps = $650

- Next is to determine the cost and profit of providing the services to this client. Adviser spends ½ hour per year discussing this account at an internal cost + profit of $350 per hour.

  $350 X ½ hour = $175

- Additional factors are then considered and weighted. These may increase or decrease the hourly calculation to arrive at a "Reasonable" compensation.

  Adviser performance: + 0% ($0)

  Economies of scale: +0% ($0)

  Benefits to client: +5% ($9)

- Summing to a total reasonable compensation of:

  $184

While this scenario is not likely to be called out as a problem, it is an irritant since it technically violates the Gartenberg Standard. In reality, the adviser could simply decline this compensation.

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Example 4: No average compensation for situation

This client purchased an annuity for his IRA, but seeks to surrender it now. The surrender charges are 4% of the account valued at $250,000. There are no ongoing services to this client.

The adviser received a 5% commission at the time of the sale but will not participate in the surrender charge. The issue is, however, that the client is now paying for compensation that the adviser received two years ago. There is no available peer group average for this scenario.

This scenario illustrates the need to consider a variety of factors when assessing the reasonableness of adviser compensation. Using Gartenberg, the adviser compensation received at the time of the sale was simply an advance. The analysis is therefore performed as if the payment and receipt occurred concurrently.

Compensation advanced by third party in anticipation of future recovery.

Applying Gartenberg, the finding is that this client should be paying less:

- The first step is to calculate what the client actually paid the adviser:

  $250,000 X 5% = $12,500

- Next is to determine the cost and profit of providing the services to this client. Adviser spent 4 hours discussing this account at an internal cost + profit of $350 per hour.

  $350 X 4 hours = $2,450

- Additional factors are then considered and weighted. These may increase or decrease the hourly calculation to arrive at a "Reasonable" compensation.

  Adviser performance: + 10% ($245)

  Economies of scale: +0% ($0)

  Benefits to client: +10% ($245)

- Summing to a total reasonable compensation of:

  $2,940

The reasonable compensation in this case is considerably less than what the adviser earned and would be considered excessive.

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What Profit is Reasonable?

One aspect of Gartenberg that has been the subject of confusion is the determination of a "reasonable profit". The adviser's profit is one component of compensation, but left unchecked could be excessive.

In attempting to provide some parameters, DALBAR gathered data on the pre-tax profit margins in financial services and related industries. The findings were unsurprising in that the range is close to initial estimates:

The average margin was 35.9%

The minimum was 16.1%

The maximum was 54.5%

Margins within these ranges are arguably reasonable and would reign in extreme cases.

How to Prove Reasonableness

Proof is having the evidence before the fact, not trying to create it afterword. There is very little credibility in trying to explain that taking home a five figure compensation was fair after a client lost $1 million.

The answer is making it undeniably clear beforehand what the pay will be and what facts were available to support your decision.

While the cost and profit factors of the Gartenberg Standard can be quantified, it is necessary to establish a credible method of weighting the other factors to establish the reasonableness of compensation.

This proof can be accomplished by estimating the time spent and allocating the cost to each client. This is a well-established practice and has been used by professionals for centuries.

The proof of reasonableness is a comparison of the compensation calculated from allocated costs and profit.

Advisers must estimate the time spent on:

- Delivering services to the client
- Discovery, research, analysis and monitoring required to achieve the results produced.

Economies for clients where applicable are used to reduce the allocation to those clients.

A further refinement is changing the allocation based on skill, knowledge and experience of each practitioner in a multi practitioner office.

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