DALBAR
The Measurement of Success

FIDUCIARY ADVISER COMPENSATION

The Pension Protection Act of 2006 (PPA) defines a new class of adviser that is empowered to give investment advice to plan participants with approved compensation. (See http://advicealert.dalbar.com/) The PPA defines the rules of engagement for fiduciary advisers through an Eligible Investment Advice Arrangement (EIAA).

EXECUTIVE SUMMARY

Level compensation is essential for an EIAA and compensation arrangements must comply with guidelines for adviser payment under the PPA.

Compensation Prerequisites

In order to qualify as an EIAA, the fiduciary adviser or affiliate cannot receive compensation that varies with investment options in the plan. Only 12b-1 fees that are level, regardless of plan assets are permitted.

Compensation Disclosures

Fiduciary advisers must disclose all fees received, directly or indirectly through an affiliate or contractual arrangement. Disclosure is made to plan sponsor and each participant before advisory service is provided.

Compensation Amount

Compensation for advice must be reasonable, which is expected to be in the range of $300 to $1,500 per year per participant.

Payment Options

Five payment options are permitted, but these are in two categories:

- ü Administratively simple, but presents risk of fiduciary breach
    1) Overall plan assets are charged
    2) Plan sponsor pays a single fee to fiduciary adviser
    3) 12b-1 fee is used to pay fiduciary adviser
- ü Administratively more complex, but risk free
    4) Participant account is charged
    5) Plan sponsor pays the participant fee for advice

Administrative Solution

FAEnroll is a service available from DALBAR that automates the administration of all of the payment options and collects the compensation for the fiduciary adviser.

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REVIEW OF HOW PPA ADDRESSES COMPENSATION

COMPENSATION ARRANGEMENTS THAT QUALIFY

An eligible investment advice arrangement can be either:

- ü An asset based fee that is uniformly applied to all investments either…
  - o In the entire plan
  - o In those participant accounts that use the adviser
- ü A specified dollar amount that is paid by either…
  - o The plan itself
  - o Participants that use the adviser
  - o The plan sponsor

PPA legislation[1] limits eligible investment advice arrangements for any plan in which:

- ü The adviser or adviser's firm receives compensation from commissions since commissions will vary when investment advice is to buy or sell an investment in the plan.
- ü 12b-1 fees paid to the adviser or adviser's firm are not the same for <u>every</u> investment option in the plan.

Plans in which 12b-1 fees are level for <u>all</u> investments in the plan are eligible.
<u>Note</u>: Plans in which company stock or directed brokerage are options may not qualify as having level compensation.

Who Is The Fiduciary Adviser?

Fiduciary advisers can be either organizations (RIA, Banks, Insurance Companies, Broker/Dealers or affiliates) or individuals (employee, agent, or registered representative). An employee of a firm may sign an EIAA that commits that individual and not the firm. This employee, however, may not participate in the compensation of the firm if the firm does not also comply with the PPA level compensation requirement for that plan.

This prohibits firms from using its employees or affiliates as Fiduciary Advisers in plans where there is un-level compensation.

[1] The Pension Protection Act states that "…that any fees (including any commission or other compensation) received by the fiduciary adviser for investment advice or with respect to the sale, holding, or acquisition of any security or other property for purposes of investment of plan assets <u>do not vary</u> depending on the basis of any investment option selected."

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DISCLOSURE

Compensation disclosure[2] specified by PPA will be evident to plan sponsors during the required "prudent selection" of fiduciary advisers. The prudent selection process implies that proposals from competing advisers are compared and that the selection is made in the sole interest of plan participants.

The disclosure of potential conflicts of interest based on compensation is likely to differentiate fiduciary adviser. Advisers with such conflicts are less likely to be selected.

Additionally these disclosures must be made to each participant before services are provided and annually thereafter.

[2] The Pension Protection Act states that fiduciary advisers must include disclosure…

(i) of the role of any party that has a material affiliation or contractual relationship with the financial adviser in the development of the investment advice program and in the selection of investment options available under the plan,

`(ii) of the past performance and historical rates of return of the investment options available under the plan,

`(iii) of all fees or other compensation relating to the advice that the fiduciary adviser or any affiliate thereof is to receive (including compensation provided by any third party) in connection with the provision of the advice or in connection with the sale, acquisition, or holding of the security or other property,

`(iv) of any material affiliation or contractual relationship of the fiduciary adviser or affiliates thereof in the security or other property,

`(v) the manner, and under what circumstances, any participant or beneficiary information provided under the arrangement will be used or disclosed,

`(vi) of the types of services provided by the fiduciary adviser in connection with the provision of investment advice by the fiduciary adviser,

`(vii) that the adviser is acting as a fiduciary of the plan in connection with the provision of the advice, and

`(viii) that a recipient of the advice may separately arrange for the provision of advice by another adviser, that could have no material affiliation with and receive no fees or other compensation in connection with the security or other property…

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Reasonable Fees

PPA requires that the fee for the advice is reasonable if paid for by the plan[3]. Industry norms are the basis for determining if a fee is reasonable. Industry practices for individual accounts with balances of $100,000 fall into two categories:

- Fees that are bundled with a transaction or product. This is prohibited by PPA and therefore does not apply.
- Annual stand alone advice fees that typically range from $300 to $1,500 (or 30 to 150 basis points)[4].

The PPA also requires that other fees paid to the adviser or firm be reasonable[5]. This requires that the plan fees must be reasonable in order for the plan to qualify to engage a fiduciary adviser.

Plan Cost Reduction

An eligible investment advice arrangement in combination with the qualified default investment alternatives and automatic enrollment prescribed by the PPA reduces the cost of providing enrollment and education meetings and materials.

It is expected that these savings will be passed on to plans when sponsors examine costs as they are required to do under ERISA.

These cost savings have the potential to offset the costs associated with engaging a fiduciary adviser.

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[3] The Pension Protection Act states…

AVAILABILITY OF PLAN ASSETS FOR PAYMENT FOR ADVICE- Nothing in this part shall be construed to preclude the use of plan assets to pay for reasonable expenses in providing investment advice referred to in section 3(21)(A)(ii).

[4] Estimate is based on a poll of advisers from 9 major firms that offer financial planning to individuals for a fee.

[5] The Pension Protection Act states…

… the compensation received by the fiduciary adviser and affiliates thereof in connection with the sale, acquisition, or holding of the security or other property is reasonable, and

the terms of the sale, acquisition, or holding of the security or other property are at least as favorable to the plan as an arm's length transaction would be.

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SOURCE OF FUNDS TO PAY FOR ADVICE

PPA is explicit in saying that it is acceptable for the plan to pay fiduciary advisers[6].

This permits but does not require the plan sponsor to use plan assets to pay the fiduciary adviser. Given that the plan sponsor, as a fiduciary, is also under obligation to act in the sole interest of the participants, the following options are available:

1) Take assets from all participants to pay for the advice provided to only some participants. Fees could be withdrawn from forfeiture balances.
   Note: This option may not be in the sole interest of participants since the fee reduces the value for participants who do not use the advice service.

2) Take assets from individual participants who choose to use the advice available under the plan. This could be a flat fee or basis points.

3) Do not take assets from the plan and plan sponsor pays a single fee directly for the total advice service.
   Note: This is less troubling than option 1), since the fee is paid outside of the plan but since the service does materially affect the plan, it may still be subject to challenge.

4) Do not take assets from the plan and plan sponsor pays a fee for each participant that uses the service. This could be a flat fee or basis points.

5) Funds may charge 12b-1 fees and rebate these back to the plan to be used as fees for advice, providing that these fee to the adviser and affiliate is level.
   Note: As in option 1) above, this arrangement may not be in the sole interest of those participants who pay the 12b-1 fee but do not use the advice service.

Options 1, 3 and 5 are administratively simpler but options 2 and 4 are the safest and most reasonable.

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[6] The Pension Protection Act states…

AVAILABILITY OF PLAN ASSETS FOR PAYMENT FOR ADVICE- Nothing in this part shall be construed to preclude the use of plan assets to pay for reasonable expenses in providing investment advice referred to in section 3(21)(A)(ii).

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RECORD KEEPING

FAEnroll provides the administrative support required to use options 2 and 4.

FAEnroll performs three critical functions on behalf of Fiduciary Advisers:

1) Captures and maintains records of advisers eligible investment advice arrangements (EIAA).
2) Captures and maintains records of employees enrolled by the fiduciary adviser under each EIAA.
3) Creates billing and payment instructions for fiduciary adviser compensation.

FAEnroll interfaces with record keepers, to collect payment when participant accounts are charged directly. Participants' payments may be made as a deduction from:

- ü Contributions
- ü Plan balances

FAEnroll collects fees from various sources, aggregates and remits payments to the fiduciary adviser.

For more information on the Pension Protection Act visit:

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