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Asset-Based Fees Under Attack—What Once Was May No Longer Be!

by David J. Witz

The trend can no longer be ignored—asset-based compensation and/or asset-based commissions are under attack. What has been an accepted industry practice for decades has become a point of contention and debate today with legal ramifications that cannot be ignored.

In fact, many industry practitioners believe we are at the end of the "Asset-Based Model" (ABM) era, where the adviser charges a percentage of plan assets for an explicit or implied bundle of services, and the beginning of the "Professional Business Model" (PBM), closely associated with a "fee for service" model similar to an accounting firm or law practice, which is emerging as the industry standard. Ironically, the PBM is familiar to many seasoned professionals who ran their practice in the early years of ERISA much like a law or accounting practice (*i.e.,* charging hourly rates, project fees and retainer fees rather than collecting transactional or annuitized commissions).

In addition to the method of compensation, another distinction between the ABM and PBM is the method of business acquisition. Although a strong sales and marketing department is important to both structures, the PBM will rely more heavily upon the intellect of its human capital to justify its pay rates. Historically, the ABM relies more heavily upon the skills of its sales and marketing department(s) and a friendly environment with product providers willing to structure investments with built in commissions that hide the effects of excessive fees by keeping the topic out of sight and out of mind. This description is not an indictment of asset-based fees overall, but it is a recognition that some unsophisticated plan sponsors have been duped into agreements that do pay excessive and unjustified compensation to advisers where fees were barely identifiable to anyone but a knowledgeable industry practitioner. Similarly, those familiar with pricing takeover engagements are familiar with plan takeovers by advisers at a lower price that remains excessive. In other words, a move from excessive to less excessive remains excessive. However, the PBM approach will significantly reduce the likelihood of these events happening in the future.

Compensation and margins will also come under pressure after the finalization of the proposed 408(b)(2) regulations. With the passage of the new regulations, downward pressure on compensation is expected for advisers as the requirement to provide full disclosure of both direct and indirect fees, as well as any potential conflicts of interest, takes effect. Unfortunately, this trend in full-disclosure not only affects the future levels of compensation but may subject past fee structures and practices to legal scrutiny. If the new regulations provide a plan sponsor with the information necessary to assess fee reasonableness, that plan sponsor has an obligation to consider what steps, if any, should be taken to recoup any excess paid in the past. If the plan sponsor

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ignores this duty, the participants and their plaintiff attorney will not. It should come as no surprise that ERISA legal counsel may suggest legal action against an adviser to recoup past excessive fees, especially where the adviser failed to acknowledge his or her fiduciary status and disclose both direct and indirect fees in the past.

Keep in mind, the new regulatory requirements under section 408(b)(2) impose new consequences for disclosure violations, but the regulation did not create a new requirement to disclose—a subtle point overlooked by most observers. In fact, the DOL makes clear, in the preamble to the proposed regulations, that a plan sponsor's requirement to obtain fee information, both direct and indirect, and the adviser fiduciary's requirement to disclose, including conflicts of interest, has always existed. However, the application of a new prohibited transaction consequence does apply for any transaction between any non-fiduciary and the plan where the non-fiduciary service provider fails to disclose, in writing, their fees, both direct and indirect, as well as any potential conflicts of interest prior to entering into a service engagement. Clearly, the new regulations, once finalized, create a boon for the PBM structure that promotes and leverages its value proposition. On the other hand, the new regulations create a precarious situation for the ABM that previously failed to acknowledge or denied fiduciary status and/or charged excessive fees, especially those who were dually registered.

Furthermore, the dually registered ABM structure will experience more downward pressure on compensation and margins if the Securities and Exchange Commission (SEC) finally addresses the discrepancies between the purpose and use of 12b-1 fees. The potential impact of SEC action should not be underestimated. In 2006 alone, the industry dispersed more than $12 billion in annual 12b-1 fees. Some of the 12b-1 fees were returned to retirement plans and either used to pay plan expenses or reallocated to participants' balances. In either case, the rebating of 12b-1 fees, Sub-Transfer Agent Fees or Shareholder Services Fees can legitimately be deemed "preferential dividends" according to the definition in Section 562 of the Internal Revenue Code. In fact, unless the SEC and the IRS take the necessary steps to correct this violation, advisers are best advised to avoid using a mutual fund that participates in an activity that clearly violates both the securities law and the Internal Revenue Code. An ABM should avoid influencing, suggesting or recommending investment structures that cause the plan sponsor and service provider to violate the Internal Revenue Code and the Investment Company Act of 1940. It is especially important that the ABM avoid participating in this activity when preferential dividends create conditions for fraudulent performance reporting to be distributed to participants which, in turn, would cause the plan to lose its section 404(c) defense.

If the regulatory activity of the DOL and SEC are not enough to cause one to reconsider the structure and future of an ABM, then the increasing risk of litigation and a persistent legislature that is threatening additional changes should. For the ABM adviser who contemplated an easy sale of his or her investment advisory practice for high multiples in the future amidst this multi-tier attack on compensation and margins, the ABM may find a future sale of its practice as easy as flipping houses in California during the current sub-prime meltdown. Clearly, the traditional strategy of building an asset-based business using investment advisory agreements with no cap on compensation or industry products which hide indirect compensation is a business model whose days are numbered. As the emerging trend continues, the value of a retirement practice will be largely determined by the same principles used to value a legal or accounting practice with the true value of the firm being directly tied to the knowledge of the firm's principals, associates and staff and the efficiencies of the firm's process to deliver higher margins without sacrificing client service. That is not to say that assets under management for a PBM will not impact its value. On the contrary, assets under management will affect firm valuations but only to the extent that the PBM can build a client base that pays the PBM its maximum retainer fee. Of course, the PBM, like the ABM, will have to justify the increase in revenue based upon legitimate reasons versus using the excuse that larger plan assets increase the adviser's liability. While increasing assets may increase adviser liability, it rarely increases time in the engagement. Also, the increased liability associated with increased plan assets is an insurable risk for a fixed and determinable cost. The PBM or ABM may be required to provide the plan sponsor with a copy of the declaration page of its fiduciary liability policy to prove the insurance exists and to prove the cost of the increase attributable to the clients plan assets and the cost for that additional liability. Otherwise, the PBM must provide other convincing reasons why a higher fee can be justified. Once the compensation cap is met, every additional dollar under management, after the maximum fee retainer has been achieved, will fail to yield additional margin to the PBM. This model is unfamiliar territory for the successful ABM whose annual pay raise is directly tied to participant and employer contributions, market returns and new business acquisitions.

Unlike the traditional ABM that enjoys increasing revenue and margin commensurate with increasing assets, a PBM's cap on fees for investment advisory services will require a PBM to increase its client base to keep pace with the ABM's revenue growth … a virtual impossibility. Of course, as PBMs garner market share, an ABM will experience increased margin pressures to abandon its pricing structure to compete with the PBM. Assuming the human capital of each firm is equal, the ABM could evolve into a PBM due to market pricing pressures over time. Thus, the ABM will work longer and harder hours for less pay. On the other hand, the ABM who stubbornly refuses to adopt change will go the way of the dinosaur because plan sponsors, when faced with the same quality of staff and identical deliverables, must prudently choose the service provider that charges the least. Of course, it is expected that staff competency and firm deliverables will prove to be a new venue for competitive bantering as the plan sponsor considers their option to secure necessary services for the operation of the plan at a reasonable price. This bantering should prove to be little more than market noise if the ABM does not secure the appropriate ERISA geeks to address high level consulting engagements that most ABMs are unable to provide. However, assuming equal competency in staff, both ABMs and PBMs will experience increasing competitive pressures to achieve higher levels of competency and efficiency while simultaneously adjusting fees downward.

Of particular intrigue, in the comparison of the ABM to the PBM approach, are the different objectives behind the ABM approach. Thus far, the focus has been on the ABM with visions of selling a practice to reap great wealth upon the sale of the practice in addition to potential excessive annual fees, but that is not the mantra of all ABMs. Some embrace the ABM approach with the intent to build a practice that pays sufficient income to provide the desired standard of living, which includes "X amount" of free time, where free time is valued at a premium. There are many individuals who embrace that ABM approach and work the equivalent of a semi-retired or part-time job. However, as the transition to PBM takes root, this adviser may be forced to work harder for the same amount of revenue received in the past. It is this practitioner, in particular, who faces the biggest dilemma in the future. Whereas, the ABM who reluctantly adjusts its business model to adapt to the PBM approach will strive to replace lost income, the ABM who places a premium on time may be more likely to exit the business. This exit could occur by selling the practice or aligning the practice with another ABM or PBM that is dedicated to staying in the game for the long term. This joint venture, of sorts, assures the ABM of some revenue without suffering the additional costs and time impositions and frees the exiting ABM to focus attention on managing money for individuals where margins are higher. Of course, one must keep in mind the risk of a prohibited transaction claim where an adviser, functioning in a fiduciary role, uses that position to cause the plan to pay additional fees. This risk alone is sufficient to encourage a complete departure of the business to focus exclusively on wealth management to avoid a prohibited transaction.

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Conclusion

The business model of the traditional asset gatherer (*i.e.,* the ABM structure) is dissolving. The future belongs to the entity (*i.e.,* the PBM) with a depth of intellectual capital that can be engaged to consult on most any level of complexity. This same entity will charge hourly rates, project fees and retainer fees for work as demanded by the market. The firm's principals, associates and staff will be well paid for their knowledge, problem solving abilities and their efficiencies. The future of the firm will be dependent upon the visionary leadership of the principals to implement a reliable business continuation plan. Future leadership will be hand picked and mentored to develop and secure the appropriate talent to continue the business without an impact on service or quality. Leadership will also explore strategic merger and acquisition opportunities where additional talent provides the PBM to maintain its competitive advantage. This PBM will not be a one-man shop that leaves the client vulnerable to the knowledge limitations of that individual as well as the emotional, physical and financial health of the sole proprietor. Do not misinterpret this comment. There are competent sole proprietors operating their practices as PBMs. They have much to offer for a price that is lower than the cost of that same skill set within a PBM with higher overhead. The individual PBM certainly has a part to play in this market, but it will be a hurdle for plans of size to justify the retention of a PBM structured as a sole proprietor. As far as the ABM is concerned, now may be the best time to reap the rewards of large multiples. In addition, for all the previous reasons mentioned, the ABM should aggressively seek to enhance its intellectual capital as it adjusts its business model to compete in the future. Of course, this analysis could be nothing more than one person's pontification. Only time will tell.

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