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EVOLUTION OF 401(K) ADVISORY FEE ARRANGEMENTS

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A significant shift in advisory compensation models portends to lower plan costs – however, plan sponsors need to be vigilant.

ERISA plan fiduciaries are obligated under ERISA to ensure that the total amount of compensation paid to a service provider is reasonable and not excessive. Faced with a decade-long series of lawsuits challenging the "reasonableness" of provider fees, and with greater illumination of expenses afforded by fee disclosure requirements, plan sponsors have aggressively pushed for savings from investment managers and recordkeepers. The upshot of these efforts has been a 40% drop in investment fees for a typical 401k participant and a lowering of administration fees by nearly 45%.

It was only a matter of time before plan sponsors would shift their attention to the advisory component, leading to wholesale disruption in advisory compensation arrangements and rooting out excessive compensation. The emerging popularity of a "fixed fee retainer" model and the underlying problems created by other advisory compensation approaches are discussed below.

Commission Model

A decade ago, most 401k advisors were simply investment brokers, non-fiduciaries collecting commissions generated from the investments offered on a particular plan's menu. With the growing demand by plan sponsors for fiduciary support, and the need to eliminate potential conflicts of interest, the commission model was increasingly made obsolete under a fiduciary standard of care. As a result, commission arrangements within the 401k industry have dropped dramatically over the past decade from 75% to less than 36% today.

Percentage of Assets Model (PAM)

Under a fiduciary arrangement, advisors are compensated on a fee-basis, the traditional method being a "percentage of assets" approach already commonly employed by fiduciaries serving the consumer marketplace. However, the use of "revenue sharing" within the 401k environment opened plan sponsors using the PAM approach to potential exposure and litigation for a breach of fiduciary duty on any 'excessive compensation' it generated for the advisor.

Fixed-Fee Retainer (Flat Fee) Model

The fixed-fee retainer model has supplanted the PAM model with a more logical and transparent advisory compensation method better suited to the higher fiduciary requirements demanded by plan sponsors. It addresses the negative implications under the PAM approach when an advisor's revenue increased simply by the growth of a plan's assets without incurring any additional workload. Under new DOL regulations and the critical need to minimize any potential conflicts of interest, plan sponsor migration to the fixed-fee retainer model for advisory compensation is only expected to accelerate.

What this means for Plan Sponsors:

- Carefully consider and review your advisory compensation arrangement.
- Commission arrangements pose conflicts of interest that need to be addressed.
- The percentage of assets (PAM) approach raises the risk of excessive revenues being generated and requires ongoing due diligence and benchmarking by the plan sponsor.
- Consider the advantages of a fixed-fee retainer model for greater transparency and protection against the potential liability of excessive revenue being generated.