PRECISION

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Things You Might Not Know About Your Retirement Plan

PARTICIPANT LOANS	CHEAP TECH TOOLS	DEATH & DIVORCE	FIDUCIARY FACT OR FICTION	COMPENSATION	GOVERNMENT AUDITS	INVESTMENT ADVISOR MODELS	MARKETING'S FIDUCIARY RESPONSIBILITY
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A DWC ERISA CONSULTANTS PUBLICATION

The $64,000 Question – How Does My Investment Professional Get Paid?

By Doug Hoefer

Plan sponsors have many plan-related decisions to make. As fiduciaries, sponsors must make all of those decisions in the best interest of plan participants and with the exclusive purpose of providing benefits to them. Hiring an investment professional (or any other service provider) is one of those fiduciary functions, and understanding how he or she is paid is a critical component in making a prudent selection.

Before diving into the deep end, let's quickly review two terms – broker and investment adviser. Although sometimes used interchangeably, there are some important differences.

Brokers

- Paid commissions tied to the investment products they sell to their clients.
- Permitted to provide education but not advice.
- Regulated by the Securities & Exchange Commission ("SEC") under the Securities Exchange Act of 1934, as well as other self-regulatory agencies, including the Financial Industry Regulatory Authority ("FINRA").
- Must hold a Series 63 registration.

Advisers

- Paid a fee for their services.
- Permitted to provide specific advice or recommendations, which must be in their clients' best interests.
- Must be registered as Investment Advisers under the Investment Advisers Act of 1940.
- Must hold the FINRA Series 65 or 66 registration, and their firms must be registered either with the SEC or with their states' Securities Commissioners.

With that background out of the way, let's turn our attention to how brokers and advisers actually get paid. There are three primary compensation models, each with its own set of pros and cons. They include commissions, asset-based fees and flat/hourly fees.

Regardless of the model used, it is important to remember that there is no requirement to select the least expensive model. Instead, the law requires that compensation paid must be "reasonable" in light of the services received. Both the Department of Labor and the courts have noted that considering only cost while ignoring factors such as expertise and level of service can be just as problematic as paying too much.

Commission-Based Model

When a plan sponsor hires a broker, that broker is paid a commission on the products he or she sells to the plan. These could include individual securities such as stocks or bonds as well as mutual funds or insurance products.

There are numerous commission options available; however, as it relates to mutual funds, there are three types of commissions paid to brokers: up-front commissions, back-end commissions and trail commissions. Mutual fund providers offer different share classes which dictate how commissions are paid. We will focus on the two most common share classes – A shares and B shares. It is important to note that different mutual fund families offer other share classes with variable commission structures, so it is necessary to review prospectuses and other documentation to understand how the broker's compensation is determined prior to selecting an investment to offer participants.

A Shares & Up-front Commissions

Mutual fund A shares pay an up-front commission, commonly referred to as a sales charge or load. The commission is paid to the broker in the first year amounts are invested in the mutual fund. The amount of the commission can vary by mutual fund provider and generally ranges from 1.00% to 5.75%, and A shares have lower ongoing expense ratios than B shares (more on that later).

Consider this example. Vanna invests $10,000 in a mutual fund A share with a 5.75% load; Bob Broker is paid a commission of $575 and the remaining $9,425 is invested in the fund.

A shares do offer breakpoints, which are discounts off the load rate. The more you invest, the lower the sales charge. For example, if the investment is $1,000,000, the front-end load is 0.00% to the plan participant; however, the mutual fund family may still pay a 1.00% finder's fee to the broker.

B Shares & Back-end Loads

B shares have a deferred sales charge, commonly referred to as a back-end load, and pay the broker an up-front commission even though 100% of the investment goes into the mutual fund. However, they carry a back-end sales charge that decreases over the length of time the investment is held.

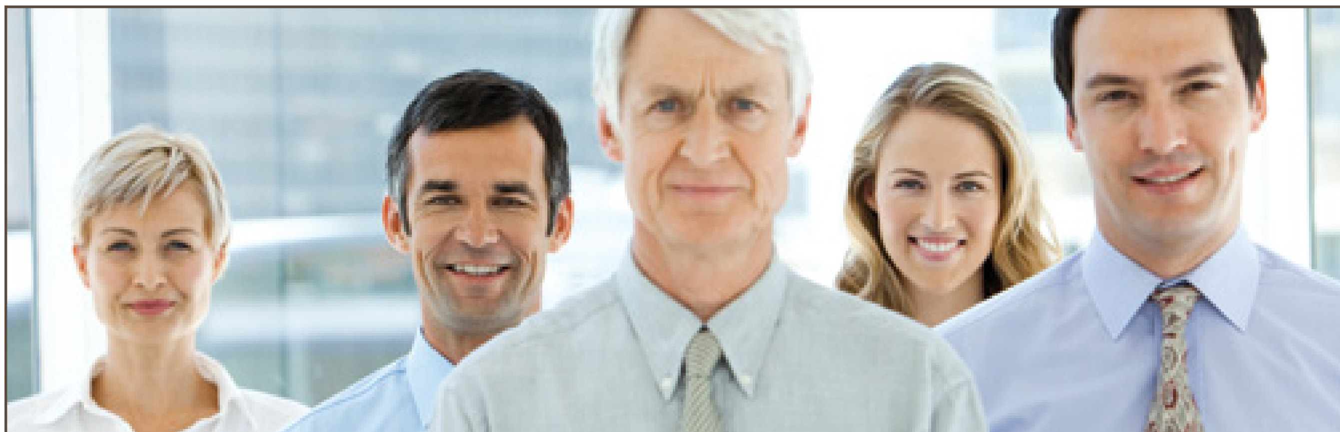
Example: Chuck invests $10,000 in a mutual fund B share with a 6-year, decreasing back-end load. Although Bob is paid a commission, all $10,000 of Chuck's money gets invested. When Chuck sells only a year later, he pays a deferred sales charge of 4.75%, meaning he receives only $9,525. If he holds the B shares for at least 6 years before selling, the back-end load drops to 0.00%, so he receives 100% of the account value.

B shares usually have a higher on-going expense ratio than A shares and are, therefore, often more expensive for long-term investors.

Trail Commissions

Both A and B shares also pay a trail commission. Often referred to as 12b-1 fees, these are annual marketing or distribution fees paid to the broker. They are considered an operational expense of the mutual fund and, therefore, create a dollar-for-dollar reduction in the investment returns. For example, if a fund generates a gain of 3.75% and has a trail commission of 0.25%, the rate of return realized by the investor is 3.50%.

The fee generally ranges from 0.25% in A shares to 1.00% in B shares, thus the comments above about A shares having lower ongoing expenses. There are some products that allow the broker to, in essence,



DID YOU KNOW?

An investment professional who gets paid on commission is not allowed to give advice to a retirement plan sponsor or participant. They can educate – buy low, sell high, diversify – but they cannot recommend specific investments. Although most investment professionals look out for their clients, the intent of this rule is to remove any incentive for a broker to recommend an investment simply because it pays a higher commission.

choose their own commission rate by providing multiple share classes with different levels of trail commissions. That means two brokers selling essentially the same product may have widely varying compensation, which directly impacts the cost charged to participants.

In today's marketplace, 401(k) plans typically have access to load-waived mutual funds. That means there is neither a front-end nor back-end load, and the trail commissions are the only ones paid.

One of the advantages that is often cited for the commission model is that it provides compensation to investment professionals to work with startup or small plans with asset levels that are too small to charge a reasonable fee. Similarly, commissions create a framework for employers to offer a plan even though they might not have the budget to pay the related fees out of pocket.

Conversely, since the commissions are built into the overall expenses of the funds, they can be more difficult for both plan sponsors and participants to identify. As a result, it is important for employers to work with their brokers and review fund documentation to understand the fees that are being paid to ensure they are reasonable.

Asset-Based Model

Plan sponsors that hire an investment adviser pay an asset-based fee equal to a percentage of the assets in the plan.

Example: Let's Make A Deal, Inc. has a 401(k) plan with $1,000,000 in assets. They hire Alex Adviser who charges a fee of 0.50% (also expressed as 50 basis points). Alex's annual fee is $5,000.

Generally, these fees are paid directly from the plan assets on a quarterly basis, i.e. 0.125% or $1,250 each quarter. In this model, no compensation is paid based on any plan transactions, i.e. buying and selling of mutual funds, and any 12b-1 fees built into the funds can be applied to offset the adviser's fee.

Many advisers tier their fee schedules based on the size and growth of the plan assets. An adviser may charge 0.50% for a plan with $1,000,000 in assets while charging only 0.40% for a plan with $2,000,000. Tiered schedules usually continue to decrease to a minimum asset charge and may transition to a flat fee at a certain plan asset size such as $10,000,000 or more.

Flat/Hourly Fee Model

A somewhat recent trend among retirement plan

advisers has been to charge a flat fee or an hourly rate for the services they provide. This may be in lieu of or in addition to an asset-based fee, depending on the actual services. For example, an adviser might charge a flat fee to select the investment menu and a lower asset-based fee or an hourly rate to meet one-on-one with individual plan participants. For larger plans, there might be an all-inclusive flat fee; however, this model is more often used for projects rather than for recurring services.

An often-cited advantage of both the asset-based and flat/hourly fee models is that fees are more transparent. They are clearly shown on both plan and participant statements as expenses rather than as a reduction in investment returns. With that said, some plan sponsors choose to pay this fee directly, which not only eliminates a charge to the participants but also provides a tax deduction for the company.

Another advantage is it can reduce costs over time versus the traditional commission model. An adviser's fee is generally negotiable and can be reduced over time as plan assets grow; whereas, commissions are usually determined by the mutual funds and are not subject to change on a plan-by-plan basis.

Conclusion

Ultimately, the decision to work with a broker or an adviser determines a significant portion of the expenses paid by participants. Each of the models we have described have pros and cons, and all of them work well in the right circumstances. Regardless of the choice, the key is to ensure the professional you hire has the expertise to provide the services the plan and participants need and the compensation paid is reasonable for those services.

As a co-founder at DWC ERISA Consultants, Doug uses his industry expertise and collaborative approach to help clients and investment professionals design optional plans. As a provider/vendor specialist, he is able to guide clients through their many options to arrive at solutions that best meet their needs.

Additional Reading

The More Things Change, The More They Stay The Same: Timeless Keys to Selecting Plan Service Providers

http://www.dwcconsultants.com/knowledge_center/TheMoreThingsChange.pdf