Age of Reason

How to evaluate adviser compensation under 408(b)(2)

Plan sponsors—through their plan committees—must evaluate the compensation disclosures made by their providers under the Employee Retirement Income Security Act (ERISA) §408(b)(2). The committees will most likely use requests for proposals (RFPs) or benchmarking services to determine whether the compensation is reasonable.

While this process may seem like a big change, it is only a matter of degree. For example, investments have been benchmarked for years. Think about the work that you have done comparing the investment returns and expense ratios of your mutual funds against peer groups—e.g., the average large-cap growth fund—and indexes such as the S&P 500. However, even in such cases as these, the benchmarking will become more sophisticated since committees will be looking at the expense ratios of mutual funds and other investments—e.g., collective trusts—as compared with those for plans of similar size. Small plans with only a few million dollars in assets will ordinarily use retail mutual funds, while larger plans may use institutional mutual funds and collective trusts with lower expense ratios.

After investments, the second-highest cost for a 401(k) plan is usually the recordkeeper or bundled provider. As a result, once the 408(b)(2) disclosures are received, the new focus for many plan committees will be to evaluate that provider's compensation.

ERISA requires that all service providers be evaluated. While that process involves a comparison of service provider compensation with the quality and quantity of the services, the starting point is usually to compare the compensation of the service provider with other service providers of the same type. For example, another common type of provider is the consultant who helps with the investments. That service provider may be called, among other things, an investment consultant, a financial adviser, an RIA [registered investment adviser] or a broker, but the common element is that the consultant provides investment information and recommendations to the plan committee.

The first step in evaluating the compensation of the investment consultant is to calculate the total compensation he receives, including direct payments from the plan or the plan sponsor, as well as indirect compensation—e.g., payments made from plan investments, such as 12(b)(1) fees and commissions. Next, the committee should obtain information about the compensation of investment consultants for other plans of similar size—which is readily available through benchmarking services. Based on my experience, the fees (when expressed as percentages) for large plans are lower than those for small plans. I have also found that the fees fall into patterns based on the plans' sizes. If the compensation paid to your consultant differs significantly from the averages or benchmarks, it may raise a red flag.

However, average compensation is not the only measure of reasonableness. Instead, there is a range that an adviser's compensation can fall within, assuming that the typical types of services are provided and that they are of good quality.

Even so, it is likely that plan committees will focus on the averages. So, what happens if, once a committee has the benchmarking data for similar plans, the consultant's compensation is higher than average? This would warrant further investigation. For example, if the *value* of your investment consultant's services is more than the services provided by the typical consultant, the additional compensation can be justified. But that value can be difficult to assess. (There are methods out there for measuring the relative value of services of investment consultants, but that is the subject for another column.)

If the excess compensation cannot be justified, the committee should negotiate to reduce the adviser's compensation and, if an agreement can't be reached in that regard, the consultant should be replaced.

As with any fiduciary decision, this process must be repeated periodically—perhaps annually—to determine that the arrangement with the plan's investment consultant continues to be reasonable. In other words, the arrangement must be monitored.

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