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Best Interest Contract Exemption and IRA Advisor Compensation: Interesting Angles on the DOL's Fiduciary Rule #18

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As advisers who work with ERISA-governed retirement plans already know, an adviser's compensation cannot be more than a reasonable amount. Because of the new fiduciary advice regulation, and the associated prohibited transaction exemptions (84-24 and the Best Interest Contract Exemption (BICE)), that requirement is being imposed on investment and insurance recommendations to IRAs. Interestingly, under the Internal Revenue Code (section 4975(d)(2)), it is already a prohibited transaction for an adviser to earn more than reasonable compensation from an IRA. However, because of lack of enforcement by the IRS, that requirement is often overlooked. As evidence of the fact that it is overlooked, think about the lack of benchmarking or similar services to help advisers determine if their compensation from an IRA is reasonable. But, that is about to change.

To appreciate the "reasonable compensation" requirement, a person needs to understand that the amount that is reasonable is determined based on the services that are provided. In its guidance, the DOL explains how reasonableness is to be determined:

> "*The reasonableness of the fees depends on the particular facts and circumstances at the time of the recommendation. Several factors inform whether compensation is reasonable including, inter alia, the market pricing of service(s) provided and the underlying asset(s), the scope of monitoring, and the complexity of the product. No single factor is dispositive in determining whether compensation is reasonable; the essential question is whether the charges are reasonable in relation to what the investor receives.*"

However, there is a difference between "market" compensation and "customary" compensation. That difference is primarily whether the market is transparent and competitive:

> "*Ultimately, the "reasonable compensation" standard is a market based standard. As noted above, the standard incorporates the familiar ERISA section 408(b)(2) and Code section 4975(d)(2) standards. The Department is unwilling to condone all "customary" compensation*

> *arrangements and declines to adopt a standard that turns on whether the agreement is "customary." For example, it may in some instances be "customary" to charge customers fees that are not transparent or that bear little relationship to the value of the services actually rendered, but that does not make the charges reasonable."*

As a hypothetical example . . . if an adviser provides a wide range of services, that might justify compensation of 1% per year of the assets under management. On the other hand, if an adviser provides a more limited range of services, that might be worth one-half of 1% per year (that is, 50 basis points). As a more specific example, BICE requires that advisers state whether or not they will be monitoring the investments on behalf of the IRA owner or plan. Obviously, all other things being equal, an adviser that provides fiduciary monitoring services is entitled to more money than one that does not.

With that understanding, the key question is, how will an adviser determine whether its compensation is reasonable? Most likely, it will be done in the same way that is in the 401(k) world. In other words, the value of services will be determined by the competitive marketplace. Since competitive market data is not generally available for IRAs, RIA firms and broker-dealers will need to work with service providers who have that information. In the 401(k) world, those are called benchmarking services.

The better benchmarking services will consider both the range of services and the compensation of the adviser. As explained above, the calculation of reasonable compensation is based on the services provided, but not just on the size of the account. In that regard, there will need to be a range of benchmarking alternatives, for example, discretionary investment advice for individual securities; discretionary investment advice for mutual funds; non-discretionary advice for both of those scenarios; recommendations for the purchase of individual annuities, including evaluations that take into account the different types of annuities (*e.g.*, fixed rates annuities, fixed indexed annuities, and variable annuities); referrals to discretionary investment managers; and so on. The benchmarking will need to consider services and compensation in the first year and in subsequent years (for example, will the adviser be monitoring the investments).

While the services do not exist today, it is likely that they will in the relatively near future, say, in the next six to 12 months.

Forewarned is forearmed. Advisers need to be attentive to these issues, now that they are front and center.

The views expressed in this article are the views of Fred Reish, and do not necessarily reflect the views of Drinker Biddle & Reath.

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