WEALTH MANAGEMENT COMPENSATION IN A REG BI WORLD

Regulation BI means a ton of change for investment firms and advisors. It also means change for customers. If we take it all for the progressive spirit, rather than the administrative design failures, Reg BI is broadly a positive for the industry and its customers. Higher standards where trust and wellness are at stake is NEVER a bad idea.

There is already a number of trends underway related to compensation in wealth management. I wrote about some of them in wealthmanagement.com this summer.

How might Reg BI influence these trends or spawn new ones? The discourse, planning, and preparation for the DOL is partially instructive to the implications we might see regarding Reg BI. So let's start there. You can refresh yourself on the compensation issues under the DOL Rule here.

One of the core aspects of the DOL was the concept of reasonable compensation. This is not explicitly part of Reg BI. (That caused a gasp of relief across the industry). But there are other aspects to Reg BI that will have compensation implications.

DISCLOSURE:

It's very simple – symmetry of information affords the creation of non-zero sum outcomes. The spirit of the disclosure expectations is to foster something closer to transparency on matters that would impact the relationship, or quality of advice or service. When linked to the Duty of Care aspect, it's easy to draw a line from transparency to the confidence factor in the duty of care.

The disclosure expectations are substantial – both in aspiration and timeline. While it is likely that in the near-term customer confusion may erupt, over time a commitment to continued disclosure and clarity will help both customers and advisors.

Transparency has a way of levelling playing fields and fostering non-zero sum outcomes.

Over time, firms will find that the disclosure expectations and transparency will drive compensation practices that align with value perceived by the customer.

Implication: We believe there will be an acceleration of new approaches to fees for services and this will spawn an evolution in compensation for advisors in the delivery of these services.

CARE:

The firm (and the rep) must use reasonable diligence, skill, and care in recommendations made to their customers. Moreover, they must be able to demonstrate that they considered factors such as costs, risks, and rewards related to the recommendation.

Advisors and firms will likely fall to the use of disciplined processes and methodologies to help ensure the factors are diligently balanced with as little bias as possible.

It would not be unexpected to see a renaissance in the commitment to education, training, and certifications by firms and advisors. Ground zero of proof that diligence, skill, and care are at hand, is to prove that the capabilities to do that exist.

Implication: Firms will pursue efforts to eliminate the subtle misaligned incentives in both compensation program designs and operations that would support an argument that costs, risks and rewards were not considered in a fully unbiased fashion. We hope there is an acceleration of efforts to incorporate skill and quality into compensation programs as well, although at this stage it is mainly the domain of the leaders.

CONFLICTS:

Firms will be required to demonstrate that they and their advisors are not exposed to unnecessary conflicts that would put the interests of the advisor or the firm ahead of the customer. Firms must also look at the breadth of their product shelf so as to not create conditions where the firm (or advisor) interest is advantaged over the customer. It's likely that the SEC embraced learning from the experience in the UK with the RDR and the unforeseen impact it had on limiting product shelf. Look for more open and objective frameworks for product qualification to become the norm. Of note, the robo-advisor community will be forced to take an objective look at their product selection approaches. It will be interesting to see how far the regulators choose to take the interpretation, specifically if cash management products are brought into the mix. Finally, there is an expectation that certain sales promotion or incentive practices are sunset. Specifically, incentives tied to a single product or narrow product set and a time period are not acceptable.

Here's where the rubber really meets the road, because this is were the regulators will go first and is closest to some of the aspirations in the DOL Rule. During the run-up to the DOL Rule, many firms tackled aspects of these conflicts.

Implication: Between product management changes and new customer pricing models, many of these conflicts can be avoided. Those firms that rolled back DOL-related compensation changes may now find themselves prioritizing redeployment of some of those changes. We anticipate some initial overcorrection on pullback from sales promotion, but that firms will use the 2020 and 2021 period to develop and deploy more customer-aligned, targeted incentives. It should be noted that if the cost/pricing of cash/liquidity products becomes a focal point for the regulators, some firms may need to aggressively revisit advisor compensation and customer account and ancillary fees in balance.

COMPLIANCE:

Firms are expected to demonstrate specific policies and procedures to ensure compliance with regulations as a whole.

Implication: The timeline is short for reaching compliance. Although there is a general perspective that demonstration of material progress will be satisfactory, provided the Form CSR is ready and available to customers in line with the June 30/2020 timeframe. Firms are facing a crunch to analyze and assess their compensation practices in a Reg BI light prior to June 2020.

At what point do leading advisors demand compensation programs that reward them effectively while at the same time mitigating any compromising optics with their customers, especially related to Reg BI disclosure and transparency?

We would urge firms to be proactive and begin a conscious effort to migrate their compensation and reward programs to a modern, forward-looking posture that aligns with the expectations of Regulation Best Interest. It is also critical that firms evaluate and consider the posture of specific States. It is clear that some will advance an agenda that incorporates a higher standard than Reg BI. What is clear is that Reg BI is going to become the minimum standard.

The Xtiva team is always happy to engage in discussion on compensation program design and operations. Just ask

us.

ABOUT REGULATION BEST INTEREST (REG BI):

First proposed: April 18, 2018
Approved: Jun 5, 2019 – View SEC media release
Compliance period: June 30, 2020