



## Should Brokers Be Forced to Disclose Their Bonuses to Clients?

*RIA securities lawyer Patrick Burns and broker recruiter Mark Elzweig debate whether new rules are needed on advisor incentive compensation*

By Gil Weinreich, AdvisorOne

In her first year as chairman of the Securities and Exchange Commission, Mary Schapiro wrote a letter to the chief executives of broker-dealers warning them about the potential pitfalls of recruiting brokers with high upfront bonuses.

"Recent press articles have reported that some broker-dealer firms may be engaging in a vigorous recruiting program for broker-dealer registered representatives," Schapiro's letter began.

"Reports suggest some firms are offering substantial inducements to potential registered representatives, including large upfront bonuses and enhanced commissions for sales of investment products," the August 2009 letter continued.

Schapiro's stated concern was that brokers may feel obliged to churn customer accounts or recommend unsuitable products to justify the upfront money.

A year later, at SIFMA's 2010 annual conference, Schapiro reiterated her concerns about incentive compensation, telling a Dow Jones reporter that the large bonuses used to lure brokers from one firm to another "may not be in the best interest of retail investors."

### No Moves to Regulate Upfront Bonuses

Yet, despite the calls for vigilance, there have been no moves to actually regulate or force disclosure of upfront or retention bonuses, which remain as much a fact of life in the wirehouse world today as ever; indeed, a Reuters story points out that the recruitment arms race has only escalated, with bonuses in the millions of dollars for top teams.

While Dodd-Frank regulates compensation for high-level executives, advisor bonuses are unaffected and the SEC is not currently engaged in rulemaking that would put teeth in Schapiro's jawboning about changing broker-dealer incentive compensation.



So who wants to change the status quo in broker compensation? Securities lawyer Patrick Burns (left) does. Or at least he is willing to say so publicly, though he believes the wirehouses themselves would like to end the arms race in broker bonuses, but are afraid to make the first move lest their competitors recruit away their top teams.

The Beverly Hills, Calif.-based attorney is not worried so much about the wirehouse firms' P&L statements as he is about his own registered investment advisor clientele.

"Our clients who are investment advisors would like to see the playing field leveled in terms of disclosures," Burns said in an interview with AdvisorOne.

The securities attorney says his RIA clients must disclose all forms of direct and indirect compensation and conflicts of interest, including soft dollars and any additional benefits that an advisor gets for using a certain custodial platform.

"If an advisor had additional benefits or services from a third-party money management firm, all that would have to be disclosed to clients," Burns says.

"If [registered investment] advisors have that level of obligation, shouldn't brokers have an obligation to disclose these bonuses?" Burns asks.



Not in the least, says veteran recruiter Mark Elzweig (left).

"Soft-dollar trading costs are part and parcel of what investors pay for trades," the New York-based principal of Mark Elzweig Co. told AdvisorOne. "This kind of disclosure is simply an a-la-carte breakdown of costs for investors to which they are entitled. These trading costs came directly from investor monies."

But to Burns, the fact of higher costs at large brokerage firms should itself attract regulatory scrutiny.

"The trade costs are certainly a lot higher at the big brokerage firms because they've got to pay these large bonuses," Burns says. "So ultimately it's kind of a round trip from the client's point of view. They have to pay higher fees."

### 'There's No Mystery About Wirehouse Cost Structures'

Elzweig, in a separate interview, strongly denied higher costs resulting from upfront bonuses are a relevant regulatory concern.

"Wirehouses disclose fees and commissions to investors," Elzweig says. "Those who feel that charges are too high relative to the value that they've received are free to go elsewhere and they often do."

"There's no mystery about wirehouse cost structures," he adds. "The percentage of firm revenues that is reserved for compensation is a constant, hot topic on Wall Street. It's regularly discussed in newspapers every quarter when firms report earnings and Wall Street research and annual reports regularly offer additional details. Investors who are interested have lots of access to this information."

As a recruiter with nearly three decades of experience, Elzweig is most put off by the notion that upfront bonuses should be regulated, and considers the idea of wirehouses ending the broker bidding war just wishful thinking.

"This idea was kicked around by Arthur Levitt's SEC back in the '90s and then tossed," he says. Nobody was able to show that the payment of lucrative signing bonuses to advisors harmed clients in any way.

"Also, major wirehouses found that they couldn't trust each other [not to pay upfront bonuses] any more than members of the OPEC cartel could rely upon one another to remain firm on a certain price for a barrel of oil. Competition makes things better — it's the American way," Elzweig says.

For his part, Burns agrees the wirehouses would be unable to stop the competition without "the SEC or FINRA taking the initiative to propose limits on bonuses or disclosure requirements to disclose that [brokers] may have to push proprietary programs."

But Elzweig considers the product-pushing argument passé.

"Wirehouse brokers typically can offer clients access to over 1,000 outside managers in mutual funds and SMAs," he says. "While that's not as broad as the choices that RIA custodians offer, still it's a far cry from 'product pushing'... The days of wirehouse brokers pushing in-house funds for hefty commissions are long gone," Elzweig says, citing Citigroup's sale of its Smith Barney brokerage division as the turning point.

"Other than IPOs, which many investors crave, and some structured products and alternative investments, wirehouse brokers don't sell proprietary products," he adds.

### Disagreement Over Disclosing Compensation

Short of banning bonuses, Burns said the "less radical solution" of forcing disclosure would be in sync "with all the talk recently of harmonizing disclosures between advisors and brokers."

Burns said it would also inject fairness into an advisory landscape where brokers must meet production quotas to pay for their bonuses while RIAs bill on fee business.

Once again, Elzweig was having none of it.

"If advisors are required to publicize their compensation, why shouldn't attorneys, doctors and other service professionals operate under the same strictures? Such an unjust, foolish rule would harm investors by encouraging talented individuals to seek careers elsewhere," he said.

"These are sour grapes proposals," Elzweig concluded. "Wirehouses control the lion's share of retail assets for a reason. Many brokers find the wirehouse model of household name, full-service platform, turnkey environment and big upfront deal to join to be a very potent combination."

"The RIA model has many attributes, but just can't compete with the wirehouses on recruiting packages. It's a better strategy for RIAs who want to hire brokers to face that fact head on and instead focus on the many strengths of their model. Recycling long ago discarded proposals and making tortuous arguments just won't get it done."

Burns, unsurprisingly, demurred.

"It's really just about the clients," he said. "Perhaps the client should be made aware of the recruitment deal at stake so they can be fully informed consumers."