DEATH BY BENCHMARKING (COMPENSATION)

While far less torturous than the Imperial Chinese method of execution known as "Death by 1000 Cuts" (Ling Chi), the use of calculated benchmarks to comply with the compensation restrictions in the new fiduciary rule is just as devastating to the advisor community.

Section II(c)(2) of the Best Interest Contract Exemption prohibits advisors or financial institutions from making recommendations that will cause "compensation for their services that is in excess of *reasonable compensation*".

Unintended executioners of the advice industry have proposed to determine what "*reasonable compensation*" is by calculating an average or median compensation benchmark. Such an approach will lead to unlimited compression of compensation!

This is Ling Chi since approximately half of cases will be below the benchmark, but half will exceed it. It is a mathematical fact, that no matter how specific or how narrow the benchmark is, half the components of that benchmark will be above and half below.

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The effect is that half the cases will then be in violation of Section II(c)(2) and will be required to lower their compensation to the acceptable benchmark level! The effect of this lowering pushes the benchmark lower, thereby causing more violations that create even more lowering until "death occurs".

Year after year, advisor compensation continues to decline just to remain compliant!

The real question is why should the advisor community voluntarily accept such a predictably devastating approach?

The only good reason would be if there was no alternative. Fortunately, there is. Section II(c)(2) requires "*reasonable compensation*", not benchmarked compensation. There are, however, two other generally accepted methods of assessing compensation and smart advisors will choose one of these methods to comply with II(c)(2). The first method is cost based and the second is benefit based.

DALBAR, Inc. 303 Congress Street Boston, MA 02210
Phone: 617-723-6400 Fax: 617-624-7200

Using the cost based method, the advisor charges fees that are commensurate with the cost of doing business. The advisor must be able to show that the compensation received is commensurate with the estimated time, and resources used and risks taken to provide services to that client. The cost based method is not simply a breakeven proposition since advisors are expected to include a margin of profit as well.

The benefit based method assigns a value to each service the advisor provides. The advisor must define the services provided in terms of benefits to clients and charge fees to the clients in proportion to their use of those benefits. The benefit based method also requires that clients agree that each has derived the benefits for which the compensation is paid.

For most advisors, the cost based method is most easily implemented as an approach to pricing as well as evaluating compliance. Further details of the cost based method and a calculator for computing reasonable compensation is included in the training course on Best Interest Contract Exemption (BICE) at http://training.dalbar.com/.

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