Cash and Equity Compensation
In Independent Financial Advisory Firms

Independent financial services firms need clear compensation systems to motivate desired behaviors. The two primary tools for this are cash compensation plans and equity compensation plans.

As noted in a previous paper, *Valuation, Economic Models & Equity Ownership in Independent RIAs,* many independent firms were founded by individuals who were also the largest producers. Because of their origins, many of these firms set up a structure in which the founders/large producers simply divided the firms profits after paying expenses. In short, their economic models do not differentiate between shareholders and revenue generators. Such a structure is fine as long as the founders remain the shareholders and continue to generate revenues proportional to their draws.

The Greek philosopher Heraclitus wrote *circa* 500 BC that “everything changes, and nothing stands still”, wisdom that applies to all institutions, large and small. With the passage of time, it is unlikely that the founders of a financial advisory firm will remain constant in their contributions to revenue generation or to the firm’s success. These changes drive a need for clarification of roles and the establishment of a compensation structure that addresses and anticipates future changes.

Role definition comes first, and this can be tricky as firms grow. In an early-stage financial services company, where viability and survival are paramount, the role of the senior professionals is to generate sufficient revenue to pay the bills. “Management” is episodic and *ad hoc,* and decision-making authority is widespread. All other personnel exist to directly support those professionals responsible for revenue generation. As firms grow, the first needs outside of revenue generation tend to be administrative functions, such as payroll, benefits, and accounting. With continued growth, complexity increases to a point at which regular decision-making and organizational management is required. Sometimes revenue generation professionals take up other roles on a part-time basis, serving as compliance officers, financial officers, or executive officers in addition to their client responsibilities. Eventually, firms face a fork in the road, at which they must either decide to continue growth or to work toward a steady state, lifestyle business. Each of those forks has its challenges. The path of continued growth dictates that someone assume those officer roles on a full-time basis.

Let’s assume for a moment a hypothetical independent financial advisory firm – we’ll call it FinCo – has decided to continue its growth and needs a full-time management team. Let’s further assume that FinCo has offices in three cities, one of which is the headquarters office. To define roles and, in turn, define compensation philosophy, it is useful to categorize personnel.

One approach is to categorize personnel by function. The first and most obvious category is revenue generation. This would include all those involved directly in working with clients to generate revenues for the firm. A second category might be those who provide indirect support to those in revenue generation, people in compliance, operations, information technology, research, and branch management. A third category might be corporate personnel who support everyone in the organization. Human resources, accounting and senior management would fall into this category. Within each of these

categories, firm leadership must generate job descriptions for each position that detailed the skills required, duties and responsibilities, and reporting requirements.

The task that follows role definition is rather more subjective and shapes a critical aspect of firm culture – the determination of the firm's compensation philosophy. There are many elements of compensation philosophy. Compensation may be based on quantitative factors, qualitative factors, or a combination of both. Compensation may be based on salary, on percentage of revenues, or on salary plus bonus. Whatever the details of the structure, it should tie to the duties and goals in the job descriptions, and it must be designed to incentivize those financial results and behaviors that firm leadership deems important.

Corporate culture and firm strategy must be considered in structuring incentive compensation plans. For example, if a firm's strategy is to compete by offering a high level of client service, the compensation plan should reward that behavior. If a firm's culture is built around teamwork, as in most trust companies, individual compensation must be tied to the success of that person's team. Conversely, if the culture is built around a "star" system, as has been the historical norm in wirehouse firms, compensation must be tied to individual success.

In financial advisory firms, the highest skill set is revenue generation. Without revenue, there is no company, so the ability to drive that is valued above all other skills. It follows that revenue generation should have the highest potential compensation opportunity. In general, all those who are involved directly in revenue generation should have compensation plans that are tied to it.

Compensation for personnel who support revenue generation indirectly – compliance, operations, information technology, research – must be crafted carefully in accordance with the behaviors and results that management wants from those groups. For example, research compensation might be tied to the firm's revenues, as management wants to incentivize research to work with financial advisors to maximize revenues. Conversely, the compensation of compliance personnel should not be tied to revenues, lest that provide an incentive to prioritize revenue generation over enforcement of regulations.

Compensation for corporate staff is less about incentivizing behavior than attracting talent by paying market compensation. That said, many firms pay bonuses to corporate staff based on overall firm results, partly to incentivize teamwork and partly to reduce fixed costs in a market sensitive business.

Management is critical to firm profitability and success, and so merits a high potential compensation opportunity. Additionally, management in financial services firms most often comes from the ranks of revenue generators. As management personnel have given up the highest potential compensation opportunity in the firm in order to manage the business, their compensation opportunity should be close to that of revenue generators.

Whatever the role definition, the personnel category or the desired behaviors, compensation must be addressed in the context of two things, market competitiveness and firm economic model. If a firm does not offer compensation that is competitive in the market, it will not be able to attract or retain talented individuals. If a firm does not understand overall compensation in the framework of its economic model, it may be insufficiently profitable.

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Once roles have been defined, job descriptions have been written and incentive compensation plans have been crafted, the next decision is the composition of the compensation. Compensation consists of two parts, short-term compensation and long-term compensation. Short-term compensation is typically cash, and long-term compensation is typically some form of equity.

There are many different ways to use cash and equity compensation. One approach that has proven effective is to view cash compensation as immediate payment – whether done monthly, quarterly, or annually – for performance that is within the control of the individual. Conversely, equity compensation is an opportunity for worthy individuals to increase their net worth over time as the firm grows. Equity compensation can be a powerful retention tool to bind high-performing individuals to the firm. Depending on the capital requirements of the firm's strategy, equity ownership may entail annual distributions of profits, in effect increasing current compensation.

The mix of cash and equity compensation is a key element of incentive compensation. Those involved in revenue generation do not manage the firm's profitability, and they may prefer that their compensation be weighted more to short-term outcomes they can control. Management personnel, though, are responsible for delivering firm profits consistently over time. Their compensation should be skewed toward equity compensation.

Our hypothetical company, FinCo, has reached a stage at which it requires a full-time management team, and one or more of FinCo's founders have stepped into managerial roles. This will entail a transitioning of those founders from revenue generators to senior managers, including re-assigning of their clients to other advisors. FinCo will need to incentivize those new senior managers to focus on the firm's needs, not the needs of their former clients. FinCo must develop a compensation scheme that does so, and almost by definition, that will necessitate a significant wealth creation opportunity in equity.

In addition, certain FinCo employees have now developed into solid financial advisors who generate meaningful revenues. FinCo will want to retain their services, and equity ownership can be an effective tool for that.

We have referred to "cash compensation" and "equity compensation", but that does not mean to imply that equity should be doled out in the same manner as salary or bonuses. While bonuses paid partly in equity may make sense for certain roles, people tend to value equity more when they have to pay cash for it.

Equity purchases can be effected in several ways. Perhaps the shareholders, board or a management committee determine each year who should be allowed to purchase equity for the first time and which shareholders should be allowed to purchase additional amounts. Offers to purchase are made to those individuals who must write checks for their purchases on a specific closing date. An alternative method is for the firm to lend certain individuals money to purchase equity, then repay the loan over several years, usually as a deduction from current compensation. This is particularly effective for getting significant ownership percentages in the hands of senior managers.

An equity ownership program cannot succeed without two essentials, an annual valuation of the equity done by a third party and sufficient liquidity to redeem ownership

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when someone retires or otherwise needs to sell. The outside valuation validates the price paid for both buyer and seller. The liquidity for retiring shareholders is confirmation of that value. The combination of the outside valuation and liquidity add immeasurably to the attractiveness of equity ownership.

Finally, all of the above steps -- role definitions, compensation philosophy, incentive compensation plans, and equity ownership – can only be credible if supported by solid governance. All of these steps must be developed by senior management and overseen by some governing body – usually a board or a management committee. In addition, the plan of governance must be outlined in the firm's operating agreement. Most importantly, the shareholders of the firm must be committed philosophically to the firm's compensation process and to its consistent application.