The Deal Makers: The Ninth Annual Recruiters' Roundtable

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While 2007 turned out to be a rocky year for the financial services industry, 2008 promises to be even more tumultuous. New leadership is in place at Citigroup and Merrill Lynch after the massive writedowns stemming from the subprime loan and credit markets mess. And, the pain isn't over yet.

At this year's roundtable, held Nov.14 at The Down Town Association in Lower Manhattan and moderated by Senior Editor Tony Chapelle, six men and two women who place advisors in firms across the country shared their views of the significance of what happened and what's ahead. The provocative discussion hit a range of topics: Wachovia's acquisition of A.G. Edwards, the strength of the deals being offered advisors and even which wirehouse might be sold. They didn't always see eye-to-eye on the issues, but in the excerpts that follow, you will see just where they all stand.

The Main Event

Tony Chappelle, *OWS*: First of all, what's the biggest story of 2007?

Michael King: The whole change that's occurring at Smith Barney and Merrill Lynch.

Bill Willis: I'll talk about collateralized debt obligations [CDOs] a little bit—very complicated topic. Wall Street itself does not [yet] know the extent of the potential damage here. Although the tone seemed upbeat coming out of the [November] Merrill Lynch conference—or at least contained. Of course, every time I hear the word 'contained,' I'm pretty sure that it's much bigger—and that has been the case. It's the second round of it all. It led to the overthrow of two empires really—Merrill Lynch and Smith Barney. The question is, 'How much more is out there that's really spooking Wall Street right now?'

King: Most of us remember when nobody left Smith Barney—about two years ago it started to open up. The plan that they put into effect now—the retention package—is a good one. Sallie Krawcheck did a very good job with that—keeping the older brokers. They can buy their books out; that will keep a lot of the older, bigger producers there because you get that enormous deal to retire over a period of time. That's a very smart move. But it's not going to affect the younger brokers much.

Of course, the other shocker—the really big shocker—is Merrill Lynch. I would say Smith Barney and Merrill were the two toughest places to pull people out of. But [now] Merrill brokers are at least willing to look. Doesn't mean we'll get a move, but they're getting out there.

Danny Sarch: This scandal is different for two big reasons. The first is that this was not based upon greed or a couple of bad people bringing them down. It strikes me more as just incompetence in putting so [many] of their eggs in one basket. And the second thing is that that it's not attached to retail so...the retail guys were not affected by this. I have yet to talk to a retail broker [who] said they had CDOs in their client's accounts.

That said, the anger that they have at the way that the firms have [landed] them in the press, so that they have to deal with their clients—dealing with the irony of an investment firm losing so much of [its] own money—has created this enormous backlash of anger, which has nothing to do with what they do every day.

The Merrill guys and the Smith Barney guys are rightfully proud of what they do every day. And then, to see their names so prominently in the press in this way, based upon incompetence of people above them and wasting the firm's capital—it really has created a tremendous amount of anger.

Mindy Diamond: I agree with Danny that this was not a question of greed or anything criminal. It was about poor risk assessment, risk analysis, risk management. And unfortunately Smith Barney and Merrill Lynch were at the head of it. What it's done is create a real problem for all of Wall Street—certain firms obviously more high-profile and more affected than others.

We're seeing a lot of Merrill and Smith Barney brokers who had never thought about moving, who had tons in their F Cap at Merrill or tons in their wealth accumulation plan at Smith Barney—suddenly it's making them rethink.

But a lot of them, instead of considering going to another major wirehouse firm—where they worry that it will be more of the same—will begin to look at some of the boutique firms or the idea of creating their own wealth management firm.

Carri Degenhardt-Burke: It's definitely a shame that [the subprime mess] came along. It's the same for Bob McCann and for Sallie Krawcheck, because they're both incredible leaders. Their brokers really, really like them a lot. Unfortunately, now [the brokers] are looking at something that is above their heads and so they feel there's a lot of uncertainty out there with what's going to happen. Is Smith Barney going to be sold off? It's a big problem right now where the brokers or financial advisors are really taking a look at all of the moving parts and saying: 'Maybe I don't want to be here anymore at all.'

Rick Peterson: Advisors have such a difficult job in the first place, of positioning their clients in certain areas, and advising clients as to why they've chosen which money managers are going to manage their accounts. And all of a sudden, they're being painted with the same brush as leaders that they didn't really like that well, at Merrill and Smith Barney anyway, as if they were at fault. They're apologizing for the actions of two CEOs who are now gone.

OWS: Are CDOs—and this blowup—the biggest story of the year?

Peterson: In my judgment, no. It's just the most recent one.

Sarch: The first six months, everything was [about] the Wachovia/A.G. Edwards merger.

Diamond: Size of the deals would be big this year. The transition packages being offered are astronomically large.

Mickey Wasserman: We've been picking a lot on Merrill and Smith Barney, but these writedowns are virtually across the board from every major firm that's out there. We heard it start a few months ago with Bear Stearns, and it's affecting most of the firms. It's not the private client groups, but the decisions of the investment individuals at these firms.

Of course, because of scale, you're going to hear more about it from Merrill and Smith Barney. What we need to do now, or what they need to do now, is preserve their culture, which I think they're trying to do. I don't think Merrill or Smith Barney are going anyplace.

Peterson: There's another story: the growth of the independents. We've hinted at that over the past few years in this forum. [LPL] Linsco, I know from personal experience, 20 years ago had fewer than 800 brokers in its entire network. It now has 11,000. I was told that [recently], which is pretty equivalent to a lot of the firms on the Street. What's caused all that? A lot of different things. Going forward, it's going to be a lot of the subprime things.

If people leave [the] majors, they don't have to apologize for actions over which they had no control. They now totally control what they're doing as independents. What caused this explosion of the independents has been the sophistication of the products and the services that they now offer. [LPL] Linsco being just one example; there are a lot of them. The Profit Formula Group within Wachovia is another one. And a second thing would be the increasing self-confidence [on the part of] financial advisors that they can do at least as good a job as—if not better than—the analysts who had been misleading people in the past.

OWS: I'm hearing that this latest scandal is pushing people past a tipping point. Are we now going to see an outflow of brokers from wirehouses?

Peterson: The incredible dynamic of this is that we have seen in the past two years the explosion of deals unlike anything we've ever experienced in all the years that we've been doing this and that's a lot of years. And yet in spite of that, we're seeing an enormous growth of people going independent for no deals. They're walking away from huge potential, upfront checks from at least five major firms, and instead going for no check, but the chance to put their own shingle on the wall and advise their own clients and grow their own businesses.

Rich Schwarzkopf: Yeah, on some of those numbers, that's just the independent part. I didn't [include] the RIAs or other things. The independent [portion] now is the biggest section of the financial services. It's almost 100,000 reps.

One of the fast ones coming up, though, is RIA—the Registered Investment Advisor. It's also one of the fastest for gathering assets. RIAs now control $2 trillion worth of assets—staggering. They're growing eight times faster than broker-dealers are as far as gathering assets.

The assets are flooding out of a lot of [the major firms] and, of course, Charles Schwab is probably the biggest and best [custodian of RIA assets], with $1.7 trillion on its books—almost the size of Merrill Lynch and yet it's only a fraction of the size of [Merrill's] workforce.

It's a growing part that we don't deal with that much because it's just not what we've been doing. But I think there is a train coming out there that the brokerage firms don't really see and have sort of ignored. You know, the banks, the independents and registered investment advisors.

OWS: Is the size of brokerage in general growing? Even though it might be moving from one channel to the other?

Schwarzkopf: We're down in one year: 10,000 brokers left the industry last year. They're going to [the RIA channel]. They're going independent, some of them.

Diamond: There's no question that we are seeing more wirehouse advisors being just fed up, having to pay the price for things that have been out of their control. But the interesting phenomenon is that the transition packages being offered are the biggest they've ever been. They're too rich for many to pass up.

Those who are willing to pass them up to go independent are those that have taken a deal once in their career, that are willing to say: 'I monetized my book once. I took some money off the table. I may not have taken it at the high-water mark, but I've taken some money off the table. So now I can afford to look for quality of life, to go independent, look to monetize my book completely, to distance myself completely from the name-brand firms.'

But [with] the deals being as large as they are, if you look back in the last decade, it wasn't that long ago that advisors said: 'Call us when deals get to 200%'—and said it jokingly almost as a way of getting us off the phone. And now they're at 200%—and well beyond—and who knows where they're going.

And the firms are holding strong in the position that they are going to play at this level. What we're going to see in 2008 is—and I don't say this with any stats in mind, but I think you're going to see 50-50. There is going to be a lot of movement. I think 50% are going to move for the checks—meaning going from one major firm to another—because they know that the deals are at the high-water mark. The other 50% are people that have probably moved once in their career, that have already taken some money off the table, monetized their book at least partially and are now looking to distance themselves from it and go independent.

Degenhardt-Burke: Another ramification of the subprime lending problem is that, perhaps in the second quarter or third quarter [of 2008], deals are going to down.

It's a shame for us recruiters, of course, and [for] financial advisors. But the money has to come from somewhere and even if the brokerage firm itself didn't have anything to do with it, the money has got to come from somewhere.

OWS: So your sources are saying to you that deals will be coming down in the second quarter?

Degenhardt-Burke: They have to.

Peterson: I disagree. I don't think deals are going to come down. I've been doing this for 20 years and I've never seen deals come down. They go away for a while. When they come back they come back even stronger than they did before.

I do see deals being structured differently. I see a lot more stock as part of the package as opposed to cash. But I see that as acceptable to brokers. I mean the upside is enormous. So if they're monetizing their deals or their businesses, why not do it with this enormous upside instead of selling out at the high, or potentially the highest that the stock is going to be trading at?

So I don't really see them going away. I saw Wachovia come down from 220% to 170% this past year. It dramatically affected their ability to recruit. As long as one firm is out there offering a significant amount of money, then everybody has got to follow, if they're going to be playing that game.

Wasserman: In everything there is a huge balance and in the financial world there is as well. And just like the deals got bigger, the independents got more aggressive as well; not as large, of course, as the major firms for employees. It really boils down to whether a financial advisor wants to become an independent or an employee.

Diamond: If you've got a broker who says, 'I don't want to be an entrepreneur. I don't want to put toner in the copy machine. I don't want to be the guy at the end of the day who is responsible for running ops,' there are a couple of different options. They can either plug into an existing independent office like Raymond James or an LPL. Models like Wachovia Profit Formula [and] Raymond James Advisor Select are quasi-independent models. Models like National Financial Partners, where they buy a percentage of a broker's practice, become more appealing over time because you've got a partner in managing the business.

Willis: I want to go back to stock price. This is a huge factor out there right now. There are people whose plans have changed; life plans have changed. You can't help it. If you work for a top brokerage and you're successful, you're going to have a ton of its stock. You're not going to be diversified in holdings.

And you trust the company, you work hard, they pay you in stock, that's part of your compensation. And now that thing has dropped like a rock. That can make a person think about moving, right then and there—getting a deal and getting back in the game and making up that money. From that point of view, that's going to be beneficial to all of us.

The other thing I want to mention about the independent network and its growth—the wirehouses have really set the table for that. For the last 10 years, they've been saying: 'Build a fee-based business.' And everybody has. And what is that? It's a very transferable business.

There is really no dependence on Merrill Lynch, Smith Barney, [or] Wachovia for products and services, [no] special sauce. None of that stuff is any good anyway. There are no proprietary products. There is nothing holding them back and if they built a good fee-based business, why not go RIA and get a 100% payout? The people who follow the model have just set up for this move.

OWS: Following up on stock price: Brokers at Smith Barney and Merrill [in October and November] have taken tremendous hits.

Sarch: Morgan Stanley, Wachovia, every single brokerage—every single financial-sector stock—is down big time.

OWS: Is that creating enough agita for people to say: 'I'm out of here.' Is that an actual 2008 inevitability?

Sarch: I had a 55-year-old from Merrill call me up crying and saying: 'How foolish am I for every five years to have something take away my stock price? And now I'm 55 and I can't afford it anymore. What a fool am I to let myself have 45% of my net worth in this one position? If I were a client, coming to me, with a similar situation in any given stock, I would have begged him to diversify. And yet here I am, with all this in the one stock.' And that person is out interviewing.

The firms have raised a standard in terms of always seeing the lower bar go up, up, up. You know $200,000 is a minimal level—or $300,000, or $400,000.

The independents have picked up a lot of these people because when you have somebody who's getting a 30% payout at let's say $350,000, that person can have a life-changing event to go to what ends up being a net 65 after expenses. If they go independent, they can take their book. It's easier to take the book with them. It's all fee-based.

At the high end, people still have deferred comp, though, granted, it's less and the payout difference becomes less a life-changing event. If you're talking about a multimillion-dollar producer—yes, I will [go] from 47% payout to 62% or something like that—but I was already making $1 million a year, so it's not as life-changing as the person who is going from 50% to 100%.

OWS: Last year, someone suggested that Smith Barney might get sold. Some of you didn't think that was even remotely possible. Is it possible this year?

Degenhardt-Burke: With [Smith Barney] being so low, at 4% or 5% of Citigroup's overall profitability, it's definitely on the chopping block. And it should probably be sold by the end of [2008].

[Editor's Note: Sallie Krawcheck told Degenhardt-Burke in an interview subsequent to this roundtable that Smith Barney isn't for sale.]

OWS: Who might be the buyer?

Degenhardt-Burke: Jamie Dimon [chairman and CEO of JPMorgan Chase & Co.], perhaps? Interesting, they don't have any distribution there. It's a personal and professional conquest for him.

King: There's a good chance it will be sold in 2008.

Diamond: I also say Smith Barney will probably be sold off in the next year or so. But I could see them saying that they're focusing more on training and growth of their existing sales force as opposed to heavy focus on recruiting. We're seeing them being more selective. We've watched candidates who've had deals on the table from Smith Barney be pulled if there was anything less than 100% clean, plain-vanilla perfect. All the firms are becoming more selective.

Sarch: People say 'spun off or sold'—[but] that could be a lot of different types of forms. Smith Barney people, as employees, would welcome the idea that they could get a stock that is based on their success and not based upon the success of their parent, the stock of which had been flat for years until this year, the latest scandal driving it down.

I can see it as a possibility. It would be welcomed by Smith Barney employees where they say they have their own stock, with Citigroup having something less than a majority ownership, that they could track their own success separately. The ties into Citigroup are so extraordinary, in terms of the lending and the products, that it's really impossible to separate and just say that. My prediction would be that they would be connected to Citigroup in a substantial way, yet having the ability to have some kind of stock that they could get and use as currency separate from the Citigroup stock.

Wasserman: I can see a piece of Citigroup being sold by the end of 2008. Not necessarily the Smith Barney Private Client Group, but just small pieces, for extra money, that are just holding back the whole ship going in a certain direction. That definitely is in the offing because they're going to need to get rid of their less-profitable centers.

Wachovia & A.G. Edwards

King: [The acquisition] was a superb move on Wachovia's part. I'm being told that [Edwards'] backup is much better than Wachovia's was. But we'll see how they keep the brokers happy.

Sarch: This [deal] had some structure to it, which is very different from the other [similar deals] that have happened. The other firms, for better for worse, created a deadline: 'We will convert by this day.' The assets [were to] be converted or custodianed over to the acquiring firm by a certain date and there was essentially a gun to the brokers' heads. If they wanted to move, they didn't want to put their clients through two transitions.

So this created a frenzy for everybody here and they had to talk to these people and talk to them to get them out interviewing and making decisions quickly. By contrast the A.G. Edwards/Wachovia [deal]—this could be brilliance, or it could be the biggest mistake; the jury is very much out.

But there is no gun to their head because Wachovia, to their credit, admitted that they weren't ready technologically to absorb all the A.G. Edwards brokers and needed a substantial amount of time. So now they're talking about converting, not in even 2008, but the beginning of 2009.

I can't judge [whether this a successful merger] based upon the price. I think that they will [retain] far fewer [A.G. Edwards brokers] than they anticipated. [Wachovia] just [offered] a premium to headhunters to pay 10% in order to get recruiters to work for them and that included a very strict hands-off on A.G. Edwards brokers.

Diamond: It's very much a wait-and-see. The smart thing [Wachovia] did with retention was that there was no drop-dead date for the brokers. The question mark is that Wachovia is a bit of a chameleon. It's as large as the wirehouses in terms of scale but holds itself out as a super-regional firm and trots itself out as a culture, much like the regional firms. It is unlikely being a firm of that scale that there won't be changes.

Willis: The execution of this merger is pretty brilliant: 'Everything is going to stay the same for another year.' It's different than any we've seen. Most people have gotten a check already.

They're happy with that. They're getting used to some of the changes that are coming. So there is this very long courtship rather than a shotgun marriage which mergers usually are. From the Wachovia side, they have a chance to institutionalize these clients as well.

Merrill's Shakeup

OWS: What does [E. Stanley] O'Neal's resignation mean to Merrill, if anything?

Schwarzkopf: He wasn't well liked at all—of course, he wasn't from the industry. I think most people look at that as a positive.

Peterson: Stan O'Neal was not very well liked within the firm—apparently within the entire firm, not just the retail network.

Wasserman: Stan O'Neal, while he fell on the sword, was at the same time discredited, which was kind of brilliant on Merrill's part. By saying that he had these clandestine talks with Wachovia which nobody knew about until this whole thing got exposed.

Sarch: Amazing how that came out.

Wasserman: Isn't it? So I don't find anything bad for Merrill coming out of Stan O'Neal's stepping down.

Willis: There are other firms where there's more ownership by employees, but Merrill Lynch has a lot of employee ownership, so that's a really big deal. You're talking about pocketbooks, retirements, college educations, etc. If you've worked at Merrill either in management or as a broker, you have been given stock as part of compensation really since Day One. So even if you're just an average producer, you get a boatload of stock; most likely your single largest investment—probably bigger than your house.

How High?

OWS: Biggest recruiting deal: Who's got it? How much?

King: I would say all the deals in many ways are about the same. The biggest deal is probably roughly—with everything front- and back-end—close to 250%. It's not all upfront. The brokers think it is, [but] that's including front-, back-end and deferred. I got a call last week. 'I want 300%.' I said: 'I want 400%.' Why not?

But seriously, a very good producer saying: 'I want the 300% deal'? It doesn't exist but look at front- and back-ends and they're all pretty similar.

Merrill's deal is a little more convoluted with revenues, but it comes to the same thing. Smith Barney has been up there. It will stay there for a while. I'm not sure Wachovia is at that level, but they'll do it in special cases.

I think UBS will [offer 250%]. But again, you've got to be careful how we phrase it because UBS will do it, Morgan will do it. I think Smith Barney will do it; Merrill will do it; Wachovia will do it.

The current deal would be 150% maximum cash, I've heard. Another 50% in stock and another 50% to make up for what you're leaving behind—a 250% deal. But the most they really want to do is 140.

Diamond: The majors are the ones paying some iteration of that deal. But there needs to be some clarity because a lot of the publications keep printing this 200% number and every broker on the street reads that and hears 200%.

What's changed in the last few years is that the firms have gotten much more selective. There are no 200% deals for $200,000 and $300,000 producers unless they're what they call "rising stars." Meaning [they've hit] $200,000 or $300,000 in production in three years or so.

A lot of people assume that [the 250%] is all upfront, but it's a max of 140% to 150% upfront; 250% presumes a certain amount of growth. Meaning they take a broker that they recruited [at] $1 million who's going to get to $1.5 million or $2 million by the end of three years. If you factor in the growth, by the end of three years, that's how they get to 250%.

On the surface, a lot of the deals are at probably 215% maximum, meaning not taking into account growth. But that's for brokers that meet a bunch of very critical benchmarks: [a return on assets] of close to one—meaning around $100 million or more in assets and over $1 million in production, at least 40% fee-based, clean, not been at more than two firms in the last 10 years; nothing on the U-4 [regulatory form]—all that stuff.

Wasserman: Let's be very clear about the look-backs—the back end of the deal. Everybody has to hit certain gates to get those additional bonuses. And I want to be very clear to all the candidates that there are no 200% upfront deals; 150% is what we're looking at as maximum upfront—and that's if you're a first-quintile guy.

OWS: Who can give me names and the max they're paying?

Peterson: Four [of the wirehouses] are hitting 200% to 220%.

Diamond: Not Wachovia.

Wasserman: [Wachovia is hitting] 170%.

Peterson: 170% max now, but we know they're going to go over that.