



## June 2008 – Wirehouse Brokers Faced Many Changes

Decade brought mergers, shift in technology and regulation

By Dan Jamieson

Wirehouse brokers have had to respond to many changes in the industry in the past decade. It wasn't uncommon 10 years ago to see the traditional broker at a wirehouse firm managing accounts on a whim. Today, it is the rare representative who doesn't use an investment process.

Technology is helping most brokers upgrade their client services, especially in managing portfolios, according to observers. Tech improvements have "come across the board, with portfolio tools, Monte Carlo simulations and new forms of analytics," said Barry Mendelson, managing partner of Capital Market Consultants LLC in Milwaukee.

More brokers also have begun using fee-based accounts over the past decade. Many felt they could do a more credible job in making recommendations without the conflict of commissions.

But as competitive pressures and technology caused fees to shrink, brokers found that they had to manage more assets to maintain revenue.

The big news for fee-based accounts came during the summer of 1999 when Merrill Lynch & Co. Inc. of New York cut the maximum price of its fee-based brokerage accounts to 1%, from 1.5%. In 2003, firms began scrutinizing the accounts, and when a federal appeals court in March 2007 made the accounts illegal, the industry had to transition clients to new platforms.

Long-brewing criticism over Wall Street's use of proprietary products caused a move toward open architecture. Faulty products from wirehouses caused "investors [to] keep underperforming," said John M. Nowicki, president of LCM Capital Management Inc. in Chicago.

In fact, most firms stopped paying brokers extra for proprietary product sales and eased back on the marketing push. In 2006, Citigroup Inc. of New York and Merrill took the ultimate step of disposing of their asset management units.

### POP GOES THE BUBBLE

The industry's move toward providing more advisory services took a hit during the bubble market of the early 1990s. Rising prices had investors convinced that they could invest online and make just as much, if not more, without financial adviser input.



To make matters worse, advisers who had carefully allocated portfolios among a range of asset classes underperformed the broad indexes.

But when the markets rolled over in early 2000, the online-trading hype began to fade.

The bear market was already under way when the terrorists attacked Sept. 11, 2001. Merrill and Citigroup's brokerage unit, then known as Salomon Smith Barney, had to evacuate headquarters temporarily; Morgan Stanley's operations in the World Trade Center had to be relocated permanently.

The terrorist attacks, combined with the corporate scandals that soon followed, killed any remaining optimism. Investors and brokers slipped into a severe emotional funk.

This turn of events was quite a change from 2000, when the industry earned a then-record \$31.6 billion in pretax profits, according to the Securities Industry and Financial Markets Association of New York and Washington.

Global news events and domestic scandals led regulators to crack down. The USA Patriot Act, which became law in October 2001, required a host of new procedures for financial services firms, including extra due diligence on clients.

About the same time, the scandal related to Enron Corp. of Houston began making front-page news, followed the next year by revelations of corporate-accounting fraud at WorldCom Inc. of Clinton, Miss., and other corporations. Those scandals led to the Sarbanes-Oxley Act of 2002.

In April 2002, New York Attorney General Eliot L. Spitzer opened a series of investigations into faulty research. The next year, he went after the mutual fund industry for market timing.

Regulators cracked down so hard on sales of mutual fund B shares that by 2005, the B share market was almost dead. By then, Wall Street chieftains were talking about going on the offensive against burdensome regulation.

But complaints about too much regulation rang hollow as Wall Street's subprime-mortgage problem unfolded last year. Chief executives at Citigroup, Merrill, Wachovia Corp. of Charlotte, N.C., and Zurich, Switzerland-based UBS AG were forced out after their companies posted huge losses.

The coup de grâce of the subprime crisis, at least so far, has been the March failure of The Bear Stearns Cos. Inc. of New York.

The credit crisis made it clear that size and scale matter, if for no other reason than many brokerage firms are now too big to fail.



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And firms got bigger in a series of mergers over the past decade. In April 1998, Sanford I. Weill, chief executive of Travelers Group Inc. of New York, said that his firm would merge with Citicorp Inc., also of New York, to become Citigroup. The bold move forced Congress' hand, and in the fall of 1999, the Gramm-Leach-Bliley Act erased restrictions on mergers between banks and brokerage firms.

In July 2000, UBS acquired New York-based PaineWebber Group Inc.

The 2007 merger of bank-owned Wachovia Securities LLC of Richmond, Va., with A.G. Edwards & Sons Inc. of St. Louis was the largest retail-securities transaction since the UBS/PaineWebber deal. The combined entity, Wachovia Securities, is based in St. Louis.

Yet even in the end, size didn't guarantee stability. Last year, industry profits vanished after the wirehouses lost \$11.3 billion, according to SIFMA. Smaller retail-oriented firms saved the day, booking \$12.1 billion in profits — giving the industry a net \$800 million profit.

Last year's results followed a record-setting 2006, when the industry produced profits of \$33.1 billion.

The environment doesn't "bode well for the year ahead," SIFMA said in a report last month.

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