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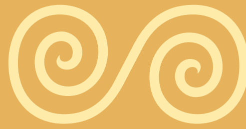
# ON WALL STREET

## JUMPING SHIP

The World Of Independent Firms Is Luring More and More Big Producers

COVER STORY



# JUMPING SHIP

## The World of Independent Firms Is Luring More and More Big Producers

By Tony Chapelle

Illustration by David McMacken

EVERYONE KNOWS THAT ONLY LOSERS who can't cut it leave wirehouses to join independent-contracting firms, right?

Guess again. The reality is that even successful reps—multimillion-dollar producers among them—are going independent in ever-increasing numbers.

Case in point: For a decade, Dawn Bennett and her team of four producers ran one of the 10 highest-grossing groups at Legg Mason Wood Walker. Overall, her Washington, D.C.-based group manages $500 million.

Frequently interviewed on television, radio and in national magazines, Bennett estimates that $125 million of the assets that her team manages are from corporate clients and institutional trustees who saw her twice a month as guest host on the now-defunct CNNfn. One chief executive entrusted her with $40 million of his firm's 401(k) holdings after he saw her on air while he was in an airport.

But the situation took a turn last summer, Bennett says. "We heard the rumor flying up and down the hallway that our chairman was considering swapping us to a wirehouse. That was the moment when the wheels went into motion." It was the beginning of an eight-month process to break free of the employee firm model.

In December, Smith Barney acquired Legg's reps in exchange for the mutual fund business at parent Citigroup. By February, Bennett's team opened a new office in the District. The Bennett Group is now an affiliate of independent-contracting broker-dealer Royal Alliance Associates. And Bennett and her crew are not alone.

There was a time when most brokers who left wirehouses to work for themselves did so because they couldn't produce enough to

survive at a major firm. Indeed, approximately 3% of the 92,000 brokers at the seven largest national full-service firms are pushed out because of poor production and go independent, says Charles Roame, managing principal of research firm Tiburon Strategic Advisors.

Yet Roame estimates that *another* 1% of major-firm brokers—ones who are already successful—choose of their own accord to go independent.

While there are no concrete statistics, it appears that ever-larger producers are joining independents. The three biggest custodian banks (Charles Schwab, Fidelity and TD Waterhouse) report that since 2000, the assets they held for registered investment advisers—a component of those brokers going independent—grew by nearly $323 billion, or almost 16% compounded annually.

By comparison, assets at the three largest employee-based wirehouses (Merrill Lynch, Smith Barney and Morgan Stanley) grew by just $224 billion during the same time, according to Charles Schwab Institutional. That represented just 2% annual growth.

Dawn Bennett had to uproot a 20-year practice. The process took months.

"We have seen over the past 18 months an increasing flow of individuals looking at either setting up their own broker-dealer and advisory group, [or] looking to leave wirehouses to join an independent firm where they feel they'll have greater control," says Anne Steer, an executive vice president with Boston-based National Financial, which is a correspondent broker-dealer for independent firms, banks and insurance companies.

There are many reasons why advisers leave wirehouses and other employee firms. They are fed up with conflicts of interest between their employer firms and their clients; they are dissatisfied with fees they charge clients; they don't like the products they are asked to sell; or they are frustrated with their inability to get access to products they want to sell. At the same time, there are three main attractions offered by going independent: the ability to cash out by selling the broker's business upon retirement rather than giving the book to the company; the ability to operate completely fee-based, advisory practices rather than having fee-in-lieu-of-commission brokerage relationships; and the all-important higher payout.

## I CAN'T GET NO SATISFACTION

By 2001, Mark Baggerly, 43, and his two partners had spent four years gnashing their teeth at Merrill Lynch & Co. What bothered Baggerly most were the financial incentives to sell mutual funds, financial plans and insurance. The deferred compensation of Merrill's advisers was based on total revenues. The company—and therefore the reps—generate higher revenues on proprietary products as a result. Baggerly says reps also made decisions based on concerns about job security.

"When you buy a new car at the Ford dealership, you don't expect objective advice from a salesman," Baggerly says. "But in the financial services industry, the expectation is that an adviser is going to give you objective advice. In reality, advisers in public companies have a conflict of interest. They get paid more if they sell the Ford."

Merrill and Smith Barney no longer have in-house fund families. Yet Merrill still pays brokers extra for generating wrap-fee business.

Baggerly and his partners never felt galvanized to leave Merrill over any particular incident. Instead, the seed to break away was planted over time. After migrating to what is now Wachovia Securities Financial Network (or FiNet) in 2001, his team last year joined GunnAllen Financial in Daphne, Ala.

Independent reps and RIAs have picked up market share after major brokerages were tainted by the investment banking and mutual fund scandals, says Roame of Tiburon, Calif. Moreover, baby boomers are now at the age when they must focus on their investments, and they are demanding unbiased financial advice.

In fact, even when the house brand's returns are superior to those of the competition, some reps avoid them, anyway. Bennett says she eschewed Legg mutual funds despite the fact that the firm's Value Trust is the only fund to beat the Standard & Poor's 500 Index for 15 straight years. Her objectivity often shocked high-net-worth individuals and retirement plan trustees to whom she made presentations.

Yet her rationale was simple: Broker-dealers often offer corporate benefit packages that contain proprietary funds, which they advertise as being free of charge. Yet savvy finance committee members instantly know these funds probably contain hard-to-spot administrative costs and higher expense ratios, Bennett says. "Boards of directors and corporations are starting to wise up. They want separation of church and state. Remain unbiased, and you have a stronger foothold of getting business and, more importantly, of keeping it."

Another reason that some reps leave wirehouses is their dissatisfaction with products they are asked to sell or their inability to get access to products they want to sell.

Richard W. Brown is a 40-year-old broker with Summit Brokerage Services in Fort Myers, Fla. He and partner Jim Haught jointly operate Brown & Haught, a $1.5 million business. Their firm's motto? "Independent financial advice without corporate influence."

"We wanted an independent contracting situation not only to run our business but also to be able to get the right

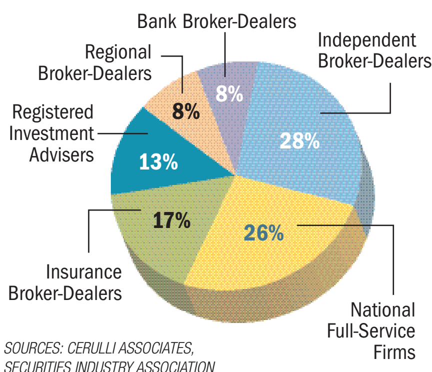
investments for our clients," Brown says.

The son of a branch manager at Raymond James & Associates, Brown started his own career at RJA and became a Chairman's Council member, although he claims he never benefited from a silver spoon. "I didn't even get my own parents' [personal] account."

When he differed with management, he moved on to McDonald Investments, where he was dismayed by what he considered the regional firm's paternalism. A portfolio manager had gotten him excited about a particular annuity from Travelers Group that would soon launch. The annuity would benefit Brown's clients who needed to invest in a taxable or tax-deferred vehicle. After waiting several weeks for the investment to pop up on his firm's approved list, he finally asked his wholesaler when it was coming out. To his surprise, Travelers had launched it long before. McDonald executives had decided not to make it available to their reps, claiming the firm already offered enough annuities.

Now, when Brown finds a new product he wants access to, he contacts Summit to run due diligence on it. It's usually approved in a couple of days. "It's totally different from saying, 'If we don't have it, too bad,' " Brown says.

As for Bennett and her team, they had been at Legg for 10 years after jumping from Wheat First Butcher Singer. They loved Legg's entrepreneurial culture. Then it was bought out. While there weren't any products that Bennett couldn't access at Smith Barney, she was told which computerized financial planning tool she had to use. "Working at wirehouses is riddled with that story," she says. Besides a wider array of investment products, Bennett now says her team can buy any financial planning program she chooses. She's also been able to do away with charging clients annual fees merely for having brokerage accounts. Meanwhile, she boasts that her new broker-dealer, Royal Alliance, supplies excellent margin loan rates for clients and better insurance rates to cover her group's accounts. "We can literally say to clients, 'We can bring you the best of the best.' "




**Independent reps and registered investment advisers have picked up market share after major brokerages were tainted by the investment banking and mutual fund scandals.**

## SOUND ADVICE

Independent reps can become registered investment advisers with their own RIA shops as well as run a brokerage operation. Most independent firms would prefer that the broker operate under the company's RIA license so that the firm can split the money management fees when the broker manages portfolios. But for those who would rather keep the whole 150 basis points, becoming your own RIA could be the way to go.

For five years, UBS Financial in Worcester, Mass., was a good place to operate for Michael Preston, now 35. As he moved deeper into supplying clients with investment advice, however, he didn't believe the wirehouse was providing enough compliance guidance for him. He felt that the firm actually undermined him.

Clients using a nondiscretionary, fee-based account were charged a fee in lieu of a commission. Legally, that meant that any advice a consultant provided had to be incidental to the primary job of brokerage execution. Yet Preston and advice-oriented reps were working in a grey area in those months before the Securities and Exchange Commission handed down the so-called "Merrill Lynch Rule," which attempted to define whether brokers had to register as investment advisers. Preston charged for advice.

Firms like UBS were also in a quandary. At one point, Preston says, UBS sent letters to his clients saying they may have been overcharged based on fees they had paid and the number of transactions that they made.

So he and his two partners left UBS and relocated to another blue-collar and underserved community—Leominster, Mass. (UBS declined to comment.) Preston and his team affiliated with Commonwealth Financial Network and became RIAs, who charge for giving investment advice. The team now manages $95 million, of which $25 million is in discretionary, fee-based accounts. They charge a fee whether they buy stocks or sell options, etc. "Here, transactions are incidental to our advice, not the other way around," Preston says. They can work on a fee-only basis or on wrap-fee platforms, or they can charge commissions. They also charge for drawing up comprehensive financial plans.

## NOW, ABOUT THE PROBLEMS

But going independent means your deferred compensation package will take a devastating hit. You'll lose any portion that hasn't vested. In a firm that uses a cliff-vest plan, you'll even lose the vested amount (although that's being challenged in several court cases). Some independents, however, are responding with recruiting bonuses. At Wachovia FiNet, for instance, a million-dollar broker reportedly can get a $250,000 upfront bonus to make up the difference.

Another potential problem is that only three independents (LPL, Wachovia FiNet and Raymond James Financial Services) provide self-clearing. Bill Dwyer, LPL's national sales director, says straight-through processing is a benefit because error rates

for simple issues inherently go up when more parties are involved. Major producers don't want to sacrifice service to their customers.

Bill Willis, a former branch manager who now operates a headhunting agency in Los Angeles, also warns that the cost of clearing through third-party providers could be higher, especially when executing trades using third-party money managers. The wirehouse producer may never have even heard of a ticket charge, particularly for a mutual fund. Yet if managed money accounts are a big part of a rep's business, this could dampen the otherwise attractive payout.

"Many wirehouse people who have been around for seven years or less have 80% of their business in managed money," Willis says. "If you're going independent, don't get mesmerized by the high payout. Know what the fees are."

Usually, the broker gets to share the managed account fee after the first 50 basis points of a typical 150-basis-point arrangement. With the third-party trading cost, however, as well as giving up a share to the broker-dealer and the money manager, the rep probably doesn't participate until after 100 basis points. In fairness, however, independent reps generally do more third-party or mutual fund wrap-account business, which Willis says is more cost-effective.

In addition, many independent broker-dealers now discourage transactional equities and large amounts of B-share mutual fund business. To do so, the firms may impose significant ticket charges. That means a broker really has to examine his business and must ask managers about the cost of doing that business.

Finally, there is the cost and headache of moving clients. Bennett had a 20-year practice that she had to uproot. The process took months. "You have to be methodical," she explains. In her case, once she left the protection of Smith Barney, she and her team had to create a limited liability corporation with an attorney. They had to find rental space. They also needed to set up their own 401(k) program.

But it was all worth it, she says. "I wish that we'd done this a long time ago. This is such a wonderful, almost extraordinary opportunity to be captain of your ship and change the destiny of your clients' lives to the positive." ■

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