Despite dissenting Fed vote, Charles Schwab Corp. cleared to close TD merger Tuesday, and 'Schwabitrade' looks less fearsome than anticipated

Fed Board member Lael Brainard voted 'no' on creating a new category killer but the San Francisco discount broker and RIA custodian got what it wanted; Schwab, TD Ameritrade shares rise on the news.

> **Brooke's Note: TD Waterhouse was founded in 1979. Ameritrade sparked to life in 1975. It's hard to believe that by Tuesday, they will be merely innards of the Schwab revenue machine even as the TD Ameritrade brand staggers forward as a zombie entity. Yes, the consolidated power of former rivals feels like a competitive threat. That uncertain feel is a large part of why there was suspense since the deal was announced last fall about whether it would or should get approved. But look at it from Schwab's and TD's perspective. Technology, competition, squeezed margins and evaporating interest rates are all bearing down on their business models. These are companies playing offense to defend their turf. I think the super-combination will be net positive. There have probably never been more viable RIA custodians out there -- all with tremendous strengths. (I heard the excitement in the voice of Greg Bruce, head of RIA custody at Raymond James this week talking about how 'disruption' gave his efforts new life.) See:** Ric Edelman throws his RIA's $30 billion-plus retail asset custody accounts up for grabs with anchor custodians -- TD and E*Trade -- set to be swallowed whole by Schwab and Morgan Stanley **But for RIAs that want a big national brand, now there is an even bigger one in Schwab. Maybe they'll even take Michael Kitces' advice and call it 'Schwabitrade.'**

"Schwabitrade" starts life on Tuesday (Oct. 6) after it received Federal Reserve approval, but its Omaha and San Francisco RIA custodians may live on as separate brands, cultures and software systems as late as 2023.

Charles Schwab Corp.'s $26 billion purchase of TD Ameritrade cleared its last regulatory hurdle, Sept. 30. The all-stock deal will close Oct. 6, and with shares of both firms subdued, the deal may be more like $22 billion.

Dan Seivert: TD was [also] starting to run out of steam a bit ... [but] Schwab was not desperate, they were smart

The Federal Reserve Board voted four-to-one to approve the final piece of the puzzle-- Toronto-Dominion Bank's purchase of Schwab stock.

The Fed's agreement was necessary owing to Toronto-Dominion's $348.8 billion (2.1%) share of total banking deposits in the United States, and the fact that it would acquire a larger than 5% stake in Schwab.

Obama appointee Lael Brainard was the sole naysayer over what some surmise was her concern that "Schwabitrade" would be a lumbering, too-big-to-fail future bailout candidate waiting to happen.

She did not respond to a request for comment.

Schwab President and CEO Walt Bettinger said the move would allow Schwab to finalize the acquisition.

"We are now focused on taking the last steps needed to close the transaction so that we can begin the important work of becoming one company and realizing the full potential of this combination on behalf of our clients," he said in release.

Art of the deal

When it was first announced, Schwab's agreement to pay $26 billion for TD yielded a 16% discount on TD's 52-week share price high. But Covid-19 dampened both firms' valuations. See: Schwab's merger with TD Ameritrade was sterling until the Covid-19 pandemic and financial collapse took some of the shine off the deal

Board member Lael Brainard voted against Fed approval.

Schwab shares closed Monday (Oct. 1) at $37.73, up from its 52-week low of $28.00, but down 27% from its high of $51.65 last December. TD shares closed at $40.92, well off its 52-week low of $27.70, but down 25% from its high of $53.99, also in December. In contrast, the NASDAQ, on which both trade, is up 1.42% year-to-date, according to its composite index.

Michael Wong, Morningstar's director of financial services equity research for North America equity argues in a Sept. 15 note that the completion of the merger will pull the combined stock out of the doldrums, as "synergies are realized." See: [The odds are now 75% that Charles Schwab Corp. swallows TD Ameritrade Holding, says Morningstar.]

All that remains are "customary closing conditions" before the deal is consummated, the release states.

Under the terms of the deal, all TD shares will be swapped for 1.0837 shares in the new Schwab.

As part of the purchase, Canada's Toronto-Dominion Bank will sell its 43% stake in TD to Schwab in exchange for 9.9% of voting stock and 3.7% of non-voting shares in the newly merged firm.

Other current TD Ameritrade shareholders and existing Schwab shareholders will hold 18% and 69%, respectively, of the combined company.

Next up: integration

The integration of the two firms will take between 18 and 36 months -- meaning true unification could stretch out to near 2024. Until then Schwab and TD will continue as separate businesses, according to the release. It will also likely cost an estimated $1.6 billion to complete.

Noreen Beaman: Deals [like Schwab-TD] ... address the inflection point industry is facing.

Schwab told RIABiz that it's too early to decide much about how the firms will come together regarding such issues as a detailed integration timeline, the first units to merge and whether it has a message for executives uncertain about their futures.

See: Fidelity, Schwab, Robinhood and even (days numbered) TD Ameritrade are hiring thousands of staff.

"We remain in the planning stages of the integration and have no decisions to announce about future plans at this time. We are committed to being as transparent as possible and will communicate decisions when appropriate throughout the integration process," a spokeswoman wrote in an email.

Nevertheless, staffing and policy changes should emerge more quickly. In fact, a number of notable executives have already left TD Ameritrade, including highly regarded strategist Dani Fava, and staunch RIA advocate Skip Schweiss.

Oligopoly

Not everyone in the industry agrees that the 'Schwabitrade' goliath is good for the industry.

The combination is a whopping, large broker-dealer with $2.6 trillion in RIA assets (Schwab with about $1.9 billion and TD with $700 million), or 51% of the market. It also has $6.1 trillion in overall administered assets, inclusive of $700 billion in RIA assets, and $1.5 trillion overall from TD. See: Reported Schwab-TD merger is a 'blockbuster' combo that creates a 10,000-RIA, $2-trillion custody juggernaut and may signal long-expected industry shakeout

It will also reduce the RIA custody oligopoly to three-- Schwab/TD, Fidelity investments and BNY Mellon's Pershing. Together they hold 80% of the $4 trillion in US advisory assets, according to Cerulli data.

Advisors will soon discover that the fee-busting competition and efficiencies that led to the TD-Schwab deal will lead to lower quality service and higher prices, says Robb Baldwin, CEO of small custodian TradePMR, via email.

Go where you grow.

Steve Boyle: An even better [chapter] is about to start.

"Advisors are going to face the crossroads of price versus service over the next few years," he says. See: One big casualty of Fidelity Investments' buckle on zero-fee commissions may be the zero-fee RIA custody tailwind of three decades duration.

The irony is that the DOJ's belief that 'Schwabitrade' will not breed a monopoly may well be based on just such an eventuality, and one Baldwin accepts could benefit his firm. See: Fidelity, others pounce on TD RIAs with a vengeance.

The RIA giant Edelman Financial Engines, for example, just put out a request for proposals to re-custody at least $30 billion of the firm's near $220 billion of managed assets. See: Ric Edelman throws his RIA's $30 billion-plus retail asset custody accounts up for grabs.

TD and E*Trade are Edelman's current primary custodians.

Technology trap

Even with the jaw-dropping scale Schwab will soon possess, there's no guarantee it will stay top-dog forever, says Matt Crow, president of Mercer Capital in Memphis, Tenn., via email. .

Matt Crow: These businesses are reconfiguring in search of sustainable margins.

"Technology gives competitors every opportunity to counter-punch. The Robinhoods of the world will be nipping at [Schwab's] heels forever.

"Future-proofing, if it's even available, requires firms to be nimble and creative. Scale doesn't make you nimble; it weighs you down [and] getting bigger isn't a creative act, it's a defensive tactic," he says.

The combination of Schwab and TD is based on the fact that scale and efficiency are the *sine qua non* for continued success, as technologies and fee compression squeeze profit margins, says Noreen Beaman, president of Orion TAMP, Brinker Capital Investments, via email.

"Deals [like Schwab-TD] ... address the inflection point industry is facing, [namely] the changing needs of the consumer, new technology and the ever evolving regulatory environment [which] ha[s] put tremendous pressure on the ability to grow and improve margins," she says.

More size becomes a necessary means to stave off an existential threat.

"Technology with a capital 'T' has decimated the profitability of any financial transaction, such that these otherwise untouchable behemoths have to merge or be purged from the landscape. These businesses are reconfiguring in search of sustainable margins," says Crow.

Twilight zone

Perhaps the greatest example is Schwab's Oct. 2019 move to cut trading commissions to zero. See: After Vanguard instigated commission war in June, Charles 'Chuck' Schwab steps up to challenge in brilliant counterstroke that paints bullseye on custody rivals.

Michael Wong says Schwab's share price should climb as it integrates with TD.

As a result, Schwab lost roughly 6% off its revenues. TD was harder hit. Its revenues fell by an estimated 25%.

Share prices quickly cratered. Schwab pounced, growing its asset-base 25% with the stroke of a pen.

But TD was also a prospect hiding in plain sight, stuck as it was in a twilight zone of being bigger than the rest, but not quite big enough, says Dan Seivert, CEO of Los Angeles, Calif.-based investment bank and valuation services firm, Echelon Partners, via email.

"TD was starting to run out of steam a bit ... [and] oftentimes the firms acquired are one-of-a-kind, or market leaders, so [those] that miss [out] on the deals meaningfully fall behind in market power."

"The fear of missing out is what drives these [acquisitions] ... [but] Schwab was not desperate, they were smart," he adds.

Too big to fail?

The Fed's decision -- widely considered a rubber stamp -- was not 100% in the bag, given Brainard's vote.

Bill Singer suggests Brainard's vote against the deal may have been predicated on a fear it could be too big to fail.

She also voted to block the E*Trade-Morgan Stanley deal, which the FED approved the same day (Sept. 30) as the Schwab-TD merger. See: James Gorman delivers chilling remarks to E*Trade RIAs.

The Fed process is rarely forensic, said Ari Sonneberg, partner and chief marketing officer at Boston-based Wagner Law Group, in an August email.

"Under the current administration, I don’t think any federal regulator, especially the Fed ... [wants] to impede business transactions," he explained. See: TD Ameritrade hedges its bets that Schwab can swallow it whole as DOJ letter lands.

But the fact that the last remaining Obama appointee voted one way, and the four Trump appointees the other, demonstrates just how politicized the merger became, says Bill Singer, attorney and writer of the Broke and Broker blog, via email.

"[Brainard's] a progressive ... and I suspect her negative vote is based on concerns about the consolidation of [a] fading broker-dealer industry into fewer- and-fewer but larger-and-larger firms.

"She may also be cognizant of the Bear Stearns and Lehman Brothers collapses during a recent period of economic pressure," he noted.

Final hurdle falls

The Fed's approval of the Schwab-TD union was the last hurdle the deal had to clear, but it was by no means the only one.

Ari Sonneberg: I don't think any federal regulator, especially the Fed ... [wanted] to impede business transactions.

As recently as last month, the firm still had to obtain approval from a number of overseas regulators, including those in Hong Kong and Singapore. See: 'Hundreds' of Schwab staff tasked with TD integration will soar to 'thousands'.

Nor was DOJ approval a swift rubber-stamp.

Several lawyers, Sonneberg included, say the regulator was extremely thorough in its examination. On Jan. 29, 2020, both Schwab and TD received a second request for information from the DoJ's antitrust division. See: Schwab's merger with TD Ameritrade was sterling until the Covid-19 pandemic and financial collapse took some of the shine off the deal.

The regulator's approval eventually came in June. This was swiftly followed by near-unanimous shareholder approval. See: Odds spike to 100% Schwab and TD Ameritrade close merger.

Robb Baldwin: Advisors are going to face the crossroads.

Although the deal was locked in by a $1 billion break up fee, the DOJ was leery of the two firms' combined dominance in RIA custody, sources say.

Particularly at issue was the fact that each held their own technology niche and mode of interacting with outside software vendors. See: Schwab and TD on hook for $1 billion should either firm get cold feet, shareholders revolt, or antitrust regulators quash deal.

The deal faced potential antitrust suits too. See: Suit against Schwab and TD Ameritrade merger draws 'stunt' accusations and judge agrees.

But its final closure, and that of other similar deals in recent weeks, including Orion-Brinker, shows how healthily competitive the market was, is, and remains, says Seivert.

"None of the [recent deals] should have been stopped as they did not block competition ... Industry concentration is not an issue, and firms consist of, and are often judged across, more than one business model," he says. See: Orion Advisor Services and Brinker Capital race to close merger in just three months, a leap toward 'unstoppable'.

That said, arguably there is room to thrive for smaller existing custodians and new entrants -- perhaps including Goldman Sachs through Folio Institutional. See: Goldman Sachs buys Folio.

Maintaining diversity

In a separate release to Schwab's TD interim president and CEO, Steve Boyle thanked his staff for their efforts, and promised the best is yet to come for the combined firm.

Dani Fava: [TD] sought out diversity ... I'd love to see [this] live on.

"For the last 45 years TD Ameritrade has been a force for positive change in financial services. To our workforce I say ... thank you ... we may be turning the page on one terrific chapter, an even better one is about to start." See: Amid 800-person hiring spree, TD interim CEO Steve-Boyle calls Schwab merger efforts 'critical' and on-schedule.

But there's one leaf Schwab should make sure it takes out of the TD playbook, says Dani Fava, now Envestnet's head of strategic development, via email.

"The one thing I'd personally love to see live on is the focus on diversity. TD Ameritrade was purposeful in its efforts.

"They sought out diversity for the good of humanity *and* they knew it was good for business.

"They were unwavering in their efforts to find, hire, and highlight different opinions from both clients and employees."