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Have Merrill's Bulls Been Led to Pasture?

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IN quick succession, just days after E. Stanley O'Neal took over as chief executive of Merrill Lynch on Dec. 2, the firm announced several executive changes. G. Kelly Martin, a member of Merrill's executive committee, stepped down as president of the international private client business to pursue other interests. Michael J. P. Marks, the chairman of its European, Middle East and African operations, retired. Paul D. Roy, the co-president of its global markets and investment banking business, said that he, too, would leave the firm.

Absorbing their portfolios were James P. Gorman, president of Merrill's brokerage network in the United States and a former McKinsey & Company executive who joined the firm in 1999, and Arshad R. Zakaria, Mr. Roy's co-president, who at 40 is now the youngest head of any big banking and securities division on Wall Street, the unit responsible for 60 percent of Merrill's profits.

It happens all the time — a new chief executive names his own team, after all. But at Merrill, the bloodletting has actually been going on since Mr. O'Neal became president in July 2001, starting with the resignations, under pressure, of Jeffrey R. Peek, the head of asset management, and Thomas W. Davis, who had run the firm's investment banking business.

More important, it signals a cultural and management revolution unique in the firm's history. In contrast with its peers on the Street, Merrill, under Mr. O'Neal's iron grip, is ruled by the cold, hard view that the current malaise of the markets will not dissolve anytime soon.

Mr. O'Neal's Merrill, it seems, is no longer bullish on America.

Over the last two years, Mr. O'Neal's crew, which also includes Thomas H. Patrick, the executive vice chairman, has presided over the loss of 18,600 jobs at Merrill, or 25.8 percent of the work force. No other investment firm has come close to cutting so deeply.

Merrill's new management team is viewed by insiders and outsiders alike as extraordinarily numbers-oriented — realists, to supporters; cynics, to detractors.

Mr. Zakaria's ascent, in particular, has raised eyebrows on Wall Street. He is "a quant," expert at putting together complicated financial instruments, but lacking in experience in relationship banking, which generally demands more advanced people skills, investment bankers who have worked with him say.

That Mr. Zakaria is talented, there is no doubt. What matters more to Mr. O'Neal, however, is loyalty, which all in the new guard at Merrill have in spades.

The revolution will be complete in April, when David H. Komansky, the former chief executive and current chairman, departs. Mr. Komansky, with his back-slapping bonhomie, born of his years as a top-producing broker, is already a faded symbol of a global expansion strategy that resulted in the corporate bloat that Mr. O'Neal is working so hard to pare.

Inside Merrill, several employees said, morale is grim. One former employee likened the environment in the investment banking ranks to Afghanistan under the Taliban. Bankers who have left Merrill in recent years express amazement that the banking and securities business — home to high-profile areas like mergers and acquisitions and equity underwriting — is being run by Mr. Zakaria. He may be recognized within the firm as a tax expert and may well have made a large number of client calls last year, but he is no relationship banker, they say.

Mr. O'Neal and company — all of whom declined to be interviewed for this article — do have supporters who believe that they are the right managers at the right time.

"These guys are workers," said Stephen L. Hammerman, a former Merrill vice chairman who retired from the company last February. "They are rolling their sleeves up and are here to do a job. They know how to deal with clients and they know how to deal with money."

TO impose his view, Mr. O'Neal has brought in a group of people that contrasts sharply with past management teams.

Mr. Gorman, 44, is from Melbourne, Australia. Mr. Zakaria hails from Bombay. The new chief financial officer, Ahmass L. Fakahany, also 44, is from Cairo. Sergio Ermotti, 42, co-head of global equity markets, is from Lugano, Switzerland. Dow Kim, 40, the firm's head of global debt, is a native of Seoul, South Korea.

Robert C. Doll Jr., a 48-year-old American from Philadelphia, now heads asset management.

Merrill's top managers are among the youngest executives on the Street. None have been with Merrill Lynch for more than 20 years, and none have risen from within the firm's vast private client group — Merrill's usual source for top managers. For all of them, starting with Mr. O'Neal, the idea of Mother Merrill as a nurturing bureaucratic womb is dead, according to top bankers at the firm.

Mr. Zakaria is the prime example of that. His startling ascent through the Merrill management ranks and his instinctive understanding of some of the most esoteric, profitable and controversial financial products that Wall Street has to offer, combined with his uncanny ability to navigate the firm's byzantine political ways, symbolizes the new Merrill manager in many ways.

Throughout his 15-year career at Merrill, Mr. Zakaria has had a hand in devising and selling some of the most lucrative financial products ever to come out of Merrill Lynch. These range from off-balance-sheet tax-shelter partnerships in the late 1980's to a variety of equity-linked instruments in the mid-1990's that allowed Merrill's corporate and individual clients to raise billions in cash while escaping hundreds of millions in taxes.

The son of an upper-class family in Bombay (his brother Fareed is a columnist and the editor of Newsweek International), Mr. Zakaria has always been at the top of his class. At Harvard, he graduated summa cum laude with a degree in applied mathematics and won an $8,000 prize from Morgan Stanley for a paper he wrote on pricing call options.

In 1985, he made the unusual jump directly to the Harvard Business School — and he breezed through it, winning a Baker scholarship and a Loeb Rhoades finance fellowship.

After earning his M.B.A. in 1987, and after a vigorous bidding war for him among all the big investment banks, he signed on with Merrill Lynch for $150,000 a year, an extremely high salary for a business-school graduate with no full-time banking experience.

Mr. Zakaria skipped through the training program and went directly to work for E. S. Purandar Das, a managing director and fellow Indian who was involved in an effort to create tax-shelter partnerships and sell them to Fortune 500 companies looking to avoid capital gains taxes. Mr. Das, a former chemical engineer with a deep understanding of the United States tax code, had less expertise in creating financial products — where Mr. Zakaria was useful.

At the time, according to court documents cited in news accounts, several big Merrill Lynch clients, like Schering-Plough, AlliedSignal and Colgate-Palmolive, were eager to lower the taxes they were paying on subsidiary sales. Mr. Zakaria worked on a team with Mr. Das that solved the problem with a plan to set up an offshore fund with a foreign partner for each client. Within the fund, securities would be bought and sold, generating an eventual loss that could be carried forward to offset the company's capital gain.

It was a brilliant piece of financial craftsmanship. One of the first purchasers was Robert P. Luciano, then the chief executive of Schering-Plough and a Merrill board member, a position he still holds. The fees for Merrill ran as high as $15 million a client.

By 1990, Mr. Zakaria was a full-fledged star. As the recession's teeth sank deeply into the firm, Mr. Zakaria, Mr. Das and Mr. Luciano's son, Richard, who had joined their team, flew around the country in a Gulfstream jet, pitching their partnerships to eager corporate clients, the court papers show.

That year, say a number of former Merrill bankers who declined to be identified, that small group pulled in more than $100 million in revenue. The combined cut for Mr. Das and Mr. Zakaria was around 20 percent, these people say. Their rewards were so large that Barry S. Friedberg, the head of investment banking at the time and a member of the compensation committee, made a private deal with his two banking stars to prevent the spread of jealousy. Mr. Friedberg, who is leaving the company, did not return phone calls seeking comment.

Nevertheless, word spread: Mr. Zakaria, then 27 and just three years out of business school, was pulling down nearly $5 million, making him one of the highest-paid bankers not only at Merrill but also on Wall Street.

In the end, though, the partnerships were too good to be true. By 1995, the Internal Revenue Service had begun to close them down as part of a drive to close tax loopholes. Mr. Das, his career already on the wane, was forced to testify in court on the nature of the partnerships and went on to identify the clients involved. Mr. Das, who later left the company, refused to comment.

Mr. Zakaria, however, moved on and has never been tainted by the fallout from the partnerships.

By that time, he had developed a close relationship with Mr. Patrick, a senior Merrill Lynch banker with a keen interest in the tax work that Mr. Zakaria was doing.

Mr. Patrick oversees all finance, tax, legal and research functions within Merrill and is a close adviser to Mr. O'Neal. He is seen within the firm as a de facto president and as an architect of its restructuring efforts.

During his 24 years at the firm, Mr. Patrick has twice served as chief financial officer, has headed the equity markets group and has run the insurance business. He is best known for having helped invent zero-coupon bond instruments convertible into equity, called Lyons for liquid-yield option notes, in the mid-1980's.

Arcane yet lucrative, these products opened a new vista for Merrill corporate clients, allowing them to raise cash by issuing debt, pay out less in interest and get a tax break in the process. They were a wild success, generating hundreds of millions in fees for Merrill and spurring copycat products from Merrill's peers.

IMPRESSED with Mr. Zakaria's work on the tax shelters, Mr. Patrick became his mentor and moved him to the firm's corporate finance group. Although the tax shelters were an embarrassment for the firm, the powerful demand for them, together with the success of the Lyons, made it clear to top Merrill executives like Mr. Patrick that the real potential on Wall Street was in the design of instruments that allowed clients to raise money while paying less taxes.

By the mid-1990's, Mr. Zakaria and his team, under the careful eye of Mr. Patrick, were churning out and marketing several similar tax-avoiding financial instruments. Called trust-preferred securities, they were an evolution of the Lyons product, with specific trademarked names like Strypes and Prides.

Each served a different purpose, but the overriding aim was the same: to allow a company or individual to raise cash while paying as little tax as legally permissible.

Mr. Zakaria's team manufactured the products, and Mr. Patrick, an experienced relationship banker, sold them to clients like Sam Zell, the Chicago-based real estate investor, and Eli Broad, the chairman of SunAmerica. While the I.R.S. has raised questions from time to time about these products, it has never prohibited them and they have wide acceptance on the Street.

On the surface, the relationship between Mr. Patrick and Mr. Zakaria seems an odd one. Gruff and cocksure, Mr. Patrick, 57, is of Irish descent, a graduate of Rutgers with an M.B.A. from the University of Pittsburgh, and a product of gritty Youngstown, Ohio. The urbane Mr. Zakaria comes from a different world.

But many who know them say they have much in common. They are both schooled in numbers and are supremely confident in their own abilities, sharing a propensity to snap at those who fail to grasp their logic. Both are golf enthusiasts and have been known to drop everything to play.

They even invest together. They were partners in their own personal investment fund, called Youngstown Global Partners, after Mr. Patrick's hometown. The fund would take positions in everything from stocks traded on the Bombay Stock Exchange to hot initial public offerings like Einstein Bagels, a company that Merrill bankers took public in 1996, which later filed for bankruptcy protection and is now owned by New World Coffee-Manhattan Bagel.

The Youngstown fund is inactive, but it is indicative of the pair's close relationship.

In 2000, Mr. Patrick was appointed chief financial officer for the second time by Mr. Komansky. One of his first moves was to recommend that Mr. Zakaria be named head of corporate risk management. That happened in May 2000, with Mr. Zakaria reporting to Mr. Patrick.

About that time, the race to succeed Mr. Komansky as chief executive was heating up. The Merrill board had decreed that by the end of 2001, Mr. Komansky was to anoint a president who would then take over as chief.

It was a bitterly contested race among Mr. O'Neal, who headed the private client business at the time; Mr. Peek, of asset management; and Mr. Davis, of investment banking. Top Merrill executives picked their horses early and hoped for the best, knowing that their jobs could well depend on who eventually won.

Early on, several Merrill bankers said, Mr. Patrick sided with Mr. O'Neal. Mr. Patrick knew Mr. O'Neal when he was a rising star in Merrill's high-yield bond department in the early 1990's, and had been impressed with his analytical mind as well as his client skills. What's more, Mr. Patrick had a contentious relationship with Mr. Peek, who was seen as a favorite of Mr. Komansky's.

Mr. Patrick and Mr. Komansky had their differences, too.

In 1993, the two were contenders for the presidency of Merrill, and when Mr. Komansky won, Mr. Patrick endured seven years of exile in Chicago, running the firm's special advisory group.

Mr. Patrick has always had a green-eyeshade mentality when looking to the firm's future. He looked askance at Mr. Komansky's charge into new markets like Canada, Australia and Japan, insiders say. In fact, like many other Merrill executives, he was an aggressive seller of the company's stock through much of 2000 and 2001, according to securities filings.

In July 2001, the Merrill board, concerned about the firm's shrinking profits, forced Mr. Komansky's hand, and Mr. O'Neal became president and the chief executive heir apparent.

Driving the decision was Mr. Luciano, who in his position as chairman of the board's management committee led the search for a new chief. He remembered Mr. Patrick and Mr. Zakaria well from their work 10 years earlier on the tax shelters for Schering-Plough and came to know Mr. O'Neal through them. The four also shared a passion for golf and spent hours together at Mr. Luciano's various golf clubs.

Several senior Merrill Lynch bankers now say Mr. Luciano was convinced that Mr. O'Neal — with Mr. Patrick and Mr. Zakaria being crucial members of his team — would have the colder, more objective approach needed to cut the fat from the firm.

Behind the scenes, William A. Schreyer, Merrill's chief executive during the 1980's, also played a significant role, these people say. He, too, knew Mr. Zakaria and Mr. Patrick from their tax-shelter work and cast his influential vote in favor of the O'Neal team.

On Oct. 5, 2001, Mr. O'Neal promoted Mr. Zakaria to his current post at global markets and investment banking. Later, in November, he named Mr. Patrick executive vice chairman.

For the moment, analysts are cheering Mr. O'Neal and his number crunchers. Profit margins in important areas like investment banking and the brokerage business are rising in the wake of the layoffs. The company's stock fell 27 percent in 2002, in line with other brokerage stocks, and closed on Friday at $39.97, 32 percent off its 52-week high.

OTHER large Wall Street firms are increasing layoffs, a sign that they, too, are growing more concerned about the depths of the market's slide.

"Although you worry that they may have cut too far, the fact that Merrill's competitors are throwing in the towel is a confirmation that O'Neal was right," said Guy Moszkowski, a brokerage analyst at Salomon Smith Barney. "And while they have downsized at just about every level, they have kept their rainmakers."

Still, many wonder how a bear-market Merrill will fare when equity markets rebound. Over the last year, many top deal makers have left the firm, and Merrill has dropped to sixth place, from third, in worldwide merger advisory work. If Mr. O'Neal and his team are wrong about the length of the market's collapse, Merrill may well suffer — and require another redesign.