

## JUST LIKE STARTING OVER

BY UDI GROFMAN AND DAVID NISSENBAUM, SCHULTE ROTH & ZABEL

As the Wall Street firms we knew continue to work through the problems of the credit crisis and, in some cases, struggle for survival, the seeds of Wall Street's reinvention are already being sown. A multitude of talented and too young to retire refugees from Wall Street's old guard are aiming to take advantage of the void in financial services and forming new firms that promise to shape the "new Wall Street."

Many of these firms will pursue a back to basics approach, offering financial advice, investment banking and brokering transactions. Others will reestablish proprietary trading and engage in asset management. A few will become bank holding companies. These firms, first and foremost, are entrepreneurial businesses. A good business plan and talented people will, of course, be key drivers of success. But there are other fundamental components that -- in our experience advising private financial services businesses from birth and up the growth curve -- are critical to building a successful financial services firm.

**Ownership structure.** Perhaps the single most important set of decisions a firm's principals will make involves the structure and terms of ownership. The ownership structure will define how the principals will relate to each other -- firm governance, compensation, the orderly addition and departure of partners and, eventually, capitalization and monetization events. Indeed, failing to address these issues thoughtfully up front has doomed many a firm, or cost the partners dearly to fix. Ownership structure will vary, depending on the business plan -- some business will be capital intensive and rely on operating and strategic partners' capital; others will be pure service businesses or invest client capital in investment funds

or structured products. As service businesses that depend almost entirely on the efforts of their principals and key employees, a compensation structure that has a discretionary component that enables the contributions of individuals to be recognized appropriately is critical. Management authority over day-to-day and major decisions should be clearly defined to allow the firm to act nimbly. Finally, all businesses evolve over time, and an orderly and realistic means for partners to join and exit the business, and for capital to be raised or for the partners' ownership to be monetized, will set expectations and can avoid heightened and expensive conflicts among the partners.

**Conflict management.** Investment banking, brokering, proprietary trading, traditional advisory services, merchant banking and asset management are among the key lines of business new Wall Street firms intend to pursue. Any combination of these businesses conducted in the same firm raises the potential for serious conflicts of interest. To be sure, many new firms will pursue only one of these key businesses and boast that they are focused and conflict-free. However, other firms will see these businesses as complementary -- and will desire to make the firm's talent available across multiple lines of business. Such conflicts are not only the sources of potential legal and regulatory problems; if not properly addressed they can impede the business plan. Prospective clients have demonstrated an unwillingness to do business with firms that can not credibly assure them that clients' interests will come first. Avoiding conflicts is important to major Wall Street firms. These firms have information barriers that usually enable each business

line to focus on profit maximization without regard to other businesses within the firm. Information barriers, however, are much harder to implement in a smaller, entrepreneurial environment. This can be a fundamental challenge to a new firm's business plan, and is often a surprising obstacle to bankers and traders who have not previously operated in a small firm environment.

*Regulation as a tool.* Financial services are inextricably intertwined with regulation, which ranges from disclosure requirements to regulatory filings to conflict of interest rules to net capital requirements. Legislators and regulators worldwide are debating how regulation of the financial industry should change, and many changes or their effects will not be known for months or years. For now, broker-dealer, investment adviser, commodities and bank regulation remain separate, existing in their own silos, as does state regulation of non-bank mortgage and other lending. Foreign countries have their own regulatory regimes. Whatever the result of worldwide efforts to revamp financial regulation, the new Wall Street firm needs to be no less sensitive -- and possibly more sensitive -- to the role of regulation in its business plan and the potential effect on its competitiveness. The best planned firms will recognize that regulatory requirements, ownership structure and tax efficiency interact and require a three-dimensional approach.

*Operations and risk management.* The new Wall Street firms will, of necessity, need to establish themselves not only with good business plans, but in the quality of their operations and risk management, including compliance. Regulators, trading partners and investors will demand it. This is especially

true of firms that plan to trade, invest or lend proprietary or client capital, as well as those that will engage in commercial banking. We believe an ever-higher expectation of quality operations, compliance and infrastructure will outlast the current crisis and the inevitable return of financial power from government centers to the world's financial centers. There are already good models of small but highly sophisticated organizations that have a professional class of operations, compliance and risk management personnel that use cutting-edge technology and systems and operate globally.

*Tax efficiency.* Assuming a firm has substantial U.S. operations and is not publicly held, a limited partnership or limited liability company will likely be the most tax-efficient structure for the partners. Tax optimization becomes more complicated when a firm has international offices or non-U.S. partners or investors, as special structuring is often desirable. Tax planning is also intertwined with compensation structures and management succession plans.

Building a successful business and a sustainable firm is a formidable task in any industry. Financial services firms face a particular set of challenges in that they operate in a heavily regulated environment, must manage inevitable and substantial conflicts of interest and, perhaps most importantly, the firms' most valuable assets "go down the elevator" each night. Tackling these issues together is, in our experience, the key to creating a solid platform on which a firm can execute its business plan, adapt to future changes and grow.

*Udi Grofman and David Nissenbaum are partners in law firm Schulte Roth & Zabel LLP.*

AS FEATURED ON

**The Deal**  
**.COM**

TheDeal.com (ISSN 1547-7584) is published by The Deal LLC.  
© Copyright 2009 The Deal LLC. The Copyright Act of 1976 prohibits the reproduction by any means of any portion of this publication except with the permission of the publisher.

WWW.THEDEAL.COM

**Schulte Roth & Zabel** LLP

919 Third Avenue, New York, NY 10022  
212.756.2000 tel | 212.593.5955 fax | www.srz.com  
New York, Washington, DC & London