

MARTIN IS EVALUATING HIS RISKS

**By Charlie Goodrich, Goodrich & Associates,
LLC**

KEY PLAYERS

Royal Bank is a large money center bank, that operates a prime brokerage and has global securities trading operations.

SpeedCo is a company formed to license software owned by Royal Bank, with the intention of using it to trade securities for a profit.

Hallmark Capital is a mid-town Manhattan-based private equity firm, and one of its focus areas is financial services.

Edward Crane worked for Royal Bank and then formed SpeedCo.

Martin Lodge is an industry veteran, early investor in SpeedCo, and final Chairman of SpeedCo.

Harry Lewis is a junior partner at Hallmark Capital and his first investment as partner is SpeedCo.

Melvin Andrews is a senior partner of Hallmark Capital and runs its financial services group.

CASE

Martin Lodge is a veteran of high-speed computerized trading. He was CEO for 10 years of one of the first high-speed trading companies, and before that, had a career in securities trading, running one of the first prime brokerage businesses at that time. (Prime brokers execute trades and provide custody for hedge funds.)

High-speed trading firms execute securities orders for others and use statistical trends from

that order flow to make many small trades for a net profit for the firm on these trades. (Lots of small losses are expected too.) Often, that order flow is purchased from retail stock brokerages such as Schwab and Fidelity.

Royal Bank bought special high-speed trading technology in 2009 from another money center bank that refocused its business after tremendous losses. Later, because, fundamentally, Royal Bank was trading with customer deposits, Dodd-Frank required Royal Bank to divest this business or shut it down in 2015.

The Royal Bank employee in charge of this project, Edward Crane, formed SpeedCo as a Delaware LLC and Royal Bank gave SpeedCo the existing computer hardware and a license to the special sauce software. In return, SpeedCo would use Royal Bank as its prime broker and so generate a lot of revenue for Royal Bank.

Coincidentally, Martin Lodge ran that prime brokerage much earlier in his career before Royal Bank purchased that investment bank during the Great Recession. That special sauce software allowed the testing of statistical models on live data without executing the actual trades so as to test algorithms and adjust them on the fly.

Martin became an advisor to SpeedCo and invested \$4.0MM of his own money. Ed Crane raised another \$26MM from a hand full of individual investors in the securities trading industry for SpeedCo. Then, SpeedCo raised another \$60MM in equity from Hallmark Capital, a New York City private equity firm that invests at the upper end of the middle market in established businesses. One of Hallmark Capital's focus areas is financial services.

The Board arrangement for SpeedCo after the Hallmark investment is that Hallmark would have 3 board seats, Edward Crane would be on the Board and he could designate 2 other

directors. The seventh director was to be a mutually agreed upon person to serve as chairman. Martin was asked to be Chairman of SpeedCo at the outset of the Hallmark investment, but declined, preferring to spend his time playing golf.

Harry Lewis is a newly minted junior partner at Hallmark and he found the SpeedCo opportunity so this is Harry's first investment as a partner. Harry's entire career, following his MBA at Harvard, has been with Hallmark. Harry has been pushing Edward Crane to spend like crazy to build the infrastructure, hire the people, and perfect the statistical algorithms without regard to cash burn. Offices in London and Hong Kong have been opened and staffed.

Edward Crane has been enthusiastic about this approach and has been aggressive in the industry arms race paying for faster communication lines, computers and for special, costly high speed access to all of the major global stock exchanges.

So far, SpeedCo can only breakeven on the trades it makes based on the statistical models and so can't cover expenses.

Melvin Andrews and Frank Whitman are the other two representatives from Hallmark that have Board seats. Melvin and Frank are much more senior at Hallmark than Harry with Melvin leading the firm's financial services group.

Melvin has been expressing his concerns at Board meetings that expenses are much higher than he expected. In particular, Melvin didn't realize so much software is needed beyond what came with SpeedCo to actually execute trades, access the stock exchanges, comply with FINRA, and so forth. All of this software can only be rented at high cost.

The independent chairman resigns from the Board. He is freeing up time for a public board opportunity that is a much more lucrative opportunity – more prestige, higher board fees

and he became skeptical of making a tidy sum from his option package at SpeedCo.

Melvin Andrews asks Martin Lodge to join the Board as an independent Chairman. Melvin has known Martin for many years and Martin has been a mentor to Edward Crane from the get go of SpeedCo.

Melvin does share with Martin his concerns about the high burn rate and frustration that so much additional software was needed. Martin is itching to get in the game again and he understood from the beginning of SpeedCo that much of this additional rented software was needed. Martin is a bit concerned about being dragged into a dispute between SpeedCo and Hallmark Capital.

Martin's lawyer reviewed all of the SpeedCo documents before he made his own investment in SpeedCo. And Edward Crane had a penchant for high priced lawyers so Martin is confident he is indemnified by SpeedCo. Martin says yes to Melvin. He then pauses, and asks Melvin, "How

good is the D&O insurance?” “It is good stuff, our own broker put the policy in place for SpeedCo.”
“I will send you a copy.”

TAKE THE ROLE OF EITHER MARTIN OR AN ADVISOR TO MARTIN

How can Martin be confident the D&O policy is indeed “good stuff?”

Who is most likely to sue whom?

What are the primary litigation risks to Martin?

If Martin is tagged in a lawsuit, how will his defense costs be paid?

What if Martin isn’t sued, yet, but sufficiently threaten by someone’s attorney that Martin thinks he needs his own legal counsel?

BONUS QUESTIONS

If you are on the board of a non-profit, however small, answer the above questions.