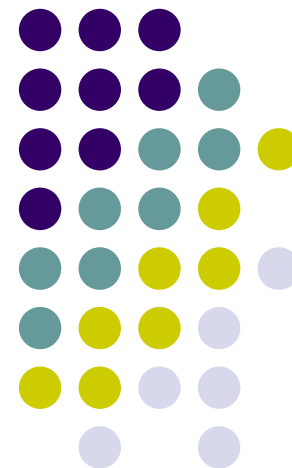


Using CI to Stay Ahead of the Curve

Jan Rivers, Dorsey & Whitney LLP
**Mark Gediman, Best Best & Krieger
LLP**

NOCALL Spring Institute
San Francisco
April 24, 2009



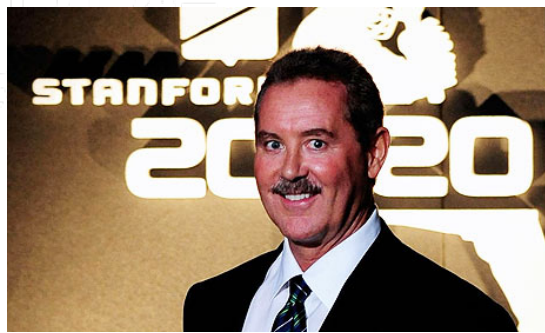


“May you live in interesting times....”

-- ancient Chinese curse, old Scottish saying, 1950s science fiction novel
quote or....

富







Same As It Ever Was? Hardly...

“And you may ask yourself- well...how did I get here?”

--- “Once in a Lifetime,” Talking Heads

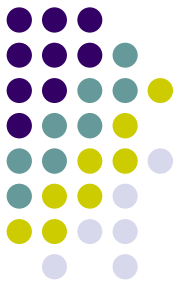




More Importantly

You may ask yourself-

What's Next?





Overview

- What's going on out there?
- Could this have been foreseen?
- What's the current situation?
- What portends for future?
- What can we do to stay ahead of the curve?



“Prediction is very difficult,
especially about the future.”

- Niels Bohr





Case Studies

- Credit Crisis
- Thatcher Proffitt

Credit Crisis- One Explanation (Alan S. Blinder)



- Six errors on the path to the financial crisis, in chronological order:
 - Wild derivatives
 - Sky-high leverage
 - Subprime surge
 - Fiddling on foreclosures
 - Letting Lehman go
 - TARP's detour



This Also Played Large Factor:

$$\Pr[T_A < 1, T_B < 1] = \phi_2(\phi^{-1}(F_A(1)), \phi^{-1}(F_B(1)), \gamma)$$

Gaussian Copula

http://marketplace.publicradio.org/display/web/2009/02/24/pm_stock_formula_q/



$$\Pr[T_A < 1, T_B < 1] = \Phi_2(\Phi^{-1}(F_A(1)), \Phi^{-1}(F_B(1)), \gamma)$$

Here's what killed your 401(k) *David X. Li's Gaussian copula function as first published in 2000. Investors exploited it as a quick—and fatally flawed—way to assess risk. A shorter version appears on this month's cover of Wired.*

Probability

Specifically, this is a joint default probability—the likelihood that any two members of the pool (A and B) will both default. It's what investors are looking for, and the rest of the formula provides the answer.

Copula

This couples (hence the Latinate term copula) the individual probabilities associated with A and B to come up with a single number. Errors here massively increase the risk of the whole equation blowing up.

Survival times

The amount of time between now and when A and B can be expected to default. Li took the idea from a concept in actuarial science that charts what happens to someone's life expectancy when their spouse dies.

Distribution functions

The probabilities of how long A and B are likely to survive. Since these are not certainties, they can be dangerous: Small miscalculations may leave you facing much more risk than the formula indicates.

Equality

A dangerously precise concept, since it leaves no room for error. Clean equations help both quants and their managers forget that the real world contains a surprising amount of uncertainty, fuzziness, and precariousness.

Gamma

The all-powerful correlation parameter, which reduces correlation to a single constant—something that should be highly improbable, if not impossible. This is the magic number that made Li's copula function irresistible.



Credit Crisis- CI Failure?

- Much debate
- Hindsight's 20/20

“Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity are in a state of shocked disbelief.”

-- Former Fed Chairman Alan Greenspan



Meanwhile in the Legal Arena

- Firms dissolving
- Layoffs and more layoffs
- Deferred start dates
- Paying associates to go away
- De-equitizing partners
- Calls for capital
- Wage freezes
- No bonuses



What Happened?

Thacher
Proffitt

Thacher Proffitt & Wood LLP



Thacher Proffitt & Wood

- Structured finance was driver of firm's business model
 - 2007: 40% of headcount and as much as 55% of revenues
 - As much as 70% of firm revenues from structured finance and real estate groups
 - Two practices worked closely together
- Growth boom to keep up with securitization boom
 - Debt reached \$30 million, putting firm at creditors' mercy when market turned



Thacher Proffitt & Wood

- Lots of “unidimensional” junior partners who were “dead weight” when market turned
- Firm tried to diversify via lateral hires
 - Most were in capital markets, thus hurt firm in downturn



Thacher Proffitt & Wood

- Subprime mortgage crises wiped out some of Thacher's clients:
 - New Century Financial Corporation
 - American Home Mortgage Investment Corporation
 - Countrywide Financial Corporation
- Series of 5 layoffs in 12 months
- Still distributed partner bonuses equal to 15% of firm's revenue despite 22% decline in partner profits for 2007



Thacher Proffitt & Wood

- 2008:
 - Partners each made \$80,000 capital contribution
 - Firm held partner holdbacks
 - Bear Stearns collapses:
 - Thacher's largest client
 - Start of Thacher's credit crisis and breach of covenant with creditor Citigroup
 - Citigroup could now force the firm into dissolution at any time
 - Defecting partners and associate layoffs left firm with 2 floors of expensive NY office space it didn't need & was unable to sublet



Thacher Proffitt & Wood

- Firm hired consultants to chart forward course
 - **Ultimatum: merge or dissolve**
- King & Spalding ended merger discussions 12/9/08
- Citigroup now demanded payment by 12/31/08
- Planning committee approached Sonnenschein resulting in firm taking on 40 Thacher partners, 60 associates and 61 staff



Thacher Proffitt & Wood

- Sonnenschein acquisition included most of Thacher's structured finance dept and members of the practice groups who worked most closely with them





“It is pardonable to be defeated,
but never to be surprised.”

-- Frederick the Great



2002 Academy of Competitive Intelligence Survey



- 98% of respondents predicted their companies' exposure to business risk would increase over next 3 years
- 92% were surprised by *at least* one significant event in the past 5 years

Frost & Sullivan Conference Survey, 9/2008 (Ken Sawka)



- Major sources of strategic surprise:
 - Rapid technology advances
 - Unforeseen customer demands and needs
 - Economic conditions
 - Competitor activities and behavior

Frost & Sullivan Conference Survey, 9/2008 (Ken Sawka)



- Coping mechanisms they used to deal with external surprise:
 - Conduct research
 - Brainstorming sessions
 - **Do nothing**

How Can You Stay Ahead of the Curve?



- Early warning systems
- Scenario planning





Early Warning Systems

- What are they
- How do they work
- What's required
- Who needs to be involved



Definition

“Those intelligence activities intended to detect and report time-sensitive intelligence information on foreign developments that could involve a threat to the United States or allied military, political, economic interests or to US citizens abroad.”

- US Joint Chiefs of Staff 1987



“Surprise attacks are successful because the other side was the captive of obsolete assumptions and beliefs that led, in the absence of countermechanisms, to **ignoring signs of risk.**”

- Ben Gilad



Blindspots

- “Supremacy of internal convictions over facts and findings” - Gilad
- Lead decision makers to adhere to wrong strategies, to ignore market evidence, etc.
- “Industry dissonance” - company’s strategy no longer fits market reality





Main Types of Strategic Risk

- Internal:
 - Operational
 - Asset-Impairment
- External:
 - Competitive
 - This is where industry dissonance falls



Early Warning is Not Monitoring

- Monitoring:
 - Identify high-certainty, high-impact events
 - These are the problems/ opportunities on your doorstep
 - Are tactical intelligence problems, no mysteries
- Early Warning:
 - High-impact, but uncertain events
 - Don't know whether or not they will occur



Early Warning is Not Monitoring

“Seeing a few steps ahead does not mean you need a crystal ball, just that you need to prepare for the uncertain possibilities.”

- Leonard Fuld

Developing Early Warning System (Wergeles)



- What competitors and other industry players do we need to watch?
- What market activities, emerging technologies, and social or political issues need to be monitored for early warning signals?
- Where are the sources of information that may indicate a potential disruptive threat or opportunity?

Four Steps for Developing Early Warning System (Fuld)



- Draw road map of possible futures
- ID the signals to watch for each of these futures
- Find the people who will watch those signals in course of their everyday work → Trend Analysis!!
- Create an approach to act upon quickly once one of the futures begins to emerge

Developing Early Warning System (Wergeles)



- Intelligence practitioner needs to:
 - Successfully identify the important issues, players and early warning indicators
 - Collect the requisite information
 - Disseminate that information to the decision-maker in a timely manner

Developing Early Warning System (Wergeles)



- Create watch list- set of prioritized issues identified by senior management as important for your company's success
 - List forms the basis of the early warning areas from CI person's perspective
- Key players are closely associated with those watch list issues
- Indicators are the various signals that would precede the activities of interest

Developing Early Warning System (Wergeles)



- Two techniques for watch-list exercise:
 - Backcasting
 - Scenario forecasting

Developing Early Warning System (Wergeles)



- Effective dissemination must include:
 - Nature of the threat (what, how, where)
 - Immediacy (when)
 - Players involved (who)
 - Characterize the likelihood that an action might occur
- Early warning alerts:
 - Phone call
 - Short meeting
 - 1-2 page summary
 - E-mail exchange with decision makers

Early Warning System Deliverables (Gilad)



- Irregular management alerts and regular executive briefings
- Reports should never be only data
- Writing of a management alert is art form; cannot and should not be done by just anyone
- In politically charged environment, buffer between analyst & management may be desirable
- Use tripwires for worst-case events



Organizing Early Warning Efforts

- Ellen Naylor:
 - Monitor secondary resources
 - Combine secondary and primary resources
 - ID primary resources w/in your company
 - ID primary resources outside your company
 - ID key events





Challenges with Early Warning

- Seat at table
- Executive receptiveness
- Lack of cohesive effort
- Strategic, not tactical





Challenges with Early Warning

- Top executives are often the last to recognize changing circumstances:
 - Ego-involvement
 - Are most insulated from field intelligence
 - No one really helps them & intelligence they seek comes from others as insulated as they are



Challenges with Early Warning

- 2 biggest red flags for lack of an early warning culture (Gilad):
 - Fierce politics
 - Very strict hierarchy

- For law firms:
 - Lawyer personality
 - Owners are involved in the day-to-day operation

Gilad Test for Early Warning Tendencies



- Does top management listen to its middle managers?
- How does the CEO perceive his role- a strategist or a statesman?
- How often does the company use strategy-consulting firms?
- How do the company's executives handle "pests"- i.e. people asking difficult questions?



Early Warning

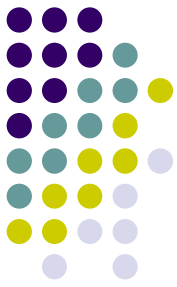
- Requires:
 - Continuity and the build-up of internal knowledge
 - Management that **trusts & listens** to its people
 - An agreed-upon, prioritized list of the most significant change drivers to watch
 - A collective, collaborative, coordinated effort



Scenario Planning

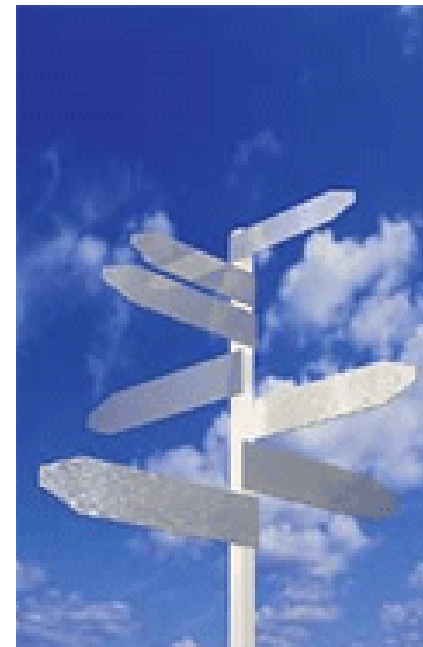
- What is it
- What's involved/ required
- Who's involved
- What's needed





Scenario Planning

- Develop series of plausible scenarios
- Develop series of strategies
- Identify options that cross all scenarios
- Implement early
- Watch for signposts

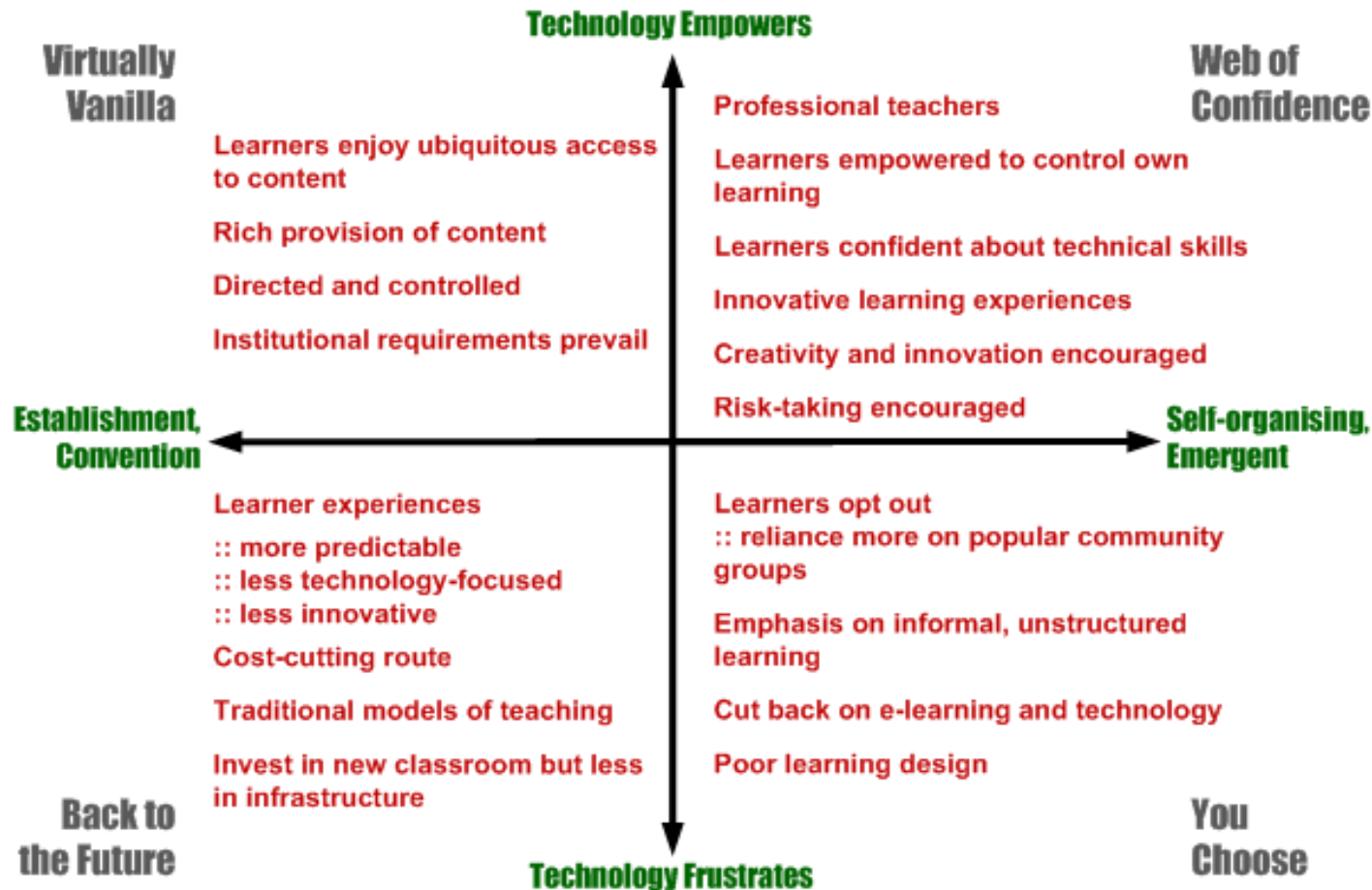




Examples of Scenarios for e-Learning

<http://www.jiscinfonet.ac.uk/infokits/learning-space-design/imagination/techniques/scenario-planning>

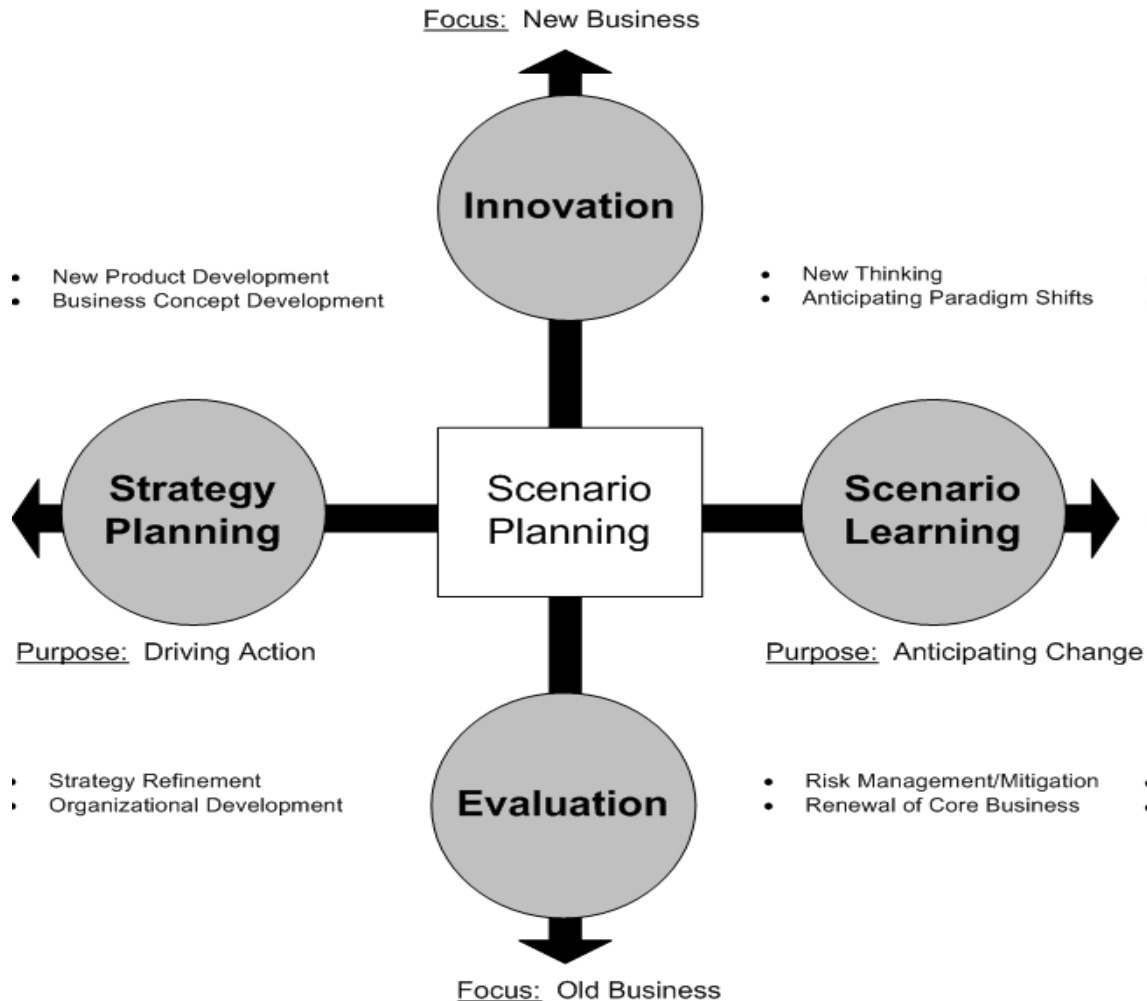
Scenario Planning | The Edinburgh Scenarios

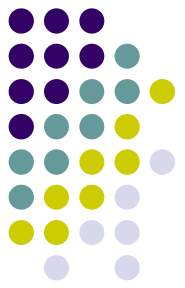




Another Scenario-Planning Model

<http://www.philology.net.au/philology/?q=node/78>





We're all in this together...





Working Together

- Understanding and meeting upper management's needs
- Working with groups w/in firm
- Building alliances/ partnerships across departments and practices

Know the major industries who make up the majority of your firm's revenue:

- What's going on w/ them?
 - SWOT
 - Regulatory issues, growing/ shrinking, new technologies, consolidation, going overseas
 - I-bank analysis



Working Together

Know the clients who make up the majority of your firm's revenue:

- What's happening in their industry?
- Monitor their revenues and other measures
- News
- Regulatory issues, etc.
- Affects of credit crisis fallout on them (closing offices/ locations, having layoffs, fewer orders/ jobs coming into them, etc.)



Working Together

Know your firm's strategic plan and goals:

- What areas are they focusing on or ignoring?
- Was much effort planned for area/ industry now hard hit by economic crisis?
- How would various scenarios affect the business?



Tools and Other Tips

West Monitor
atVantage
Alerts
Blogs
Twitter
Google
Redwood
Government Agencies
Associations



Competitive Intelligence

Tools

Market

Business

Client

Competitors

- Legal Business News Monitors
 - Blogs
 - Twitter
- Practice Specific News Monitors
- Information funneled from Attys

- Law Firm Groups
- Professional Associations
- Redwood
- Elite
- Firm News Monitors
- Internet

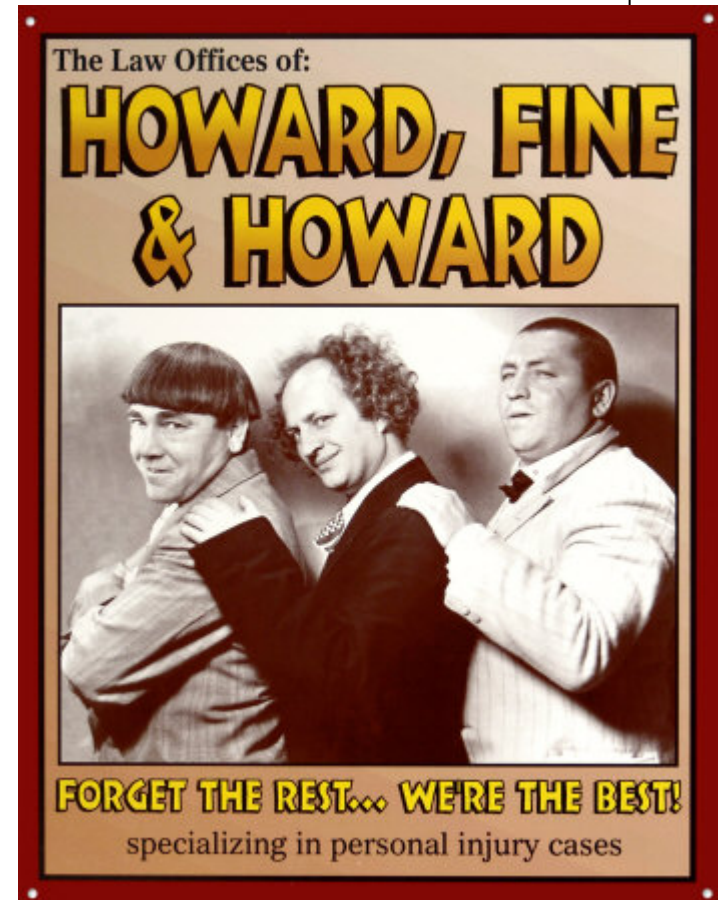
- News Sources
- Public Records
- Courthouse News Service
- Extranets
- CRM
- West Monitor
- atVantage

- Contract person to make inquiries
- Public Records
- Courtlink

Tools:

What's going on in your firm?

- Redwood Analytics
- Billing Department Reports
- Increases/Decreases in Practice Group productivity?
- Types of news mentions





Tools:

What's going on in the Legal Industry?

Blogs:

-3 Geeks and a Law

<http://www.geeklawblog.com/>

-Above the Law

<http://www.abovethelaw.com/>

-Legal Pad from Law.com

<http://legalpad.typepad.com/>

-Lawshucks

<http://lawshucks.com/>

Twitter

<http://twitter.com>



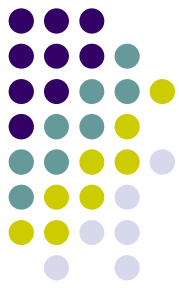


Tools:

What's going on in the Legal Industry?

News:

- National Law Journal
- Regional Sources:
 - LA Daily Journal
 - SF Recorder
- American Lawyer
- ABA Journal



Tools:

What's going on in the Real World

- National and Local Papers
- Local TV Stations
- Feature Reporting → Is there a recurring theme?



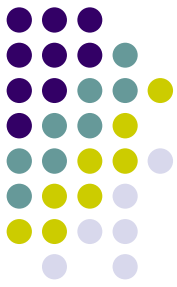


Examples (via LexisNexis) :

- “The <Office of Federal Housing Enterprise Oversight> agency...has required Freddie Mac to increase by 30% its cushion of reserve capital” **Monterey County-Herald, February 2004**
- “Mortgage giants Fannie Mae and Freddie Mac could pose a threat to the country's financial system if their ability to take on new debt is not restrained, Federal Reserve Chairman Alan Greenspan said yesterday ” **AP, February 2004**
- “Subprime Market Has Boomed During Past Decade” **Ventura County Star, November 2004**
- “Washington Mutual's Growth Strategy Plagued by Missteps; The nation's largest thrift is cutting jobs and closing offices after problems with integrating its acquisitions” **LA Times, August 2004**



So, what will the future bring?





Current Curves

- Outright survival
- End of Lawyers
- Restructuring of the law firm model
- End of billable hour



End of Lawyers?

- How the legal marketplace will operate in the future
- Trends “...strip lawyers of the control and influence they’re accustomed to exercising over the legal services marketplace.” —Jordan Furlong, Law21.ca blog
- Clients will call the shots as time goes on

Not really “end” but could be if lawyers ignore or resist the changes in the surrounding environment

2009 LMA Law Firm Scenario Planning Workshop (4/2009)



- Scenario #1- The Great Pretenders
- Scenario #2- Shattered!
- Scenario #3- The Big Chill
- Scenario #4- Davids vs. Goliaths



Questions?

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