FOR BUSINESS

Entrepreneurs are frequently lauded as the growth engine of the economy because of their ability to turn an idea into a source of production and employment. The *Yale Law Report* talked with three alumni about their experiences starting and running businesses.

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Although it was nearly twenty years before he would go to law school, **Ed Nicoll** ’97 saw an opportunity in the shifting of the legal superstructure around the finance industry.

Prior to 1975, the commissions charged by brokers in the New York Stock Exchange were fixed by law. However, as part of a broad series of reforms that year, commissions were deregulated. Nicoll and Larry Waterhouse, a stockbroker and friend of Nicoll’s, decided to open a brokerage, called Waterhouse Securities, and compete with the large firms by offering lower prices.

Nicoll and Waterhouse were not the first to come up with this idea; in fact, Nicoll calculates that Waterhouse Securities was the sixteenth discount brokerage. They raised around $200,000 in investments and commitments (“What we then thought was an enormous amount,” says Nicoll). Nicoll, being only in his early twenties, couldn’t get a loan for his contribution to the initial funding. “I ended up borrowing $3,000 off my MasterCard,” he remembers.

Before they could open, they had to establish relationships with vendors, who would help them execute their trades and navigate a long regulatory approval process. Then they had to think about the mundane things, like furniture for the new office. They bought a used partner’s desk and Waterhouse and Nicoll wheeled it up Wall Street on a dolly to the fledgling Waterhouse Securities. On April Fools Day 1979, they opened their doors and put an ad in the *Wall Street Journal*—and they got a serious and unexpectedly strong response. Nicoll, Waterhouse, and their ten or so employees were off.

Though their business model was designed to shake up Wall Street, Nicoll and Waterhouse wanted to project a sense that their firm was well established and worth the trust of potential customers. They chose Waterhouse as the name for the firm since it resonated with Price Waterhouse and was “a solid name,” according to Nicoll. They put columns on their letterhead and joined the NYSE. “We wanted a highfalutin address,” says Nicoll. “We literally moved into the last building on Wall Street.... Anyone who knew Wall Street knew it was a terrible address...but we thought when we went out to our retail customers, since they didn’t know who we were, that it was important.”

Despite the complications of compliance, finance, and accounting inherent in their industry, Nicoll says that much of what they did was little different from running a candy store—paying bills, managing employees. Waterhouse, as the older and named partner, acted as CEO, spending his time on finance issues and establishing relationships with vendors. Nicoll acted as president and focused on operations. “I did all the work. And he took all the glory,” Nicoll jokes. Nicoll was a detail man—down to the level of each word of code in the firm’s software. “I was very technologically savvy and I wrote a lot of programs that helped me to become more efficient.” He worked in BASIC, TRS-DOS, and UNIX, though he admits he was never good at documenting his work in any programming language.

“We were just a low-cost, well-oiled machine that took advantage of a rip in the time-space continuum of business caused by the regulatory disruption,” Nicoll says to explain the company’s growth in its early years. They opened offices in Los Angeles and San Francisco by 1981, quickly adding employees. “Because I was young, I was very comfortable hiring young people and giving them a lot of responsibility and sending them around the country,” says Nicoll. And this energy contributed to the company’s growth.

“I had a very loyal group of managers,” Nicoll says. “They would say, I think, that I was a good person to work for. But they would also say that I was a little bit nuts. I’m a bit of a screamer. I put my whole heart and soul into it.”

Nicoll adds, “When you own a business, nothing’s fun until you look back at it.” Then he recounts the moment when he knew that Waterhouse Securities was going to succeed, and he smiles a little in the comfort of reminiscing. After a few years, Nicoll and Waterhouse got an offer of $10 million for the business. “I did some quick calculations and I was worth about $500,000,” Nicoll says. “Larry, who owned much more than I did, was all of a sudden a millionaire. And I said to him at that time, ‘Boy, if I were you, I’d hit it big.’ But he didn’t.”

The partners’ faith in Waterhouse Securities was only shaken once after this, on Black Monday 1987. “Back then, you would do a trade and then you would send in a check after the trade. And we had people who bought stock the previous day... and their stock was down twenty, thirty

An image of Ed Nicoll, CEO of Instinet, appears on the electronic display of the NASDAQ marketsite in New York's Times Square, Friday, April 22, 2005, during a press conference to announce that NASDAQ will acquire Instinet.

Photograph by Diane Bondareff / AP Photo

points. And had they not paid, we would have been out of business," Nicoll says. "But people sent in their checks."

The business repaid their faith, continuing to grow, and Nicoll and Waterhouse took the company public in 1987 and then, when it had expanded to eighty offices and about 1,500 employees, sold it to Toronto-Dominion Bank in 1997. TD Waterhouse is now one of the largest online brokerages, familiar for its commercials starring Sam Waterston.

Nicoll can find a multiplicity of sources to cite for Waterhouse's success: there was the original regulatory change, which created an anomaly in the market; the firm was founded at the beginning of a long bull market; they had efficient business practices. Nonetheless, he points to the organization's singular purpose as its greatest advantage. "[Waterhouse] really stuck to its knitting in terms of serving individual investors," says Nicoll. "It never steered into giving advice, it always served what we call 'self-directed investors.'… We wanted to find people who were financially literate themselves, who felt that they could manage their own money, and then give them the lowest cost way that they could affect that.… We stuck to that from beginning to end."

At the same time, Nicoll says that entrepreneurs have to have the courage to "reinvent" themselves to manage a growing organization. "The skills that propelled you on as a kid, punching your hands through walls and screaming at people, are not necessarily the skills that make you successful running a complex global organization."

Nicoll says he loved his time at Waterhouse, but by 1994 he felt that he wasn't learning anything new. So, he reinvented himself one more time and became a law student, despite never having taken a college course. (He had gone straight from high school, to working on a sheep farm, to being a stock broker, to founding Waterhouse.)

There was some overlap between old persona and new, in that Nicoll ended up negotiating the sale of Waterhouse to Toronto-Dominion Bank while taking a class in The Law and Economics of Corporate Control. But, he says, he never mentioned his out-of-class experience in corporate deal-making and regulation. "I was smart enough to know not even to bring it up because that was a no-win situation for me," he says.

And for a few years after the sale, Nicoll took calls from TD's computer programmers with questions about the code he'd written years before but never properly documented.

Gerson Lehrman Group

Mark Gerson '98 and **Thomas Lehrman** '04 founded a research company called the Gerson Lehrman Group in 1998. As Lehrman tells it, their original concept for the business "was not that clear in our heads." Gerson had just finished law school and Lehrman had been on a fellowship in Spain after working for an investment firm, but they both wanted to start a business. They began by commissioning experts in various fields to write guides—"primers on their industry," says Lehrman—which Gerson Lehrman intended to sell to investors, businesses, consultants, lawyers, and others. "We both just enjoyed spending time with each other. We both were hard working, and I guess we both figured it would find a way of working itself out," remembers Lehrman.

After publishing the first several guides and finding few customers, Gerson and Lehrman realized they needed a sharper idea of how to market their product.

They decided to focus on selling research to fund managers and investment researchers. And after talking with a number of customers and potential customers, they refined their product, even though it meant discarding the original publishing model. "One of the things that customers were really interested in doing was following up directly with the specialists who had written some of the books," says Lehrman. Gerson and Lehrman saw a chance to provide a unique service by putting investors directly in touch with experts.

By early 1999, they were setting up the infrastructure to provide specialized research services. They focused on the health care and telecommunications industries, because both were undergoing powerful technological and regulatory changes, and many of Gerson Lehrman's potential customers were business experts, not experts in science or the law. Gerson Lehrman set up what they called Councils of Advisors, which were networks of experts (heart surgeons or semiconductor researchers, for example) who agreed to provide one-on-one consultations, participate in seminars, and/or fill out surveys.

"The more savvy fund managers are always looking for a research edge," says Lehrman. And Gerson Lehrman's unique approach made them a source of cutting-edge information. They sold subscriptions to their network of experts. By the end of 1999, Gerson Lehrman had about thirty clients and a pool of experts thousands deep. Though they hadn't broken even yet, Lehrman says, "It was very clear that we were on the right track."

Thinking of the thousands of interactions between clients and experts that they would have to handle if the business continued to grow, Lehrman says, "We recognized that a very important part of the business, in terms of enabling this growth, would be a focus on developing world-class information systems." They hired a chief technology officer, which Lehrman says was a big step forward, but they also had to plan how they wanted the business to work before automating those processes in their IT systems. Lehrman recalls some of the questions they had to deal with: "How would clients interface with us? What would our role be in helping them to understand the particular parameters of the project? How would we bring the experts into a particular project? How many would we bring in? And how would we handle all the emails and online collaboration which would be needed to enable those relationships? And again, we were inventing this from scratch because no one had ever really done it before."

Today, Gerson Lehrman's network of experts includes more than 150,000 people. Their original two areas of expertise have grown to seven, including legal, economic, and regulatory affairs and energy and industrials. They have offices in eight cities and approximately 180 employees.

But Lehrman is no longer the co-CEO of the firm. He stepped back from direct management of the firm when he started law school in 2001. He is currently working on nonproliferation policy at the U.S. State Department, though he still sits on Gerson Lehrman's board. Gerson is still running the company, with the help of an expanded management

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team. While Gerson and Lehrman are no longer partners on every decision about the business, they remain close friends. Says Lehrman, "I know that this came with risks, but in our business we did not distinguish between our business lives and our friendship. From the very beginning, it was very clear to me that Mark was going to be both a dear friend and a very effective business partner."

Open Source Risk Management

Unlike Nicoll and Lehrman, **Daniel Egger** '92 went to law school before he started a business. Which is just as well, since he probably won't have time to be taking any classes for a few years yet. He founded Open Source Risk Management in 2003, and comparing the business's development to a child's, says OSRM has gone from crawling to walking, but is far from out of the house.

The company was formed to address a vulnerability in the open source software movement. The open source movement—the programmers, developers, and businesses that produce computer programs that are distributed for free and can be modified and redistributed—has grown rapidly over the last few years. Linux may be the most prominent open source program. It can be used as a server platform or a desktop operating system and has been adopted by companies, including IBM and other Fortune 500 corporations, which benefit from the ability to tailor the system to their needs. However, in 2003 a company called the SCO Group sent demand letters to more than 1,500 companies that use Linux, claiming that part of the Linux software infringed on SCO's intellectual property. SCO eventually sued two companies that used Linux. These legal actions threatened to freeze the development of Linux.

"It's kind of an obscure issue," Egger admits, but one with significant ramifications. "The license that makes Linux available has explicit disclaimers of warranty, and says that the software is made available as is, and there's no indemnification associated with it," says Egger. "Combine that with the fact that copyright and patent are strict liability regimes in which innocent use is no defense, and you have a company that's using Linux, they know nothing about the inner workings of it, they've acquired it in good faith, and yet they are liable for patent and copyright infringement." Egger further points out that even if a claim is not valid, the expense of a lawsuit could cripple a business. "It may be obscure to the general public, but CIOs and VPs for information technology know that if they had to stop using Linux their whole operations would be completely disrupted."

Egger asked himself what would be the most efficient mechanism to deal with the risk of such lawsuits in order to allow businesses and software developers to continue working with open source software. He used the law and economics perspective he learned from Guido Calabresi to come up with a solution. "It seemed to me that the most effective mechanism would be some form of insurance where you would have a centralized body that would have an incentive to know about the risks, and to define what is and isn't an insurable risk, and to pay any licenses that should be paid." Then Egger asked why he shouldn't be the one to provide such a service.

Having already run a startup business and having worked as a seed-stage venture capitalist, Egger says, "I applied the due diligence process to this, the same as I would do to any idea that came through the door." He consulted with leaders in the Linux community, executives at companies that were using Linux, and vendors. Egger says the response to his proposal was uniformly positive. "This was a problem that everyone was worried about and felt that there was no good solution to, and we articulated a solution." He took a leave from his position as a partner at Eno River Capital and devoted himself to getting OSRM up and running.

"There's nothing like creating a valuable product or service literally from scratch. It's just very, very exciting," says Egger. OSRM began by evaluating the existing litigation risk in the Linux operating system. They searched for ownership disputes in Linux, then did a copyright review. "We came out with our own independent announcement last January, right in the thick of the whole SCO case, in which we said that we were unable to find any copyright infringement [in the Linux kernel]." The next step was a patent review, which Egger calls an "interesting challenge." The software they were examining has millions of lines of code, and they would have to check that against as many as 10,000 patents. "That's where our real technology expertise comes in, in figuring out statistical models so that we can accurately predict the patent infringement risk and keep it manageable."

OSRM currently offers risk management consulting services, and is working on getting everything lined up to offer open source insurance. "We have companies that have agreed to purchase the policy along the terms that we have laid out. And we're in the process of getting our regulatory approvals." He adds that he's never been involved in a start-up project that's gotten as much attention as OSRM, but to offer an insurance product they have to line up both several re-insurers and a sizable community of clients before they can launch. However, Egger promises, "Come hell or high water we'll have our product in 2005."

Egger hopes that the debut of his company's product will aid the development of the open source movement by allowing companies that want to work with open source software to reliably price the risk of litigation. And he has designed the entire company to be in tune with the interests of the open source community. One thing he didn't anticipate was that customers would be interested in his providing risk management for open source programs other than Linux. Now he's looking at expanding OSRM's portfolio. "It's just a bigger scale of work than we first thought, but the basic model is the same," he says.

An Entrepreneur Looks Back

Ed Nicoll has now passed through several incarnations in his post-entrepreneurial career. When he finished law school in 1997, he found that the industry he had worked in was greatly changed by a combination of discount brokerages like Waterhouse and technological development, as the World Wide Web enabled electronic trading.

Nicoll no longer had to start from nothing when he saw a business opportunity. He orchestrated a takeover of an online trading firm, Datek, and was able to raise around $900 million dollars to support the deal. He guided Datek for two years, then sold it at a profit to Ameritrade, and spun off a small unit of Datek that served institutions into a company called Island. Nicoll merged Island with Instinet and took over the management of the new company, which by 2005 was handling a quarter of the trades on NASDAQ. As this article went to press, Nicoll was overseeing the implementation of a deal in which two of Instinet's three divisions were sold off, while he would continue to operate one as an independent business.

Being at the head of an international corporation and negotiating with other lodestars of the information and finance industries, like Reuters and NASDAQ, has given Nicoll a unique perspective on his early days as an entrepreneur. He argues that many of the same qualities are important in both roles. "The world still pays an enormous dividend to people who are willing to work hard, who are willing to pay attention to detail, who are willing to tackle the most difficult tasks first," he says. He also talks about the importance of staying in touch with every component of the business and being able to adjust quickly when changes are needed.

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But he identifies a fundamental difference between his two roles. At Instinet, he's overseen a reduction in the number of employees, whereas at Waterhouse, which steadily expanded, he watched people he had hired move up the management ladder. "Growth is obviously better than shrinking, but it also fundamentally is a salve to a lot of underlying problems," says Nicoll.

Nicoll also misses the hands-on ethos of the entrepreneur that once had him pushing a desk up Wall Street. Though he now has departments under him to manage his company's information technology and worry about data storage, he wistfully remembers that at Waterhouse he occasionally had to sleep in his office with an alarm set to wake him up every hour in order to nurse his computer system through a download. "I'm not sure I'm as successful as a senior executive of a global company as I was as a young entrepreneur driving up a hill with a band of fifteen men and women," says Nicoll. "I yearn for those days. I'm very fond of them." Y