

# Electronic Trading Agreements for Quants

*By Mauro Viskovic, Viskovic LLC  
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Hedge fund advisory firms that use quantitative-based investment strategies need to be mindful of various issues prior to executing an electronic trading agreement with a brokerage firm. Such agreements, if not carefully reviewed and negotiated, can detrimentally affect quant firms.

A primary matter to address when negotiating an electronic trading agreement is the protection of the advisor's proprietary trading codes. Certain provisions in a broker's standard template of the electronic trading agreement can potentially undermine the advisor's efforts to safeguard its codes.

For example, the electronic trading agreement will likely have a very broad definition of the broker's electronic trading service, which may include all "trade data" or "trade related information." A related provision in the agreement will then establish the broker's proprietary rights in the trading service. As such, it is critical that the trading service definition be modified to exclude the trade order inputs provided by the advisor. Otherwise, the broker's proprietary rights may extend to that trade order data. That would be problematic because if the advisor forfeits any rights in its trade order data, then there is an increased risk that such data may be transferred to third parties or reverse-engineered for the purposes determining the advisor's trading codes that generate the trade order data.

To fortify the advisor's rights in the trade order data, the electronic trading agreement should contain an explicit provision stating that the advisor exclusively owns all data posted to the electronic trading service. Moreover, the agreement should contain language that prohibits the broker from transferring such data or attempting to reverse-engineer such data to decipher the advisor's proprietary trading codes.

Another vital issue for advisors is preserving the confidentiality of their codes and any other proprietary information. Such information is highly sensitive from a competitive standpoint and advisors employ substantial safeguards to protect the proprietary and confidential information related to their investment strategies, portfolio holdings and investor base. As such, the electronic trading agreement should provide for robust confidentiality protections and restrict the broker's use of the advisor's confidential information solely to its providing of the electronic trading service and for compliance with applicable laws.

Advisors should also minimize any risk that a third party might assert rights to all or any component of the electronic trading service and thus reduce exposure to an infringement claim.

To address that risk, the advisor would need an indemnification provision in the agreement that requires the broker to hold harmless the advisor against any such third party infringement claims.

Furthermore, any boilerplate limitation of liability provisions in the license agreement should be excluded from applying to the broker's indemnification obligation. In that regard, such limitation of liability provisions should also not apply to any breaches by the broker of the provisions relating to confidentiality or the advisor's rights in its proprietary information.

Advisors should note, however, that the electronic trading agreement would likely, in turn, obligate the advisor to indemnify the broker for any liabilities arising out of the advisor's use of the trading service. The agreement should exclude from this indemnification obligation any liabilities attributable to the broker's gross negligence or willful misconduct.

Electronic trading agreements can pose considerable risks to quant firms. Each agreement is different and must be meticulously reviewed by a qualified attorney to recognize and advise how to address potential risks. Negotiating important terms in the electronic trading agreement will help avoid undesirable outcomes and the possibility of costly and time-consuming litigation.

*Mauro Viskovic is the Founder and Managing Member of Viskovic LLC, a New York City law practice representing clients in corporate, securities, commercial, employment and tax law matters, focusing on issues affecting the quantitative investment management community.*

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