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Hedge Fund Vendor Agreements

Hedge Fund-Specific Issues in Portfolio Management Software Agreements and Other Vendor Agreements

By Robert R. Kiesel and David L. Cummings, *Schulte Roth & Zabel LLP*

Hedge fund managers require various third party vendor-provided products and services to manage their daily operations. Typical agreements entered into by hedge fund managers for such products and services include trading system agreements, license agreements for investment analysis tools, risk management and portfolio valuation software, market data license agreements, software development agreements, hardware purchase agreements, website design agreements, consulting agreements and administration agreements.

All vendor agreements cover a common set of issues, including vendor performance obligations, indemnification and limitations on liability. In addition to these common issues, vendor agreements entered into by investment managers contain a few distinctive issues arising from the unique structure and the private nature of hedge fund groups. These unique issues are discussed below with emphasis on information technology (IT) agreements.

Choosing a Vendor and Vendor Breach

It is prudent to conduct due diligence on a proposed vendor and its creditworthiness prior to entering into a contract, especially if the vendor is not a household name. The financial substance of a vendor can determine how aggressive the hedge fund manager will need to be in requiring the vendor to place intellectual property (such as software source code) in escrow with a third party agent for release to the hedge fund manager upon the vendor breaching the agreement or reorganizing or ceasing its business. If applicable technology is mission critical, it is prudent for the hedge fund manager to secure rights in advance to use the licensed technology upon the occurrence of a vendor breach.

Note that some vendors will not negotiate changes to their agreements. In this situation, discomfort with the vendor's contract provisions can be soothed somewhat if the hedge fund manager can get comfortable with the vendor's product and the vendor itself. The best source of this due diligence information is other customers of the vendor. It is routine for vendors to offer customer references. Hedge fund managers should take advantage of these offers.

Hedge Fund Structures Background

Some hedge fund-specific vendor contract issues relate to the unique structure of hedge fund groups. A U.S. domestic hedge fund is typically structured as a limited partnership with two management entities: the general partner of the hedge fund limited partnership, and the hedge fund manager of the hedge fund. The GP is typically formed as a limited liability company that is controlled by its managing members. The hedge fund manager is often formed as a limited partnership, controlled by a general partner (a limited liability company that, in turn, is controlled by its managing members that are often the same as the GP's managing members). While the GP has overall responsibility for managing the hedge fund, the GP delegates management of the day-to-day operations and investment activities of

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the fund to the hedge fund manager. Offshore hedge funds are typically organized in tax haven jurisdictions, such as the British Virgin Islands or the Cayman Islands, as corporations. Similar to domestic funds, management of day-to-day operations and investment activities of offshore funds are handled by the fund's manager. Funds typically also hire an administrator to process investor subscriptions, manage routine investor communications and conduct some portfolio asset valuations.

A single hedge fund manager entity may manage multiple affiliated hedge funds at the same time. Similarly, a single entity may be the GP of multiple domestic hedge fund limited partnerships. In both domestic and offshore funds, the hedge fund manager employs a staff and is paid a management fee for managing and advising the funds. The hedge fund entities themselves serve solely as investment vehicles that have no employees (their only assets are cash and investment portfolios).

Issues Related to Hedge Fund Structure

Party Selection

When a hedge fund group enters into a vendor agreement, the appropriate contracting party must be selected from the various entities comprising the hedge fund group. The hedge fund manager is the entity responsible for managing the operations of the funds, and is the entity employing the people that will actually use the vendor's product. Accordingly, it is typically the hedge fund manager that enters into vendor agreements.

In some cases, a hedge fund may be a direct party to a vendor agreement, such as an administration agreement. In these instances, the agreement needs to permit the hedge fund manager to use the applicable services/products.

IT Agreement Standard Scope Restrictions

Standard form IT vendor agreements limit the use of supplied technology to the customer's "internal use" only. Broader rights are necessary to permit the hedge fund manager's affiliated funds, fund general partners, investors and administrators to obtain the benefit of the hedge fund manager's use of the products. Specifically, when a hedge fund manager enters into a vendor agreement as a service recipient, it is useful to include contractual language stating that "the services provided to the hedge fund manager may be used by the hedge fund manager, for the benefit of the hedge fund manager or its affiliates (including managed accounts and managed investment funds)."

Liability for Trades

A related problem arises with trading systems. A hedge fund manager uses electronic trading systems to enter into transactions on behalf of the hedge funds it manages. Although license rights to use the system must be granted to the hedge fund manager, the agreement should also provide that the specific hedge fund on behalf of which a trade is made will be the only entity liable for settlement of the trade. Hedge fund managers should include language similar to the following to make the distinction clear: "With respect to the satisfaction of the obligations and liabilities arising under or pursuant to transactions, the vendor shall only have recourse to the entities to which the hedge fund manager provides investment advisory or investment management services, and only to the extent of that portion of a transaction that is allocated to such entities, and shall not have recourse, whether by set-off or otherwise, in respect of such obligations, to or against the hedge fund manager or any of its affiliates."

Use of Output/Results

Another issue involves the use and sharing of a vendor's product output or results, such as the use of market data

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or investment tool analytical results in charts and statistics provided to investors, administrators and the media. Because standard form vendor agreements will not allow this sort of data/output disclosure or distribution, rights to distribute this data/output must be specifically negotiated. For example, a market data vendor will usually allow limited redistribution rights for snap-shots of historical data (i.e., the data may be relatively current, but is static, not self-updating on a real-time basis). If the vendor agreement does not permit such use, hedge fund managers might consider adding language permitting that "in the ordinary course of the hedge fund manager's business, the hedge fund manager may include limited excerpts of the data in internal correspondence or memoranda, or in reports, presentations, graphs and other publications to its clients and prospects."

Issues Related to Hedge Fund Secrecy

Offerings of private investment fund interests are typically exempt from SEC registration under Rule 506 of Regulation D of the Securities Act. The Reg D exemption is available only as long as the issuer offers the interests on a private placement basis (i.e., without general solicitation or advertising). Registered investment advisers are allowed to hold themselves out as investment advisers, but hedge fund interests themselves are still required to be privately placed. Accordingly, publicly disseminated information about a hedge fund manager and its funds must be closely guarded. Regulations contribute to the private or secret nature of hedge funds, but the private nature of hedge fund investors reinforces a hedge fund manager's propensity for discretion. Several contractual issues stem from this need for secrecy.

Confidentiality

One of the most important assets of a hedge fund manager is its proprietary business information. Vendors should be responsible for keeping information about a hedge fund manager and its funds (including trades made and trading strategies) confidential. While vendor agreements typically obligate the vendor to keep its client's non-public information confidential, they do not usually specify the specific business information that is important to a hedge fund manager. Standard confidentiality provisions cover information of the contracting party, but do not always cover confidential information of the contracting party's clients and investors. For instance, in the context of a trading systems agreement, the agreement should state that "all information and orders communicated by the hedge fund manager through the trading system, information regarding the hedge fund manager's trading activity, business practices, policies, and strategies and all information regarding the hedge fund manager's clients, shall be deemed confidential information."

A note on data ownership: hedge fund managers routinely input highly sensitive data into their technology systems. Technology vendor agreements should provide that the hedge fund manager owns all such information (in addition to requiring the vendor to treat the information as confidential). IT vendors in some narrow instances may be granted rights to use the data on an anonymous basis, but hedge fund managers should be careful not to grant ownership rights in the data to third parties.

In-House Systems versus Third Party Systems

A hedge fund manager's secrecy and security concerns can be so great that it may choose to create its own IT systems, despite the increased expense, rather than use third party vendors. Internal development raises a host of issues that need to be considered, many of which relate to ensuring that the hedge fund manager owns or can use all developed technology and related materials (e.g., software source code,

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processes, and documentation), including, whether: (i) the developer is an employee or an independent contractor of the hedge fund manager; (ii) the hedge fund manager or one or more hedge funds pays for the development costs; and (iii) the developer is permitted to use general know-how that it has obtained during the course of development in relationships outside of its relationship with the hedge fund or hedge fund manager. Similar issues regarding ownership and usage rights need to be considered in situations where systems are built on top of existing commercial software and when commercial software is customized. Lastly, even though systems may be insourced, they are built by employees and consultants that will need to be under restrictive contracts containing the same protections discussed here with respect to third party vendors.

Privacy

If it is possible that a vendor will have access to fund investor personal non-public information, such as addresses and other personally identifying information, the contract should require the vendor to: (i) keep such personal information confidential; (ii) not use the personal information for any purpose except as required to perform the contract; and (iii) limit disclosure of the personal information to only the vendor's employees who need to use the information to perform a contractual obligation. The vendor should represent that it maintains adequate backup facilities with respect to the information and adequate security measures to protect against unauthorized access to the information. In addition, the vendor should agree to protect the information in accordance with the requirements of personal information and data security laws.

Arbitration

Hedge fund managers usually prefer vendor disputes to be resolved by arbitration rules and proceedings rather than by litigation. As opposed to public litigation, arbitration is private and can be kept confidential, and permits the parties to seek substantially the same remedies and relief that a court can provide.

Publicity

Vendor contracts often include provisions permitting vendors to use a customer's name in marketing a vendor's products. Hedge fund managers generally prefer not to allow vendors to use their names in marketing or for any other purpose. The very existence of the relationship between the hedge fund group and the vendor is considered confidential.

Conclusion

When a hedge fund manager enters into a vendor agreement, the unique structural, regulatory and privacy concerns of the manager and the manager's affiliates should be considered, in addition to the routine issues that are common to vendor agreements entered into in other industries.

Robert R. Kiesel is a Partner at Schulte Roth & Zabel LLP, chairs the firm's Intellectual Property, Sourcing & Technology Group, and is also a member of the firm's Finance Group. He focuses his practice on the preparation and negotiation of various types of commercial agreements, including information technology agreements, equipment and vendor finance agreements, supply agreements and services agreements.

David L. Cummings is an Associate in the Intellectual Property, Sourcing & Technology Group at Schulte Roth & Zabel LLP. David's practice includes the preparation and negotiation of various types of information technology, intellectual property and services agreements.