Trade Errors

How Should Hedge Fund Managers Approach the Identification, Prevention, Detection, Handling and Correction of Trade Errors? (Part Three of Three)

By Jennifer Banzaca

Trade errors can cause substantial harm to hedge fund managers and their investors. Such errors can, among other adverse consequences, undermine investors’ confidence in a manager’s trade execution capability; cause a manager to miss investment opportunities; and divert investment and operating resources in the course of correcting errors. As such, managers, investors and regulators are theoretically aligned in their shared interest in avoiding trade errors. As a practical matter, however, there is no regulatory roadmap to best practices for trade error prevention, detection and remediation. SEC guidance has been sparse on this topic; and industry practice has largely filled the vacuum left by the dearth of authority.

Accordingly, in the area of trade errors (as in other areas, such as principal transactions), hedge fund managers are left to divine industry practice — and, further, to conform relevant practice to the specifics of their businesses. How can hedge fund managers do this?

To begin to answer this hard and multifaceted question, The Hedge Fund Law Report has been publishing a three-part series on preventing, detecting, resolving and documenting trade errors. This third installment in the series discusses the allocation of losses and gains resulting from trade errors among a manager and its clients; limitations on the allocation of trade error losses; documentation of trade errors; whether managers can obtain insurance to cover losses resulting from trade errors; and common mistakes managers make in handling trade errors. The first article in the series discussed the challenge of defining a trade error; a manager’s legal obligations relating to the handling of trade errors; and the policies and procedures that managers should consider to prevent, detect, resolve and document trade errors. See “How Should Hedge Fund Managers Approach the Identification, Prevention, Detection, Handling and Correction of Trade Errors? (Part One of Three),” The Hedge Fund Law Report, Vol. 6, No. 10 (Mar. 7, 2013). The second article in the series outlined various measures to prevent trade errors; detect trade errors after execution; report trade errors once identified; resolve trade errors; and calculate losses resulting from trade errors. See “How Should Hedge Fund Managers Approach the Identification, Prevention, Detection, Handling and Correction of Trade Errors? (Part Two of Three),” The Hedge Fund Law Report, Vol. 6, No. 11 (Mar. 14, 2013).

How Should Hedge Fund Managers Approach Allocating Gains or Losses Resulting from Trade Errors?

General Overview

Managers differ as to how they allocate losses and gains resulting from trade errors, and this variation is attributable in part to differences in a manager’s investment strategy, organization and operations. Kevin Duffy, a partner at Kaufman Dolovich Voluck & Gonzo LLP, explained, “Some funds have very complicated strategies, and those are the ones, I think, where the manager becomes more responsible
for trade errors. If it is a simple equity trade, I think the standard is different. Each and every fund is going to apply a different allocation methodology depending on the strategy and the organization of the firm.” Brian Vahey, Principal at Berkeley Research Group, LLC, explained, “How trade errors get resolved is going to be a different answer for every fund.”

**Losses**

Unsurprisingly, there is much more focus on the allocation of losses from trade errors than on the allocation of gains. The SEC has clearly indicated that it generally expects managers to bear losses associated with trade errors, but much uncertainty remains as to whether and when managers can cause clients to bear such losses.

Current market practice points to numerous managers taking responsibility for losses from their trade errors only if they have acted with gross negligence or bad faith and/or where losses from such trade errors are material. Sometimes, such arrangements are reflected either implicitly or explicitly in agreements with a manager’s clients (including in an investment management agreement between a manager and a fund) or in trade error policies disclosed to the manager’s clients.

**Materiality**

With respect to the development of the materiality threshold for the allocation of trade error losses, Timothy Selby, a partner at Alston & Bird LLP explained, “The SEC has some guidance out there that their preference is that the investor gets some benefit from trade error gains and that managers absorb the losses. It is not a rule, just a preference. So, this is how many managers do it. However, some managers say that there can be so many different trade errors, depending on the amount of trading they do, that they can spend a large portion of their time just managing those. So, they try to use a materiality threshold where trade errors that result in gains always benefit the fund, whereas the allocation of the losses would depend on the size of the loss. For example, trade errors that result in a loss of less than $25,000, or some other relatively small amount, would be borne by the fund; anything greater than that amount would be the responsibility of the manager. Obviously, the numbers will vary from fund to fund and manager to manager.” Elizabeth Fries, a partner at Goodwin Procter LLP, added, “Typically, the manager would reimburse the loss, particularly if it is material.”

**Culpable Mental State**

Most hedge funds require their clients to bear losses resulting from trade errors if the manager has not acted with a designated culpable mental state, which is usually defined as gross negligence. However, some managers are willing to absorb trade error losses resulting from their simple negligence.

Commenting on current market practice, Brad Caswell, a special counsel at Schulte Roth & Zabel LLP, explained, “It is still the industry standard that most managers have a gross negligence standard. Ordinary mistakes would not necessarily rise to that level. Under this standard, the costs related to ordinary mistakes would be borne by the fund.”

In outlining the reasoning for the use of the gross negligence standard, Caswell explained, “The manager is essentially providing a service to the funds for a fee. Like custodians, administrators or other service providers, the investment manager may make an ordinary mistake, and the agreements make it clear to clients upfront that the manager is only going to be responsible for an error where the error rises to the level of gross negligence.” However, managers need to keep in mind that repeated instances of the same or similar
“ordinary mistakes” may rise to the level of gross negligence, Caswell cautioned.

The methodology for allocating trade error losses is often reflected (either implicitly or explicitly) in agreements between managers and their clients. For instance, although investment management agreements between managers and their clients typically do not explicitly reference trade errors, they do include exculpation provisions defining which party will be responsible for bearing losses arising out of manager (or employee) misconduct in managing the client’s portfolio. Typical exculpation provisions in investment management agreements between hedge fund managers and their funds (or managed account clients) include language indicating that the manager will not be liable for any losses that do not arise out of the manager’s (or its employees’) gross negligence, willful misconduct or bad faith. These exculpation provisions implicitly cover losses resulting from trade errors, which result from the management of the client’s portfolio. See “Exculpation and Indemnity Clauses in the Hedge Fund Context: A Cayman Islands Perspective (Part Two of Two),” The Hedge Fund Law Report, Vol. 4, No. 1 (Jan. 7, 2011).

Caswell explained, “Managers have to act in the best interest of their clients. With that said, hedge fund managers have investment management agreements with their clients that set forth a standard of care.”

Fund documents can also contain similar exculpation provisions that can bind a manager and its clients. Selby said, “The standard is contractually determined. When it is with the broker, the contract will establish what the standard will be with respect to trade errors. With manager errors, it depends on the fund documents. It is really all over the map.” However, the lack of explicit language addressing trade error losses and the appropriate mental state triggering liability may present problems for managers. Fries noted, “Historically, hedge fund managers have had a gross negligence standard in their fund documents. There is a question as to whether the gross negligence standard is an appropriate standard to apply to trade errors. It can be difficult to apply a standard, absent express language addressing trade errors.”

**ERISA Limitations on the Allocation of Trade Error Losses**

The Employee Retirement Income Security Act of 1974 (ERISA) prohibits a manager from allocating trade error losses to ERISA plan investors where benefit plan investors (e.g., corporate pension plans) own 25 percent or more of a class of equity interests in a manager’s hedge fund, thus making the manager a plan assets manager subject to ERISA’s substantive provisions. ERISA subjects managers of plan assets to heightened fiduciary duties, which prohibit, among other things, such managers from allocating trade error losses to ERISA plans. See How Can Hedge Fund Managers Accept ERISA Money Above the 25 Percent Threshold While Avoiding ERISA’s More Onerous Prohibited Transaction Provisions? (Part Three of Three),” The Hedge Fund Law Report, Vol. 3, No. 24 (Jun. 18, 2010).

Kelli Moll, a partner at Akin Gump LLP, explained, “To the extent that the standard of care is a higher standard, for example, if you are running ERISA plan assets and, therefore, you are an ERISA fiduciary, the manager always bears the losses on those trade errors because that is what ERISA requires.” In some instances, ERISA plans may try to negotiate with managers to shift responsibility for trade error losses to the
manager, even if the manager is not managing plan assets. Selby explained, “When you negotiate with the plan asset managers, they try to get an acknowledgement from the manager that they are a fiduciary and they do not want the burden of trading errors shifted over to them. The issue you come across with the plan asset money is when they come into a fund and represent less than 25 percent of a fund's assets, then the fund is not deemed to be a plan assets fund. So, the issue is more likely to come up in a fund with more than 25 percent of its equity securities owned by plan assets or a managed account comprised of all ERISA money.”

Duffy commented that, where trade error losses are material, managers must bear responsibility for all losses for both ERISA investors and non-ERISA investors. “My feeling is that if it was material and it was the manager’s fault, then they have to eat all of the loss. It does not matter if someone is an accredited investor as opposed to an ERISA investor. They cannot parse it out. It is all or nothing.” However, if a trade error is immaterial, Duffy indicated that it is a judgment call as to whether the manager can cause the non-ERISA plan investors to bear their portion of trading losses while the manager bears the ERISA investors’ portion of trade error losses.

This is becoming a more prominent issue for hedge fund managers, particularly as ERISA-covered benefit plans are increasingly expressing interest in alternative investments, including hedge funds, and more carefully scrutinizing managers’ policies and procedures. According to Fries, “Under ERISA, your fund is not subject to the ‘plan asset’ rules unless at least 25 percent of your investors are ERISA plan (and individual retirement account) investors. Historically, it is pretty unusual (though becoming more common) to be in that position as a hedge fund manager. However, ERISA and other investors who have significant fiduciary obligations imposed upon the people choosing to invest in a fund may pay more attention to and be more concerned about the manager’s policies and procedures, including with respect to trade errors.” See generally “Applicability of New Disclosure Obligations under ERISA to Hedge Fund Managers,” The Hedge Fund Law Report, Vol. 5, No. 9 (Mar. 1, 2012).

Gains

The vast majority of hedge fund managers allow affected funds and accounts to keep gains resulting from trade errors. According to Goodwin Procter’s Fries, “Most often, the fund keeps any gains that resulted from a trade error. If you are doing daily reconciliations and you find an error prior to settlement, there are some changes you can make so that you can avoid a problem, particularly if you catch it before settlement.”

Selby added, “Most fund managers always pass the gain over to the fund. It is unusual for a manager to keep the gains. I cannot think of a circumstance where a manager would feel the need to do that. They are only put in that position by virtue of using the fund’s assets. So, I do not see how the manager could keep the gains. I think the manager would only get a benefit from a trade error gain through its performance compensation.”

Under What Circumstances Can Hedge Fund Managers Net the Gains from Trade Errors Against Losses Resulting from Trade Errors?

The SEC has not provided any definitive guidance in this area. As a result, managers differ as to whether they permit netting of trade error gains and losses. “I think that whether a manager can net losses and gains really depends on the
situation,” Fries commented. “Generally, netting creates the potential for negative incentives because a netting policy might suggest that, when you have an error, you should wait around until you have another so that you can net losses and gains. On the other hand, if you had some programmatic trade and there were several errors all at once, there may be a justification for netting on that basis.”

To mitigate abuses that can result from the netting of trade errors, managers can narrowly define the circumstances under which netting will be permitted.

For starters, managers should only net gains and losses in the same fund, cautioned Duffy. “You absolutely cannot cross-trade trade errors. If you have a gain and a loss in the same day in the same fund, you can net those. You cannot start cross-trading from one fund to another.” See “SEC Charges Hedge Fund Manager with Impermissible Cross Trades, Inflating Valuation and Misleading Investors in a Scheme to Hide Fund Losses,” The Hedge Fund Law Report, Vol. 5, No. 45 (Nov. 29, 2012).

Akin Gump’s Moll agreed that netting can only be done within the fund. “If, during any month, the fund has both gains and losses from trade errors, those amounts could be netted together, provided there is disclosure to investors regarding that practice. To the extent a fund has a net loss, either the manager or the fund would bear the losses depending upon the standard of care governing the arrangement. You cannot net with ERISA investors and you can only net intra-fund.”

Additionally, netting should only be permitted for trade errors that occur over a short, delineated span of time. However, Duffy pointed out that, most of the time, trade errors are identified fairly early on and are resolved as soon as possible, meaning that they may not occur frequently, which will make netting infrequent. “Even if a manager theoretically could net the gains and losses from trade errors, with just the timing involved, I do not think it is going to happen all that often.”

### Documenting Trade Errors

Hedge fund managers must document trade errors for numerous reasons. Most importantly, the SEC will likely inquire about the occurrence of trade errors and the resolution of such errors during examinations of hedge fund managers. Caswell cautioned, “In examinations, the SEC will ask advisers if there have been any trade errors during the reporting period.” A hedge fund manager that fails to demonstrate that it has handled trade errors consistently, diligently and in good faith (consistent with its fiduciary duties) risks further action from the SEC concerning specific trade errors and heightened scrutiny of its entire compliance program. See “Ropes & Gray Partners Share Insights Gleaned from Successfully Navigating Presence Examinations with Hedge Fund Manager Clients,” The Hedge Fund Law Report, Vol. 6, No. 10 (Mar. 7, 2013).

Concerning the details to be documented, hedge fund managers should explain, for each trade error, what actually occurred; when the trade error was discovered and reported; how the manager analyzed the trade error; and what corrective measures were taken to resolve the trade error. Caswell suggested, “In documenting the issue, you want to note what happened; whether the issue was an ordinary mistake or if it rose to the level of gross negligence; and what you have done to resolve the issue.”

With respect to systems designed to document trade errors, Vahey added, “With any good system, your operations group
should record all trading issues and the corrective actions taken. “If you notice a common thread, whether it is the person committing the error or the system error, you can take some corrective action to try to keep it from happening again.”

**May Hedge Fund Managers Purchase Insurance to Mitigate Their Risks from Trade Errors?**

Management Liability policies for hedge funds have two coverage parts: (1) directors and officers (D&O) liability insurance, which provides coverage for funds and fund managers as well as their respective officers, directors and employees against claims for alleged errors, omissions, negligent acts, misstatements, misrepresentations and breaches of duties brought by investors, regulators or other third parties; and (2) errors and omissions liability insurance for mistakes made in the management of the fund, which can include coverage for trade errors, using an endorsement called Cost of Corrections (CoC) coverage. For more on D&O insurance, see “Hedge Fund D&O Insurance: Purpose, Structure, Pricing, Covered Claims and Allocation of Premiums Among Funds and Management Entities,” The Hedge Fund Law Report, Vol. 4, No. 41 (Nov. 17, 2011).

Richard Maloy, Jr., Chairman and Chief Executive Officer of Maloy Risk Services, explained, “Coverage for trade errors is part of the management liability contract through the errors and omissions component of the policy. Historically trade errors were covered by the errors and omissions section of the policy if there was litigation from a third party (usually an investor). However, litigation rarely arose and the litigation was the trigger for coverage, so there was rarely a policy response to the trade error. In 2008-2009, trade error coverage was enhanced by creating the CoC endorsement, which permitted the making of claims, even in the absence of litigation. The theory behind this change was that if the trade error was large enough (or happening often enough), it might lead to investor suits against the manager for negligence or mismanagement. Litigation is costly for insurers. Therefore, to help the managers fend off potential costly litigation, insurers created the CoC endorsement.”

Maloy continued, “CoC coverage is not available from every insurer. Some will offer it while others will not. The coverage is not overly expensive (5 percent additional premium) since the retentions (i.e., deductibles) are often very high. Retentions for CoC coverage start at $500K and are often $1 million or more depending on the size of the fund. Funds employing certain investment strategies will also have a very difficult time finding CoC coverage, such as hedge funds employing quantitative strategies or other high volume trading strategies.

The coverage is very broad and provides coverage for the following types of trading errors:

- Trading in the wrong security, derivative, asset, liability or other instrument or investment;
- Trading on the wrong side of the market (i.e. taking a short position when instructed or directed to take a long position or vice-versa);
- Trading for a quantity different than specified in the instructions or directions or involving leverage different than specified in the instructions;
- Duplicating a prior execution of the same order;
- Trading that is or was different from directions from a customer or client; or
- Otherwise failing to execute the order as specified in the instructions, directions or permissions.
There are provisions within the endorsement that must be met to gain coverage and mainly focus on timeliness of reporting the error to the insurer. Once a manager realizes a trade error has occurred, typically it must report the trade error to the insurer within 7 days. Maloy explained, “Of our hedge fund client base, which is more than 100 funds, roughly 98% have the CoC endorsement, and for the few who do not, the absence of such coverage was for one of several reasons: coverage was unavailable for their strategies; the manager believed that infrequent trading meant that the risk of trade errors was low; or the manager felt that having a high retention made such coverage not worthwhile.”

**Common Mistakes Hedge Fund Managers Make in Handling Trade Errors**

Managers must learn from the common mistakes made by other managers in addressing trade errors to avoid the negative consequences associated with improper handling. Such mistakes include, among other things, employee failure to report trade errors, hasty and improper resolution of trade errors and the failure to properly document trade errors.

One of the most common mistakes is for employees to avoid reporting trade errors and to try to resolve the situations on their own. Employees may do so out of fear and may attempt to cover up their mistakes. This can lead to inconsistent and improper handling of trade errors by the employee. As a result, it is imperative for hedge fund managers to stress to employees the importance of reporting a trade error as soon as it comes to light and include such a requirement in its trade error policies and procedures. “To make sure errors are reported, one of the things to do is to make sure it is in the policies and procedures that errors must be reported immediately,” Duffy said. Immediate reporting is necessary to facilitate the proper analysis and coordination of an appropriate response by the manager’s compliance department.

Second, hedge fund managers may rush to judgment in evaluating trade errors, which can cause problems if appropriate follow-up does not occur. “I think one issue that I have seen is the concept that people claim there was a trade error before they fully investigated the facts,” Fries noted. “The difficulty with that is when you have an SEC examination and they see an e-mail claiming that a trade error has occurred, and they ask you where your file is on that error, if you do not have one because you ultimately concluded there actually was not an error, it could be problematic. Accordingly, once something is labeled an ‘error,’ even in an informal e-mail, it would be wise to be sure it is fully addressed.”

Third, some managers fail to appropriately document trade errors, Duffy explained. This can be particularly detrimental when the SEC examination staff asks the manager how it addresses trade errors. Duffy explained, “It is important the error be documented and that there is a record of what happened, what the trade should have been and what corrective action was taken.”

Added Caswell, “One of the biggest mistakes a manager can make is not documenting the error and what was done to correct it. Two years down the road during an examination, you might not be able to remember the details of the error or the resolution. So, you need to keep detailed records.”

Fries added, “There are recordkeeping requirements to keep a record of trade errors. As a practical matter, a manager should probably have a file memo that identifies the error, why it occurred, when it occurred and what was done to correct it. The CCO can determine on a case-by-case basis what else is required.”