IP Issues for Hedge Fund Managers

by William M. Ried

Hedge funds differ from mutual funds in their leveraging practices, pricing, and liquidity, as well as in their fee structures, investor profiles, and degree of regulatory oversight. The alternative investment strategies of hedge funds allow them to hedge against market downturns, and to utilize borrowing, derivatives (which are inherently leveraged) and arbitrage, including investing in asset classes such as distressed securities and currencies. Hedge funds often offer alternative strategies to achieve capital appreciation and capital preservation in bear markets. As a free-standing industry, hedge funds managed $1.5 trillion in assets in 2005.[1]

Intellectual Property (IP) law deals with trademarks, copyrights, and patents, as well as related subjects such as trade secrets and domain names. In recent years, IP has taken on a growing importance in business valuation, corporate transactions and litigation. Companies large and small have come to recognize the need to understand and protect their IP and avoid IP conflicts.

This article addresses some IP issues regularly faced by hedge fund managers, emphasizing the distinctive intersections of the hedge fund business and IP law.

Trademarks

Do hedge fund clients need to worry about their company and fund names? Should they seek to register these names as marks? Can they stop other firms from using similar names?

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Trademark Clearance

The first issue to consider is trademark clearance. Choosing a name or service mark (a trademark used in connection with services) for a new company or fund should begin with an agreement among the fund's decisionmakers on a list of five marks that are minimally acceptable to all. The best names or marks will be those that are neither similar to any familiar competitor mark nor strictly descriptive of the company or fund. Counsel can quickly screen these five marks through an online database for obvious conflicts with marks that have been registered or applied for either federally or in an individual state. Counsel also can quickly run Internet searches of these marks. With some luck, which increases with the originality of the five marks, two or three will face no obvious obstacles to use and registration. At this point, the hedge fund manager should approve the ordering of comprehensive trademark searches of the two or three marks that appear to be available. These searches, conducted by independent search firms retained by counsel, produce reports on in-depth searches of potential conflicts between the subject mark and marks previously registered or applied for, words used as domain names or appearing in Copyright

Office records, and company and product names in industry listings, newspaper articles and telephone directories.

After reviewing and following up on the search results, counsel will typically provide the hedge fund manager with an assessment of the risks both of use of each mark and whether an application to register each mark federally is likely to succeed. The initial advice will be given orally, to avoid the cost of issuing written reports on marks the fund will not use. Counsel then will issue a search report letter concerning the mark chosen by the fund manager that summarizes the relevant citations in the search report and counsel's analysis. This letter serves as evidence that the fund manager selected the mark in good faith, which will refute any allegation that treble damages should be assessed for willful trademark infringement. This letter also may prove useful as an historical snapshot of the availability of the mark on a specific date.

Searching marks for hedge funds presents unique difficulties. First, a preliminary scan of marks primarily shows only trademark applications and registrations, but most hedge funds do not apply to register their company and fund names. Second, even a comprehensive search report, which also examines domain names and common law sources, may not reveal a hedge fund name because there is no comprehensive list of active hedge funds. Moreover, a search for a fund name in news reports or domain name records may not be reliable. The hedge fund manager must understand that conducting a trademark search is at best a means of increasing the comfort level that use of or application for a mark will buy protection rather than a trademark dispute. No trademark search will ever provide certainty that a mark is available. New applications take a couple of weeks to show up on the Patent and Trademark Office records, search terms do not always reveal all relevant citations, and common law searching is not uniform because there is no established universe of sources to examine. Therefore, while a trademark search may provide somewhat less comfort to a hedge fund manager than to the operator of another kind of business, the search still will identify potential obstacles and allow a fund manager to "invest" in the mark most likely to succeed.

Trademark Registration

Once the hedge fund manager selects a mark, the law firm can prepare and file a trademark application for under $1,000 in legal fees and official filing fees. An application based on current use requires a specimen of such use. For an application based on the applicant's intention to use the mark, the filing date sets the owner's priority, or the date on which its rights begin. If and when an intent-to-use application matures to registration, the owner will obtain rights in the mark dating back to the application date. Within three months from the application date, the Trademark Office typically will provide an initial response, identifying infirmities such as that the mark is primarily a surname, merely descriptive of the services, geographically misdescriptive or confusingly similar to a prior registration or application. When marks are deemed confusingly similar in terms of sight, sound, and meaning, in the context of the goods and services they cover, the mark with the earlier priority date (based on use or application) prevails. If all goes smoothly, registration will issue 15 to 18 months from the application date.

The discussion of trademark clearance demonstrates one advantage to registration: It puts others on notice that the mark is protected and they

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may use a similar mark for similar services only at their peril. A second advantage is the security of building a brand without the risk of having to later change the name and begin building credibility all over again with a new brand. Third, a registration will aid enforcement.

Trademark Enforcement

To protect a trademark from use by another of the same or a similar mark for similar goods or services, the trademark owner must show two things: (1) that it has rights in the mark and (2) that use of the second mark is likely to cause a significant proportion of relevant consumers to be confused into thinking there is an association between the two marks or their owners. A federal registration is *prima facie* evidence that the owner has exclusive rights in the mark for the goods and services listed on the registration. This satisfies the first element of proving the owner's rights in the mark and puts the burden on the defendant to prove the registration is invalid.

Without a federal registration, the trademark owner must in the first instance prove it has rights to protect. This is done in the non-hedge-fund context by showing the extent of advertising and promotions, unsolicited news coverage and revenues produced under the mark, as well as by expert opinion and public survey evidence. The nature of hedge funds, however, makes it difficult to prove common law rights in a mark sufficient to enjoin another's use of a similar mark. Hedge funds are not permitted to advertise[2] and the customer base of a typical hedge fund is quite small. As discussed in regard to trademark clearance, general news coverage of hedge funds also may not be extensive. Thus, without a federal registration in hand, a hedge fund manager often will face an initial obstacle of proving the fund has any rights to protect. Moreover, even if a hedge fund is recognized by consumers in a specific market, the manager's common law rights would extend only as far as the fund's geographical reach. Thus, the manager of a New York hedge fund could have difficulty enforcing trademark rights in Minnesota or Arizona. In contrast, federal registration accords nationwide rights without any need to show local use. Thus, hedge funds managers have a need for federal trademark registration that is distinct from the need of consumer product companies with nationwide reach or even the managers of mutual funds with widespread consumer bases.

Trade Secrets and Employment Agreements

The Hedge Fund Association says the heavy weighting of hedge funds managers' remuneration toward performance incentives attracts "the best brains in the investment business."[3] The kernel of "genius" provided by one of these brains often distinguishes the trading strategies of a successful hedge fund and raises questions about the proprietary nature of trading strategies. The fund manager may seek to harness and control the rights to trading strategies in an employment agreement with a quantitative analyst. The manager may seek assurance that it will not be subject to a claim from a quant's former employer over a trading strategy he or she agreed to leave behind. The manager may seek a license to assess and possibly employ trading strategies owned by another. The manager may hire a consultant for his or her time and the rights to an existing trading strategy.

Employment Agreements

The first priority for a new hedge fund is to put in place a standard agreement that each employee signs before starting work. Trying to convince existing employees to sign a new employment agreement can meet with resistance from some employees, which leaves the fund manager in the awkward position of deciding what to do next. At the point of signing on with a new firm, however, only those with clear claims to existing IP are likely to object to such an agreement. The standard employment agreement should:

1. State that the employee brings to the job nothing subject to IP or other proprietary rights of any other party, specifically including the previous employer in the case of hiring a quant away from a competitor. If the employee brings IP of value to the relationship, such as rights to a valuable trading strategy, the agreement should schedule these rights and address use of and treatment of revenues from this strategy;
2. Make clear that the employee will be privy to confidential information of the fund and agrees strictly to maintain this information as confidential both during and after the term of employment;
3. Make clear that the fund manager owns any product of the employee's efforts during the term of employment that has to do with the fund's business. Thus, if the employee has a

moment of trading strategy inspiration in the shower, on vacation, far from any fund office, equipment or personnel, this idea still belongs to the fund; and

4. Provide that, at the conclusion of employment for whatever reason, the employee shall leave behind all trade secrets embodied in any physical media, and refrain from soliciting fund customers or employees. Any additional "non-compete" provisions must be limited in time and geographic scope to be enforceable, each person's right to make a living will be protected by law and policy.

Hedge funds managers must be particularly cautious in hiring employees from competitors. It is only safe to assume the competitor has in place a strict employment agreement and the new employee may come with IP baggage that could lead to conflict with the prior employer. The fund manager should protect against this first by including in the fund's employment agreement that the employee will bring no inappropriate materials to the fund. However, the fund manager should also inquires about potential employees, former responsibilities and seek specific assurances as to matters of concern. The fund manager also should respond quickly and openly to any concerns voiced by the prior employer. In one recent matter, a prior employer complained that our client's new employee had opened an account on an investor service Web site, which suggested he was accessing the account on the same service used by the prior employer. A prompt and very brief letter from the employee advising his prior employer that he had opened a new and unrelated account resolved the matter.

Consultant/Vendor Agreements

The treatment of trade secrets is also a critical issue in the hedge fund manager's licensing of trading strategies or market indicators, or in hiring a consultant to bring to the job both future energies and rights in existing strategies or indicators. The owner of these rights typically will demand strict confidentiality protections, both in an initial nondisclosure agreement (NDA) and in any license agreement to follow.

Copyrights protect the expression of ideas or any original description of trading strategies or market indicators, but not the underlying ideas. Patents can protect market indicators or trading strategies, but such protection has its drawbacks. Thus, the protection of a trading strategy is typically maintained through secrecy, including reasonable efforts to limit access to details of the strategy to those with a need to know such details and who are contractually restricted from divulging these secrets.

A vendor or consultant offering to disclose a trading strategy will reasonably seek an acknowledgement that the strategy is confidential and that the hedge fund manager will maintain this confidentiality whether the fund uses or declines to use the strategy. However, the fund manager must protect the fund in this instance much the same as a consumer product company must guard against the submission of unsolicited ideas. The fund manager must make certain that the initial NDA preserves the fund's rights in independently created or publicly available strategies. Thus, the fund manager must not by contract acknowledge the vendor's exclusive rights in a strategy that could turn out to be similar to strategies already employed at the fund, subject to current research by the fund, or common knowledge within the industry.

Addressing the knowledge and output of a consultant is more complicated than an employee. Both individuals may bring independent rights to the job, which should be scheduled up front, but while the employee's subsequent output should belong entirely to the fund, the consultant's loyalties may be split. The consultant may be engaged by others during the time he or she is working for the fund. The consultant also can be expected to look to what can be taken from each engagement to the next one. Relative bargaining power will determine who owns what. In any event, the consulting agreement should clearly delineate the ownership of and right to use materials brought by the consultant to the fund or produced during his or her retention, alone or in cooperation with fund employees, and with or without the use of fund information and resources.

Patents

Beginning with the *State Street* decision in 1988,[4] business methods and processes such as trading strategies and market indicators have been patentable in the United States. After this decision, patents have been issued on such inventions as "automated strategies for investment management"[5] and "device to detect stock names having the highest current value and its method of use."[6] There are risks, however, in seeking patent protection for such processes.

Trading Strategies

As a rule, a stock-picking or arbitrage strategy should not be patented. As a *quid pro quo* for the legal right to exclude others from making the invention, the inventor must provide a written disclosure that teaches "the best mode for carrying out the invention," and this disclosure is published as early as 18 months after the application is filed and no later than when the patent issues. This reflects the basic trade-off in the patent system, that the invention should be dedicated to the public when the patent expires. However, the value of financial strategies that rely on exploiting latent market inefficiences may be destroyed by publication.

While a patentee has the right to prevent others from making, using or selling the invention, it may be difficult to detect and then to prove infringement of a patent covering a trading strategy, because the infringer will not voluntarily make public its trades or the basis of these trades. Moreover, a patent application that also will be filed abroad will be published without any assurance that a patent will issue, or that the issued patent will cover what the fund manager considers proprietary about the strategy. Thus, by applying for patent protection, the fund manager may publicize and destroy the value of the trading strategy without ever securing the right to exclude others from using the strategy.

Publicly Disclosed Innovations

In contrast to trading strategies, publicly disclosed financial innovations may be appropriate subjects for patent applications. Because disclosure will deny trade secret protection to such innovations, patent protection may be the only way to preserve a market advantage. Assuming the fund manager could detect use of these innovations by competitors, the manager also could hope to enforce the patent.

When an offering memorandum or other public document, or disclosure to a rating agency or banker, will teach the essentials of the structure, the only way to maintain market exclusivity may be through patent protection.

Finally, patents pursued generally by other financial services companies, which may also be appropriate for fund managers, cover software, computer management methods, or methods of funding of investment vehicles, hedging transactions or risk layoffs.

The Patent Process

The process of patenting financial structures begins with a search by counsel to confirm that the structure is unique in that it is not anticipated by "prior art." A US application must be filed within one year of the first disclosure of the invention, and before any disclosure if patent protection will be sought in any other country. Next, if the innovation will proceed through development stages that will be made public, provisional applications can be filed as each new feature or improvement is about to be disclosed outside the company. A formal US patent application must be filed within one year of the first provisional application and international applications may also be filed within this period. The US application will be examined three to five years after it is filed, and if all goes smoothly, the patent will issue five to six years after the application is filed. The patent application could cost $10,000 to $30,000 for the original filing, and a similar amount over the next four to six years. Once the patent issues, the patentee has the right during the patent term (20 years from application, with typically two to four years of extension to compensate for Patent Office delays) to exclude competitors from using the structure, or to license the patent.

Conclusion

As the importance of IP rights continues to grow and as the hedge fund industry matures, the intersection of the two becomes more important and evident. The intelligence and insight that makes for a successful hedge fund manager should also make this manager recognize that investing in IP protection may produce valuable assets and serve as a smart hedge against the distraction of IP conflicts.

NOTES

1. Michael Steinhardt, "Do You Really Need a Hedge Fund?," *Wall Street J.*, April 14, 2006, p. A16.

2. Securities Act of 1933, § 4(2) and Regulation D.

3. Dion Friedland, "About Hedge Fund Strategies," Hedge Fund Association site at *http://www.thefha .org/aboutus.cfm2* (last viewed April 14, 2006).

4. State Str. Bank & Trust Co. v. Signature Fin. Group, Inc., 149 F.3d 1368 (Fed. Cir. 1998).

5. U.S. Patent No. 6,317,726 B1.

6. U.S. Patent No. 6,289,321 B1.

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