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Title: Opalesque Exclusive: As the value of algorithms rise, funds should ensure operational risk protections rather than rely on legal protection

From [Kirsten Bischoff](#), Opalesque New York:

The hedge fund industry, mainly through its associations and representative groups has by and large supported the need for increased regulation. However, one aspect of the proposed hedge fund registration that has met with objection is the requirement that managers submit detailed reporting on positions and leverage. The managers' concern here focuses on what they determine is confidential information that, if made available in a public forum would reveal their "secret sauce" and take away the edge that their investors pay for.

As the industry grapples with finding a balance between necessary secrecy and forced transparency the worries over the protection of trade secrets are legitimate, but perhaps misplaced. If this financial crisis has highlighted anything - it is that regulatory and legal protections have not kept up with the leaps in cutting edge technology.

For hedge fund firms with trade secrets such as algorithms the immediate focus should be on the operational protection of these formulas - as leaks and thefts are a much more immediate threat through the hiring and firing of employees, contractors, and subcontractors, than they are through delayed position reporting to regulatory agencies.

"The problem we are facing as a society is that we are transitioning from an industrial society that was dominated by commerce and primarily the sale of goods, to a society where the most important objects are intangibles. And so courts and businesses are struggling with the definitions and categorizations of those intangibles and the identification of the legal protections around them," Alexander Montagu, Founder of New York-based law firm [Montagu Law](#), specialists in IP and Licensing services.

Algorithms are classified as "trade secrets"

Because an algorithm may be considered a "trade secret" it is the responsibility of the firm that owns the algorithm to protect it in a way that would be considered reasonable. Legal protections are NOT extended to trade secrets where the owner

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does not use reasonable measures to safeguard their secrecy.

The sophisticated funds understand that they need to keep these algorithms confidential and typically take precautions to protect their firms from outside intruders. "What I don't think they understand is how to protect their trade secrets in terms of the people who helped to create them," Montagu says.

The charges that Goldman Sachs has leveled against former employee Sergey Aleynikov have brought some of the protection challenges faced by firms to light. But as more and more hedge fund managers start up their own firms, there are considerations they can make during the start up process that will add levels to the protection of their algorithms.

Keeping collaboration within your legal jurisdiction

A hedge fund firm that subcontracts to service providers outside of the legal jurisdiction of the firm is taking a much greater chance in terms of the security of his "trade secret". US hedge funds can sometimes be very focused on only US laws, says Montagu. He gives the example of a hedge fund manager who has developed an algorithm and in building it utilized contributors located in Bombay.

Let's say one of those contributors is a math professor who then leaves that firm and shortly after rumours surface that a hedge fund in London is using an algorithm based on yours and earning a fortune. What are the legal steps you can take? They will be very limited, says Montagu. The protections outside your core jurisdiction can be far less, and should give firms pause as to whom they hire as collaborators and in what jurisdiction they are located.

Determining the best type of collaboration

If an employee whose job involves the development of trading algorithms leaves a firm and launches their own fund, or goes to work for a fund and it can be determined that they are using portions of a firm's algorithm, the legal steps that can be taken are favourable to the employer. If the authorship happened during the course of their employment at the firm and their position there is developing algorithms for the firm, then the firm is the likely owner of the work and the employee is unlikely to be successful with an argument that he or she authored the algorithms on his or her own time using his or her own computer, etc. a point that should be noted by those programmers staying up late nights and weekends planning for the day when they can launch their own strategy).

However, a pre-launch firm, that is perhaps looking to cut costs by not hiring

employees, but by hiring freelance contractors needs to approach algorithmic protection with further precautions. "If a contractor authors something, then unless their contract specifically says that the ownership is the firm's and not the contractors, then the contractor will own it," points out Montagu.

The steps that companies have taken in dealing with trade secret protection up until this point have been very piecemeal says Montagu. Likewise, the courts have had to take a similar patchwork approach to regulating technology that has burst out of the traditional legal boundaries of individual countries and requires the establishment of international legislation and treaties. "I believe that we are going to see lot more of these cases in the future," he says.

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