Legal Considerations for Proprietary Traders Participating in a Lift-Out

By Mauro Viskovic, Kranjac Manuali & Viskovic LLP

The "Volcker Rule" of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act has restricted the proprietary trading activities of Wall Street's biggest banks. As a result, many traders at such proprietary trading desks are migrating en masse for better opportunities at investment management firms.

Such transitions often take the form of a "lift-out" in which a particular team of proprietary traders leave a bank to form an investment management firm that will exclusively manage a separate account of a major hedge fund. Traders involved in these lift-outs need to be wary of myriad legal concerns implicated throughout each step of the process.

Traders must initially focus on issues associated with the termination of their bank employment. Banks generally hold their proprietary traders to restrictive covenants concerning the bank's trade secrets and the solicitation of the bank's employees and investors. The costs of a lawsuit defending against allegations of a breach can be overwhelming, while the associated liabilities for violating those restrictions can be financially crippling. As such, it's important for traders to have a thorough legal review conducted of their rights and obligations under their bank employment documents well in advance of their departure. If handled correctly, the transition can be seamless and managed without conflict.

The key phase of the lift-out will be the negotiation of an account management agreement under which the trading team will manage an account of the hedge fund that has retained them. Such documents are extraordinarily complex and need to be reviewed and negotiated by experienced counsel. Items perceived to be straightforward, such as compensation, are subject to intricate calculations and convoluted exceptions. As a general principle, in rendering its investment management services, the trading team is seeking to obtain as much independence and control as possible.

Beyond the negotiation of the account management agreement, the traders must address legal organizational matters. The traders would generally form a limited liability company through which they would operate their investment management business and have an operating agreement drafted that addresses ownership percentages, voting rights, management and other issues relating to the rights and obligations of the traders. To the extent any traders will not participate in the ownership of the firm, those individuals should be subject to employment agreements and trade secret agreements prohibiting disclosure of the firm's confidential information and explicitly providing that all intellectual property developed during the course of their employment belongs exclusively to the firm.

Finally, another result of the Dodd-Frank Act is that the traders will likely need to register their firm as an investment adviser with the Securities and Exchange Commission. As a registered investment adviser, the firm assumes various fiduciary obligations to their clients, annual filing obligations, specific recordkeeping responsibilities, limitations on performance fees, disclosure requirements, and many other ongoing compliance obligations.

Executing a lift-out of a proprietary trading team is a complex endeavor and can have numerous pitfalls for the traders involved. Careful planning and proper legal counseling is critical to enable traders to identify potential stumbling blocks, mitigate associated risks and maximize the potential rewards of their venture.

Mauro Viskovic is a Partner with Kranjac Manuali & Viskovic LLP, representing high frequency and quantitative traders. He has negotiated lift-outs of proprietary trading teams moving from global banking institutions to investment management firms.