The HEDGE FUND LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 10, Number 2 January 12, 2017

DERIVATIVES

Best Practices for Fund Managers When Entering Into ISDAs: Negotiation Process and Tactics (Part One of Three)

By Kara Bingham

In the world of hedge funds, trading of over-the-counter (OTC) derivatives in the form of swaps has become ubiquitous. Funds trade swaps for a variety of reasons, including to hedge certain risks, take speculative positions, access difficult-to-trade assets or employ synthetic leverage. See "What Is Synthetic Prime Brokerage and How Can Hedge Fund Managers Use It to Obtain Leverage?" (Apr. 2, 2010). Some funds prefer to use swaps to gain exposure to the underlying asset class, even when it could be accessed directly, as in the context of equity investing.[1]

In its simplest form, a swap is an agreement to exchange cash flows at specified intervals during the agreed-upon life of the transaction. Prior to implementation of the Dodd-Frank Act, dealers were typically the counterparties to a fund's swap transactions. Today, certain derivatives that previously traded on a bilateral basis now trade on an exchange, referred to as a swap execution facility (SEF), and are required to be cleared, causing both parties to face a clearinghouse. See "A Practical Guide to the Implications of Derivatives Reforms for Hedge Fund Managers" (Jul. 25, 2013); and "Practising Law Institute Panel Discusses Sweeping Regulatory Changes for Hedge Fund Managers That Trade Swaps" (Nov. 29, 2012). Still, many swaps continue to be traded on a bilateral basis with each party taking on counterparty credit risk to the other party – that is, the risk that the other party will default at some point during the life of the transaction. See "Aksia's 2014 Hedge Fund Manager Survey Reveals Manager Perspectives on Economic Conditions, Derivatives Trading, Counterparty Risk, Financing Trends, Capital Raising, Performance, Transparency and Fees" (Jan. 16, 2014).

Most dealers require a fund to execute a variety of complex documents prior to entering into swap transactions on a bilateral basis with the fund. The responsibility for reviewing and negotiating these documents can be a daunting task for a manager's legal, compliance and operations professionals.

In an effort to distill the complexities of these documents and the negotiation process, The Hedge Fund Law Report interviewed several experts that negotiate these agreements on a daily basis on behalf of their fund clients. In this three-part series, we review the various trading agreements required for a fund to engage in the OTC trading of swaps, explain certain key negotiated provisions in swap agreements, discuss common amendments requested by dealers and provide guidance on what are currently viewed as "market terms" for certain provisions. This first article provides background on the various agreements that govern swaps, explains how the Dodd-Frank Act has introduced additional complications to the documentation process and offers advice on best practices for negotiating with dealers. The second article will review the most commonly negotiated events of default and termination events in the trading agreements and offers suggestions for negotiating these provisions. The third article will analyze the key considerations for funds with respect to the collateral arrangements – the delivery of margin to mitigate counterparty risk – between the two parties.

An Introduction to the ISDA

Most dealers require a fund to execute a form of International Swaps and Derivatives Association Master Agreement (Master Agreement) as a prerequisite to trading swaps bilaterally with the fund. The Master Agreement is a preprinted form and is executed without any modifications to the document. Any amendments, additions or deletions are set forth in the schedule[2] to the Master Agreement (Schedule). The terms governing the exchange of collateral between the parties are set forth in the credit support annex[3] (CSA, and together with the Master Agreement and Schedule, the ISDA). Paragraphs 1 through 12 of the CSA are standardized, and any modifications to these provisions are documented in paragraph 13 of the CSA. Negotiations between the fund and the dealer center on the provisions in the Schedule and CSA.

Unless otherwise specified, the legal and credit terms in the ISDA are intended to govern all OTC derivative transactions that are executed pursuant to the Master Agreement, which may include, among others, interest rate swaps; currency swaps; commodity swaps; equity swaps; caps; collars and floors; currency options; foreign exchange transactions; equity and equity index options; commodity options; and bond options.

A confirmation prepared by the dealer sets forth the terms specific to a transaction (Confirmation). Legal counsel to the fund does not typically review Confirmations that are limited to the economic terms of a transaction, such as rate or price, notional amount, maturity, collateral and so forth. Certain more complex transactions, however – such as swaps on equities or baskets of equities – trade pursuant to a "Master Confirmation," which is negotiated by legal counsel alongside the ISDA; in such cases, a one-page addendum is attached for each transaction that sets forth that transaction's economic terms.

The terms in the Confirmation generally override the Schedule and CSA. See "In a Total Return Swap to Which a Hedge Fund Is a Party, Which Governs: The ISDA Master Confirmation or the Credit Support Annex?" (Nov. 8, 2013). Accordingly, hedge fund managers should educate their investment and operations professionals to elevate to the firm's legal counsel any Confirmation that includes non-economic terms.

The ISDA Negotiation Process

Certain factors tend to increase the fund's likelihood of receiving its requested terms in the Schedule and CSA. Unfortunately for the fund's negotiators, many of these factors are outside of their control. The private fund's overall perceived profitability to the dealer is one of the key factors motivating the dealer to fast track the negotiation process and agree to terms that deviate from the dealer's set of standard terms, noted Fabien Carruzzo, a partner at Kramer Levin Naftalis & Frankel. Dealers often view the fund's asset size and trading volume as indicators of a fund's profitability to the dealer. Small or newly launched funds will need to be realistic about their leverage during the ISDA negotiation process.

Another factor that may influence the negotiation process with the dealer concerns whether the fund is engaged in other profitable lines of business with the dealer, noted David Geffen, president and founder of Geffen Advisors. Having a sense of what the market is for certain terms in the ISDA is also helpful, he noted. If a fund indicates that it has received a particular term from multiple dealers, this can be a powerful negotiation tactic.

Selecting a Version of the Master Agreement: 1992 Versus 2002

The first step in the negotiation process for the fund is to select a version of the Master Agreement. Presently, two forms of the Master Agreement are in use: the 1992 version and the 2002 version.[4] While there is overlap between a number of provisions in these versions, there are material differences that counterparties should review.[5]

Robin Powers, a partner at Rimon Law, noted that presently most dealers prefer to use the 2002 Master Agreement. "The industry tends to view the 2002 Master Agreement as more favorable to the sell side, while the 1992 Master Agreement is generally viewed as more favorable to the buy side," Powers explained.

If a fund prefers to use the 1992 Master Agreement, most dealers will agree to this request, Powers clarified. She cautioned, however, that if the parties do enter into the 1992 Master Agreement, in most cases the dealer will include significant amendments within the Schedule so that the fund will end up being subject to many of the provisions found in the 2002 Master Agreement. For additional insight from Powers, see "Lehman Brothers Bankruptcy: ISDA Issues" (Sep. 22, 2008).

Utilizing a Term Sheet

Some practitioners and their fund clients prefer to use a term sheet during the ISDA negotiation process. Geffen works with his clients to develop a term sheet that includes a list of terms that the client would like to include in its ISDA.

Ideally, the term sheet is sent to the dealer before the dealer circulates its form Schedule and CSA. Geffen explained that one goal in using the term sheet is to eliminate a round of edits, so that the first draft of the Schedule and CSA sent by the dealer incorporates as many of the fund's requested terms as possible.

Others in the industry have found the term sheet approach less helpful, however. Seth Bloom, counsel at Purrington Moody Weil, whose past experience includes working at dealers, suggested that term sheets will only cover a handful of issues and are often ignored in favor of boilerplate dealer templates.

Managing Expectations

Undertaking the negotiation of a new ISDA can be a long and resource-intensive process. Carruzzo advised that, in his experience, negotiations take an average of three months, but he clarified that this length of time often depends upon the traction that the client has with the dealer and the level of negotiation pursued by the fund. In 2006, ISDA issued a survey reporting that it takes its members on average between 30 and 150 days to negotiate an ISDA. The survey pointed out, however, that extreme results of negotiations lasting more than a year are not unusual.

The Dodd-Frank Act and the European Markets Infrastructure Regulation (EMIR) ushered in many regulatory changes to the trading of swaps, slowing down the negotiation process, noted Purrington Moody Weil partner Tess Weil. There is more pressure from the buy side to actively participate in the ISDA negotiation process, Weil added; therefore, in her experience, dealers are finding it harder to ignore buy-side concerns and are more receptive to facilitating client goals. See "Ropes & Gray Attorneys Discuss Implications for U.S. Hedge Fund Managers of the European Market Infrastructure Regulation" (Jul. 18, 2014); and "How Have Dodd-Frank and European Union Derivatives Trading Reforms Impacted Hedge Fund Managers That Trade Swaps?" (Oct. 17, 2013).

Dealing With the Unresponsive Dealer

All too often, negotiations stall due to an unresponsive dealer. Geffen explained that when this happens, he seeks to elevate the open issues to the appropriate group within the dealer, be that the business team, risk team or the credit group. His firm regularly engages directly with these groups.

Carruzzo advised that if negotiations are moving slowly, he often schedules a call with the dealer and requests that the business people that are in a position to make a decision on the open issues (e.g., the credit officer in charge of the relationship or traders on a specific desk) join the call in order to find a compromise and expedite the resolution of open issues.

Utilizing the Umbrella ISDA

Managers that manage multiple private funds that trade swaps often prefer to use an "umbrella" ISDA, which in its most basic form contemplates more than one party being on at least one side of the ISDA, each individually and separately facing the counterparty (Umbrella ISDA). Those managers that use an Umbrella ISDA typically have a separate form of Umbrella ISDA for each fund structure organized in the same jurisdiction.

When multiple funds execute the same ISDA, any terms specific to a fund (e.g., net asset value (NAV) decline triggers, tax representations or document delivery requirements) are set forth in addenda to the Schedule or CSA. Carruzzo explained that an Umbrella ISDA simplifies the documentation process and eases the investment manager's burden of monitoring ISDA terms, as the majority of terms are aligned across the manager's funds.

This is a common approach followed by larger managers, as well as managers that continually launch new funds, agreed Geffen. He cautioned, however, that managers that elect this approach must ensure that the Umbrella ISDA contains clear and robust separation language. Specifically, Geffen looks for language within the ISDA clarifying that it is being utilized solely as a matter of convenience by the parties, affirming that no fund is responsible for the obligations of another fund and acknowledging on behalf of each party that it is as if each fund entered into a separate ISDA with the dealer.

When utilizing an Umbrella ISDA, investment managers need to ensure that the allocation of any expenses incurred in negotiating the agreement are allocated according to manager's expense allocation policy. See our three-part series on managing expense allocations: Part One (Aug. 25, 2016); Part Two (Sep. 8, 2016); and Part Three (Sep. 15, 2016).

Investment Manager Representation Letter

For the sake of convenience, it has become common practice for the investment manager to execute ISDAs on behalf of the fund. However, prior to acting in this capacity, the investment manager should ensure that the fund has delegated to the manager this authority in the fund's constituent documents.

Carruzzo also recommended that, because the dealer will request the investment manager to make certain representations as part of the ISDA negotiation process, the manager should insist that any of those representations are set forth in a separate side letter between the dealer and the investment manager. "Having the investment manager make any and all representations to the dealer in a separate side letter bolsters the argument that the investment manager is simply executing the ISDA on behalf of the fund pursuant to authority delegated to it and is not actually becoming a party to the ISDA," he explained.

Revisiting the Negotiation of a Fund's ISDAs

Funds that do not have the time to fully negotiate an ISDA or newly launched funds that have received less than ideal terms should consider reopening the ISDA negotiation one to three years later, when the fund is more mature, Geffen advised. Carruzzo also advocated that his clients with mature funds review the terms in their ISDAs every one to two years or when the manager launches a new fund and replicates existing trading agreements.

When conducting that review, Carruzzo noted, by way of example, that he may consider the following factors:

- whether the market has moved on the terms that the fund previously received;
- whether there has been a material increase in the volume of trading under the ISDA with the dealer, which may enable the fund to obtain better terms;
- whether the products being traded under the ISDA have changed; and
- whether the fund's NAV has materially increased, which may lead him to revisit NAV-related terms.

How Dodd-Frank's Clearing Requirement Transformed Swap Trading

The Dodd-Frank Act and EMIR fundamentally changed how certain swaps are traded, as they ushered in requirements that standardized swaps, as determined by the applicable regulator, are subject to a central clearing requirement.

For cleared swaps, the parties face a clearinghouse as opposed to each other, thereby eliminating the counterparty credit risk exposure that counterparties have to each other when entering into bilateral transactions. See "Don Muller and Joshua Satten of Northern Trust Hedge Fund Services Discuss the Impact of OTC Derivatives Reforms on Hedge Fund Managers" (Feb. 7, 2013); and "OTC Derivatives Clearing: How Does It Work and What Will Change?" (Jul. 14, 2011).

Swaps that are subject to a clearing requirement are also required to be executed on a SEF, to the extent that the swap is made available for trading on a SEF. The purpose of the SEF is to provide pre-trade transparency to market participants and post-trade transparency to the regulators and industry. See "K&L Gates Investment Management Seminar Addresses Compliance Obligations for Registered CPOs and CTAs, OTC Derivatives Trading, SEC Examinations of Private Fund Managers and the JOBS Act (Part One of Two)" (Jan. 30, 2014).

Notably, the ISDA is not the relevant agreement for swaps that are traded on a SEF and subject to central clearing. Rather, the fund must engage a clearing broker, typically a futures commission merchant (FCM), and enter into a futures agreement with the FCM. An addendum covering cleared swaps, known as the cleared derivatives addendum, will also be required. See "Dechert Webinar Highlights Key Deal Points and Tactics in Negotiations Between Hedge Fund Managers and Futures Commission Merchants Regarding Cleared Derivative Agreements" (Apr. 18, 2013).

[1] See, e.g., Juliet Chung and Katy Burne, Banks Pitch Swaps As Alternative to Buying Stocks, Wall Street Journal (Jul. 29, 2015), available at http://www.wsj.com/articles/banks-pitch-swaps-as-alternative-to-buying-stock-1438211487.

[2] A copy of the Schedule is available for download for free from the ISDA website.

[3] A copy of the CSA is available for download for a fee from the ISDA website.

[4] A copy of the 1992 and 2002 Master Agreements are available for download for a fee from the ISDA website.

[5] For a summary of the changes between the 1992 and 2002 Master Agreements published by ISDA, see "Key Changes in the 2002 ISDA Master Agreement."

The HEDGE FUND LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 10, Number 3 January 19, 2017

DERIVATIVES

Best Practices for Fund Managers When Entering Into ISDAs: Negotiating Event of Default and Termination Event Provisions (Part Two of Three)

By Kara Bingham

One of the lessons learned by investment managers that previously traded swaps with Lehman Brothers was the importance of having robust legal documentation in place to govern these trades. For example, the filing for bankruptcy by Lehman Brothers Holdings Inc. (LBH) generally triggered an event of default by LBH in its swap contracts that were traded under the 1992 or 2002 International Swaps and Derivatives Association Master Agreement (Master Agreement)[1], entitling LBH's counterparties to certain remedies. See "Lehman Sues J.P. Morgan Over Allegedly 'Inflated' Claims Under Derivative Contracts and Improper Setoffs" (Oct. 25, 2012); and "The Lehman Bankruptcy and Swap Lessons Learned Negotiating an ISDA Master Agreement in Today's Market" (Mar. 4, 2009).

In this second article of a three-part series, we review commonly negotiated events of default in the Master Agreement and additional termination events in the schedule to the Master Agreement (Schedule, and together with the Master Agreement, the ISDA), in addition to suggesting tactics fund managers can employ when negotiating certain key provisions. The first article provided background on the various documents required to trade swaps and explained the impact the Dodd-Frank Act has had on trading these instruments. The third article will analyze the key considerations for funds when negotiating the collateral arrangements – the delivery of margin to mitigate counterparty risk – between two parties.

Events of Default Versus Termination Events

Events of default were historically viewed as circumstances where the defaulting party was to blame, while termination events were viewed as something that happened to the affected party. While triggering an event of default or termination event tend to lead to the same end result – the ability of the non-defaulting party to early terminate and employ close-out netting – there are three key differences under the Master Agreement, explained Rimon Law partner Robin Powers:

1. An event of default will result in the early termination of all transactions, whereas certain termination events only result in the early termination and close-out of affected transactions.
2. Under the 2002 Master Agreement, a party is required to notify the counterparty when it experiences a termination event but not an event of default.
3. Section 2(a)(iii) of the Master Agreements makes it a condition precedent for the non-defaulting party to continue to make payments on transactions for which no event of default has occurred and is continuing. A similar condition precedent does not exist with respect to termination events.

The third distinction became a matter of contention after the insolvency of LBH, when certain counterparties to swap contracts with LBH were net-out-of-the-money. These counterparties were incentivized to sit on their rights and not close-out the transactions. See "British High Court Interprets ISDA Master Agreement to Suspend Non-Defaulting Party's Payment Obligations Until Defaulting Party Has Cured the Default" (May 17, 2012); and "Lehman Brothers Claims That Withholding of Payments Under Swap Agreement Violates the Automatic Stay of Bankruptcy Code" (Aug. 19, 2009).

One solution to the condition-precedent risk is for the parties to negotiate a limit (typically 30 to 90 days) on the period for which a party can refuse to make payments after an event of default has occurred, explained Powers. After that period has expired, the non-defaulting party is required to either resume performing under the ISDA or terminate and close out the transactions.

Events of default and termination events are set forth in Section 5 of both Master Agreements. Additional termination events are designated in the Schedule. For purposes of this article, we assume that the parties are entering into the 2002 Master Agreement. Where the terms in the 1992 Master Agreement are materially different, it is noted below. Capitalized terms within quotation marks shall have the meaning specified in the 2002 Master Agreement[2].

Events of Default

Events of default set forth in the Master Agreement are bilateral in nature, as they apply to both parties and, where applicable, also apply to any "Credit Support Provider"[3] and "Specified Entity" of a party. They include:

1. failure to pay or deliver;
2. breach of agreement and repudiation of agreement[4];
3. credit support default;
4. misrepresentation;
5. default under specified transaction (DUST);
6. cross-default;
7. bankruptcy; and
8. merger without assumption.

Negotiations tend to focus on cross-default and DUST.

Cross-Default

Cross-default, in the ISDA context, may be triggered when a party to the ISDA defaults under a separate agreement relating to borrowed money. While cross-default only applies if the parties elect it within the Schedule, dealers will generally insist that this event of default applies to their hedge fund counterparties. Most dealers will also agree to be subject to this event of default, but they may seek to negotiate the provision to make it more favorable to them.

Specifically, cross-default occurs when an event described below occurs under an agreement or instrument relating to "Specified Indebtedness" in an amount not less than the stated "Threshold Amount":

- a default under an agreement or instrument that has resulted in the Specified Indebtedness becoming, or becoming capable at such time, of being declared, due and payable (Debt Defaults); and
- a failure to make any payments on their due dates under that agreement or instrument after giving effect to any applicable grace period (Payment Defaults).

The parties typically negotiate three key aspects of cross-default, each as described below.

<u>Definition of Specified Indebtedness</u>

Specified Indebtedness is defined in Section 14 of the Master Agreements as obligations in respect of borrowed money and is intended to capture credit agreements and the like. As some hedge funds do not have obligations with respect to borrowed money, dealers may insist on expanding this definition to include derivative transactions[5].

Powers explained that dealers may request the definition of Specified Indebtedness to be expanded as it applies to the hedge fund, but not as it applies to the dealer. This sort of amendment results in the cross-default term being a credit term for the hedge fund, as opposed to both parties. In her view, if the hedge fund is taking on this exposure, so too should the dealer.

<u>Threshold Amount</u>

Cross-default is only triggered when the amount of Specified Indebtedness that is defaulted upon equals or exceeds the Threshold Amount set forth in the Schedule. Each party is thus motivated to negotiate a high Threshold Amount for itself, as this minimizes its risk of a default.

Certain dealers prefer setting the Threshold Amount at a fixed dollar amount, while others prefer the figure to float as a percentage of the fund's net asset value (NAV), noted Powers, with 3 percent being the common percentage for funds. Whether the fund prefers a fixed or floating amount generally depends upon the fund's NAV – larger funds will often prefer a floating amount, while smaller funds prefer a fixed dollar amount. Powers added that dealers will often insist on a formulation where the Threshold Amount equals the lesser of the fixed dollar amount or percentage.

When the scope of Specified Indebtedness is expanded to include derivatives, noted David Geffen, founder and president of Geffen Advisors, he strongly recommends that his clients clarify within the Schedule how these transactions will be valued to determine whether the Threshold Amount has been breached. The easiest way to address this is to state that the amount that was owed and not paid when due will be used, he advised.

The 2002 Master Agreement clarified that Debt Defaults and Payment Defaults shall be aggregated to determine if the Threshold Amount has been reached.

Cross-Acceleration and Administrative Error Carve-Outs

Funds seek to soften the effect of cross-default in two ways.

First, funds request that cross-acceleration, as opposed to cross-default, apply to Debt Defaults, noted Akerman partner Jack Habert. With cross-acceleration, the party to the ISDA can only declare its counterparty in default if the third party (e.g., the creditor, lender or derivatives counterparty) accelerates payment of the obligation. Cross-acceleration is accomplished by deleting the words "or becoming capable at such time of being declared," from Section 5(a)(vi)(1), Habert explained.

Powers added that in her experience, many dealers have come to accept cross-acceleration in lieu of cross-default.

Second, funds often request an administrative error carve-out from Payment Defaults. A Payment Default that is not indicative of a true credit problem should not trigger cross-default, explained Powers. While each dealer has its own administrative error carve-out language, she noted that the provision generally states, "the payment default was of an administrative or operational nature, the party had the funds to make the payment at the time it was due and the party cured the error within a specified period of time."

When negotiating this provision, the cure period should only begin to run once the party receives notice from the counterparty that it failed to receive the payment, argued Fabien Carruzzo, a partner at Kramer Levin Naftalis & Frankel LLP. Otherwise, the failing party would have the burden to continuously monitor that its counterparties actually receive payments, which is operationally inefficient and could render the carve-out inoperative.

Default Under Specified Transaction

DUST is often referred to as a limited cross-default with respect to other derivatives transactions (i.e., derivative transactions not executed under the ISDA). As with cross-default, there are several aspects of this provision to consider.

First, DUST concerns a "Specified Transaction" between one party to the ISDA (or its Credit Support Provider or Specified Entities) and the other party (or its Credit Support Provider or Specified Entities), and excludes transactions executed under the ISDA between the parties. This is in stark contrast to cross-default, which covers obligations between one party to the ISDA (or its Credit Support Provider or Specified Entities) and any third party.

Second, the 2002 Master Agreement substantially expanded the definition of Specified Transaction to include not only derivative transactions, but also repurchase (i.e., repos) and securities lending transactions[6]. For any funds using the 1992 Master Agreement, dealers will almost always amend the definition of Specified Transaction to align with the broader definition found in the 2002 Master Agreement, advised Powers.

Third, some dealers will seek to expand the definition of Specified Transaction further by adding additional transactions in the Schedule. For example, if the dealer and the fund have a credit facility in place, the dealer may seek to include the credit facility within the definition of Specified Transaction, such that a default under the credit facility will also trigger a DUST[7]. For more on credit facilities utilized by funds, see our three-part series: Part One (Jun. 2, 2016); Part Two (Jun. 9, 2016); and Part Three (Jun. 16, 2016).

Finally, under DUST, a failure to make delivery receives the benefit of cross-acceleration (as opposed to cross-default), Powers explained; consequently, the non-defaulting party may only declare an event of default under the ISDA if it elects to accelerate the obligations of all transactions outstanding under the documentation governing the Specified Transaction. Powers pointed out that she prefers that cross-acceleration also apply to Section 5(a)(v)(2), which sets forth an event of default for failures to make any payment due on the last payment date, or any payment on early termination, of a Specified Transaction.

Designating Specified Entities

Attention should be paid to how the dealer proposes to define in the Schedule the fund's Specified Entities, as defaults by a Specified Entity under cross-default and DUST would also trigger an event of default[8].

Dealers will often identify the fund's affiliates as its Specified Entities, but Habert said he prefers to avoid this approach and requests the dealer specifically designate which of the fund's related parties shall constitute Specified Entities. "The Specified Entity analysis should center on whether the businesses of the fund and the proposed Specified Entity are so intertwined that a default by the Specified Entity would signal a legitimate risk to the dealer about the fund's continuing ability to pay and perform," he explained. If not, the entity should not be included as a Specified Entity.

Termination Events

The termination events described in the Master Agreements are as follows:

1. illegality;
2. force majeure[9];
3. tax event;
4. tax event upon merger;
5. credit event upon merger; and
6. additional termination events (ATEs).

Negotiations center on the ATEs in the Schedule. Unlike termination events in the Master Agreement that apply on a bilateral basis, most of the ATEs in the Schedule only apply to the fund.

Decline in the Fund's NAV

ATEs that concern a decline in a fund's NAV over a specified period of time (NAV Trigger) typically result in the most negotiation. Habert provided a basic example of a NAV Trigger: "as of the last day of the calendar month, the NAV of the fund has declined by 20 percent or more from the last day of the preceding calendar month (without giving effect to redemptions)."

NAV Triggers typically have four components that should be considered, noted Habert:

1. the amount (typically expressed as a percentage) of the decline in the fund's NAV;
2. the period of time over which the NAV Trigger is calculated;
3. the starting and stopping point for each calculation; and
4. the factors used to calculate the fund's NAV for purposes of the NAV Trigger.

Most dealers request monthly, quarterly and annual NAV Triggers, explained Powers. Some dealers prefer that the calculation period align with calendar months, while others will request a rolling 30-day, 90-day and annual period. Rolling (i.e., daily) NAV Triggers are complex to monitor as dealers may seek to test the fund's NAV on any day during the period against the fund's highest NAV achieved during the period, she explained. Habert added that he also prefers NAV Triggers that are calculated at delineated time intervals, thereby giving a fund some flexibility in managing its performance rather than being forced to react to sudden market fluctuations.

The third component takes into account the starting and stopping point for each NAV Trigger. Funds should consider the operational components of how they typically calculate the fund's NAV and try to align the NAV Trigger with their existing operational processes.

With respect to the fourth point, the key thing to consider is whether the NAV Trigger is measuring (1) an overall decline in the fund's assets under management (AUM) (in which case subscriptions, withdrawals and redemptions are included); or (2) a decline in the fund's performance (in which case subscriptions, withdrawals and redemptions may be excluded). Dealers prefer that all NAV Triggers be calculated as an overall decline in the fund's AUM, Powers explained.

"Nevertheless, most dealers will agree to a monthly NAV Trigger that measures the fund's performance. Dealers are split when it comes to the quarterly NAV Trigger, with some agreeing to a performance calculation trigger, while others insist on a total AUM decline figure. For the annual test, it is almost always a total AUM decline calculation," Powers noted. In certain instances, a fund may seek to negotiate with the dealer to take certain items into account in the calculation of the fund's AUM, such as capital commitments, to provide greater flexibility, added Carruzzo.

Where possible, funds should seek to align the second, third and fourth components of the their NAV Triggers across their trading agreements, so if the fund gets close to a NAV Trigger, the fund will not be forced to perform and monitor a multitude of triggers, advised Habert.

It is also important to align NAV Triggers for cross-default purposes, noted Carruzzo. If a fund has multiple versions of NAV Triggers across its trading documents and some NAV Triggers are weaker than others, a trigger in one document could trigger a cross-default in other documents. "In order for a fund to avoid the need to obtain a waiver from the dealer for a NAV Trigger, funds may consider negotiating a deemed waiver provision that would make the ATE no longer actionable by the dealer when certain conditions are satisfied, such as the expiration of a period of time since the NAV Trigger occurred and was notified to the dealer," Carruzzo suggested.

Other ATEs

Key person events are also commonly requested as ATEs by dealers. Habert explained that the negotiation becomes more complicated for larger funds with multiple decision-makers. In these cases, he advocates that a key person event should only be triggered when the majority of the investment decision-makers leave the firm.

A change in the investment manager to the fund is another common ATE, noted Habert.

One compromise often accepted by dealers with respect to these two ATEs is that the departure of a key person and change in the investment manager will not trigger an ATE if they are replaced by a person acceptable to the dealer within a period of time specified by the dealer.

In terms of ATEs that apply to the dealer, Powers noted that some dealers will agree to an ATE of a credit downgrade. "When Lehman went into bankruptcy, there were some funds that had credit rating declines in their ISDAs that protected the funds," she added.

The Role of the Calculation Agent

The calculation agent is the party responsible for determining settlement amounts owed between the parties. The dealer generally appoints itself as the calculation agent. Powers explained that she typically requests that the fund or a third party become the Calculation Agent if the dealer has experienced an event of default. Habert also requests that dealers agree to act in good faith and in a commercially reasonable manner when serving in this function.

Dispute rights regarding valuation and determinations made by the Calculation Agent are not embedded in the Master Agreement. That being said, all dealers maintain their own dispute right provisions that they may offer up during the negotiation. When reviewing this language, Powers seeks to ensure that no payments on disputed amounts will be paid until the dispute is resolved and that any disputes will be resolved in a timely manner.

[1] It should be noted that an event of default was also typically triggered at the time of LBH's bankruptcy in cases where LBH was identified as a Credit Support Provider to the Lehman Brothers counterparty in the Schedule.
[2] A copy of the 2002 Master Agreement is available for download for a fee from the ISDA website.
[3] A Credit Support Provider refers to a person that delivers or issues a "Credit Support Document" (defined as a document given in support of a party's obligations under the Master Agreement) on behalf of a party to the ISDA that secures the obligations of such party. Examples of Credit Support Documents include guarantees and letters of comfort.
[4] In the 1992 Master Agreement, this event of default is referred to as "breach of agreement."
[5] One way that dealers attempt to broaden the scope of Specified Indebtedness is to import into its definition the list of derivatives set forth in the definition of Specified Transaction (found in Section 14 of the 2002 Master Agreement).
[6] See Section 14 of the 2002 Master Agreement for a full list of transactions that constitute Specified Transactions.
[7] Note that a default under a credit agreement between the parties to the ISDA would not typically be captured under cross-default, as cross-default applies to agreements between a party to the ISDA and a third party.
[8] A Specified Entity is also relevant with respect to the following event of default and termination event, respectively: Section 5(a)(vii) – Bankruptcy; and Section 5(b)(iv) – Credit Event Upon Merger.
[9] Force majeure is included as a termination event only in the 2002 Master Agreement.

The HEDGE FUND LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 10, Number 4 January 26, 2017

DERIVATIVES

Best Practices for Fund Managers When Entering Into ISDAs: Negotiating Collateral Arrangements (Part Three of Three)

By Kara Bingham

When the Dodd-Frank Act introduced central clearing for certain standardized, liquid swaps, one of its primary goals was to reduce the amount of credit risk between counterparties to derivatives that historically traded in the over-the-counter (OTC) market. For cleared swaps, a regulated clearinghouse is interposed between the two original parties to the transaction. The clearinghouse becomes a counterparty to each of the original parties, which post margin directly with the clearinghouse. Consequently, once the trade is cleared, the parties no longer have exposure to each other. If one party defaults on the trade, the clearinghouse is contractually obligated to pay all amounts owed to the non-defaulting party.

The clearing model is in stark contrast to the bilateral trading model that applies to uncleared swaps, where one party delivers collateral directly to the other party. To mitigate counterparty credit risk, parties enter into a credit support annex (CSA),[1] which sets forth the collateral arrangements between the parties, such as whether a party is required to deliver collateral to the other party and the type of collateral permitted. See "Celent Report Identifies Best Practices for Over-the-Counter Derivatives Collateral Management" (Jul. 29, 2009).

In this final installment in our three-part series, we discuss the key considerations for funds when negotiating the CSA. The first article provided background on the various agreements that govern swaps and explained the impact the Dodd-Frank Act has had on trading these instruments. The second article reviewed the most highly negotiated events of default and termination events in swap trading agreements and offered suggestions for negotiating these provisions.

An Introduction to the CSA

Parties may choose from various forms of the CSA issued by the International Swaps and Derivatives Association (ISDA), depending upon whether they seek to have their collateral arrangements governed by New York, English or Japanese law. Unless the context suggests otherwise, we have assumed for purposes of this article that the parties are negotiating the 1994 version of the CSA governed by New York law, and capitalized terms within quotation marks shall have the meaning specified in that agreement. It should be noted that in 2016, ISDA issued revised versions of the CSA to consider the new variation margin requirements for non-cleared swaps, which will also be highlighted herein.

Paragraphs 1 through 12 of the CSA are standardized, and any modifications to these provisions are documented in Paragraph 13. As drafted, the CSA is bilateral in nature, meaning that it contemplates that both parties may post and receive collateral as security for a derivative transaction subject to the 1992 or 2002 ISDA Master Agreement (Master Agreement).[2]

Collateralization and the Negotiation of the CSA

Variation (Mark-to-Market) Margin

The primary way that parties historically managed their counterparty credit exposure was for one party (Pledgor) to deliver collateral to the other party (Secured Party) to the extent that the Secured Party had a net exposure[3] across all its open OTC derivative transactions under the Master Agreement.

Note that neither of the terms "variation margin" nor "mark-to-market margin" are used in the 1994 versions of the CSA. They have become common industry terms, however, and refer to the delivery of collateral to protect counterparties from fluctuations in the market value of their OTC derivative transactions. See "Hedge Fund Sues Wachovia and Citibank Alleging the Banks Demanded Excessive Collateral in Connection With Credit Default Swaps Based on Collateralized Debt Obligations" (Mar. 11, 2008).

One-Way CSAs and Asymmetrical Thresholds

While the CSA contemplates a two-way exchange of collateral, in the past, dealers often insisted that the CSAs be one-way in nature, meaning that only the dealers' counterparties (e.g., hedge funds) were required to deliver collateral, explained Purrington Moody partner Tess Weil. One-way CSAs can be accomplished in a few ways.

First, in Paragraph 13, the dealer can limit the definition of Secured Party to the dealer, so only the dealer will be entitled to receive collateral for its mark-to-market exposure. Another option is to set asymmetrical "Thresholds" in Paragraph 13 of the CSA. To the extent that a Pledgor successfully negotiates a Threshold greater than zero, this will decrease the amount of collateral it must post to the Secured Party. A Threshold set at the value of infinity will result in that party never having to post collateral to the other party; thus, the CSA becomes one-way in nature.

Historically, certain dealers insisted that they receive the benefit of high Thresholds, while their counterparties often had Thresholds equal to zero. Today, one-way CSAs and Thresholds only in favor of the dealer are less common, explained Weil.

In terms of hedge funds negotiating their own Thresholds, Fabien Carruzzo, a partner at Kramer Levin Naftalis & Frankel, noted that some large funds that carry a significant amount of leverage with a dealer may successfully have been able to negotiate their own Thresholds. However, with the advent of regulated variation margin and the prohibition against Thresholds, one-way CSAs and Thresholds will soon become a thing of the past.

Independent Amounts

Another tool that parties (and particularly dealers) use to minimize counterparty risk is the requirement that the counterparty post an "Independent Amount," the technical term for what is commonly referred to as initial margin. The Independent Amount, which may be calculated at the portfolio level or on an individual transaction basis, provides an additional buffer for the party receiving the collateral in the event of a default by the counterparty. The posting of an Independent Amount is in addition to the posting of variation margin and typically results in the over-collateralization of the party receiving the collateral.

A confirmation will specify an Independent Amount that is negotiated at the time of a transaction (Confirmation). Some dealers require a fallback provision in the CSA, stating that if an Independent Amount is not otherwise set forth in the Confirmation, then the Independent Amount shall equal a specified percentage of the notional value of the trade. The fallback Independent Amount, warned Carruzzo, is typically significantly higher than what a portfolio manager for the fund would negotiate, making it important for the investment professional to negotiate Independent Amounts at the time of execution.

<u>Segregation of Independent Amounts</u>

One concern that came to light with the bankruptcy of Lehman Brothers was the difficulty a party would have recovering Independent Amounts from an insolvent counterparty that had rehypothecated Independent Amounts or commingled Independent Amounts with their own assets. This led to an industry-wide discussion[4] about whether Independent Amounts posted by private funds should be segregated from the dealer's assets and held with an independent third-party custodian.

Unlike in the prime brokerage context, applicable law does not limit a dealer's right to rehypothecate these assets, although a limit could be negotiated between the parties. See "How Fund Managers Can Mitigate Prime Broker Risk: Preliminary Considerations When Selecting Firms and Brokerage Arrangements (Part One of Three)" (Dec. 1, 2016). The CFTC weighed in with the adoption of the Collateral Segregation Rule, guaranteeing counterparties such as private funds the right to elect (while not requiring) that Independent Amounts be segregated with an independent third party custodian.

Costs of Segregating Independent Amounts

One of the best ways to protect a fund's assets in the event of a dealer's insolvency is to have the fund's Independent Amounts held with an independent third-party custodian and to negotiate robust collateral access rights, explained Carruzzo. There is a cost in doing so, however, including the establishment of a new custody account; negotiation of additional custody and collateral control arrangements; and payment of initial set-up and ongoing custodial fees. Because of the additional costs associated with this practice, private funds typically only pursue this option if they have sufficient exposure to the dealer to justify the cost.

Conditions Precedent to Performance

Like the Master Agreement, Paragraph 4(a) of the CSA includes conditions precedent to performance, one of which provides that a party may cease delivering and returning collateral to a counterparty that has experienced an "event of default, potential event of default or specified condition." Unlike the condition precedent in the Master Agreement and subject to negotiation by the parties, however, the condition precedent in the CSA contemplates permitting a party to cease performing upon the occurrence of a termination event or an additional termination event (ATE), as the term specified condition refers to both.[5]

Fund counterparties should seek to negotiate a sunset provision on this condition precedent such that after a certain amount of time, the non-defaulting party must either resume making margin payments (or returning margin) under the CSA or move to early terminate the transactions, suggested Robin Powers, a partner at Rimon Law.

New Mandatory Margin Rules

In 2015, as required by the Dodd-Frank Act, the CFTC and other regulators promulgated rules imposing minimum margin requirements (Mandatory Margin Rules) on swap dealers, major swap participants and certain other regulated institutions with respect to their trading of certain uncleared swaps.

With respect to initial margin, the Mandatory Margin Rules require covered swap dealers trading swaps with funds that have "material swaps exposure" to collect and post initial margin on a daily basis. A fund will be deemed to have material swaps exposure if it and its affiliates have an average daily aggregate notional amount calculated in accordance with the Mandatory Margin Rules that exceeds $8 billion.

While most funds are accustomed to posting initial margin, this will be a sea change for dealers who historically have not had to post Independent Amounts, explained Warshaw Burstein partner Marilyn Selby Okoshi. Compliance with the new initial margin rules began September 1, 2016, and is being phased in over a four-year period.

The Mandatory Margin Rules also require covered swap dealers to collect and post variation margin with all financial end-users, which include private funds. Mark-to-market margining is required regardless of whether the fund has material swaps exposure. The Mandatory Margin Rules as they apply to variation margin are codifying what the original CSA was intended to do, noted Okoshi. "From an operational perspective, the new rules may not alter the relationship for funds that have bilateral CSAs with their counterparties with zero dollar Thresholds and 'Minimum Transfer Amounts' (MTAs)[6] below $500,000," she explained, "although their documentation will need to be updated."

The deadline for compliance with the new variation margin requirements is March 1, 2017, at which point affected market participants will need to amend or adopt new documentation to comply with the new rules.

See our two-part series on the impact of the final swap rules on hedge funds: "Increased Margin Requirements" (Feb. 18, 2016); and "Increased Trading Costs" (Feb. 25, 2016).

Variation Margin Protocol

In 2016, ISDA released the 2016 Variation Margin Protocol, which is intended to assist parties with compliance with the Mandatory Margin Rules. Protocols were first introduced by ISDA in 1998 as a way for market participants to implement industry standard changes to their documentation. See "Katten Partner Raymond Mouhadeb Discusses the Purpose, Applicability and Implications of the August 2012 ISDA Dodd-Frank Protocol for Hedge Fund Managers, Focusing on Whether Hedge Funds Should Adhere to the Protocol" (Jan. 24, 2013).

One of the primary benefits of adhering to protocols is the elimination of the time and cost associated with bilateral negotiations between dealers and the end-users. Private funds need to understand, however, that when they adhere to a protocol, they are supplementing their existing documents; therefore, managers should ensure they understand the provisions included in the protocol and arrange for easy retrieval of protocol documents. See "Five Steps for Proactively Managing OTC Derivatives Documentation Risk" (Apr. 25, 2014).

It is expected that many market participants will rely upon the 2016 Variation Margin Protocol to ensure compliance with the Mandatory Margin Rules. Carruzzo warned that completing the protocol is slightly more complicated than adhering to some of the earlier protocols, however. Consequently, funds should begin the adherence process sooner rather than later, to ensure their trading of uncleared swaps continues without interruption. As an alternative, funds may elect to enter into an amendment to their CSAs with their dealer counterparties.

The Role of the Valuation Agent

The "Valuation Agent" determines the amount of a party's exposure and related margin payments, as well as the value of any collateral to be posted. The CSA, in many cases, contemplates the role of Valuation Agent as a shifting one, where the party that is owed margin is the Valuation Agent for that collateral call.

This can result in a deadlock, however, where both parties take the view that they are owed margin, noted Carruzzo. For this reason, some dealers insist upon always being the Valuation Agent, unless the dealer has experienced an event of default, in which case dealers are typically willing to cede this role to the fund or to an independent third-party valuation agent.

Unlike the Master Agreement, the CSA contains a hard-wired dispute mechanism. In most cases, the parties agree to the dispute mechanics as set forth in the CSA. However, fund counterparties should understand, explained Carruzzo, that if the dealer is the Valuation Agent at all times, for illiquid trades where the dealer is unable to obtain a valuation quote from an independent dealer, the dealer's original valuation will prevail in the event of a dispute.

[1] A copy of the CSA is available for download for a fee from the ISDA website.
[2] A copy of the 1992 and 2002 Master Agreements are available for download for a fee from the ISDA website.
[3] The technical definition of exposure is included in Paragraph 12 of the CSA; however, it generally means the netted mid-market mark-to-market value of the

transactions that would be payable to the Secured Party by the Pledgor if all transactions were terminated as of the valuation date.

[4] See a 2010 white paper published by ISDA discussing steps that end-users can take to mitigate or eliminate losses of Independent Amounts in the event a dealer becomes insolvent.

[5] Specified conditions are elected in Paragraph 13 and include termination events, including any ATEs. To the extent that ATEs are included as a specified condition, the guidance note in the CSA indicates that only ATEs that are otherwise designated in the schedule to the Master Agreement should be included.

[6] An MTA sets a threshold below which collateral will not be transferred between the parties. The parties may specify an MTA at any level in Paragraph 13 of the CSA, and different amounts may apply to each party. The purpose of an MTA is to eliminate the need to move collateral of a de minimis amount that does not otherwise pose a material credit risk.