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.

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

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*."