DEVI'S CORNER: WHEN THE BANKS WON'T CALL YOU BACK - NAV TRIGGERS' EFFECTS ON HEDGE FUNDS

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Between 2007 and 2009, many hedge funds declined in size due to investor redemptions and/or performance declines. These same hedge funds trade derivative agreements under an ISDA Master Agreement that typically contain provisions defined as Additional Terminations Events (''ATE'') which can be triggered by the decline of a fund's net asset value. If an ATE is triggered, the financial institution on the other side of the ISDA can terminate all of the derivative transactions under the ISDA.

The occurrence of an ATE also provides the financial institution with the right to stop posting or returning collateral. Similar provisions also exist to provide a broker with the right to terminate a lockup or other term commitment under a hedge fund's prime brokerage arrangements.

While many hedge funds suffered net asset value declines that triggered ATEs in the last two years, in a significant number of instances, hedge funds' trades were not terminated and positions in prime brokerage were not liquidated. There were increased margin requirements and requests from risk and credit management teams for more detailed information on their portfolio. As positions were sold, the brokers also trapped cash as additional collateral. In some instances, funds worked with their prime brokers to liquidate some positions as needed to de-leverage and meet the additional collateral requirements.

As hedge fund net asset values returned to stability, collateral was once again released to hedge funds. Trading increased or remained uninterrupted provided the financial institution felt comfortable with a hedge fund's creditworthiness. Transparency and communication was key to maintaining relationships between a hedge fund and its trading counterpart throughout the crisis. While trading and financing continued, if a hedge fund had previously triggered an ATE, the financial institution continued to retain the right to terminate. However, as time passed, when the financial institution felt comfortable providing a waiver and agreed in principle to a hedge fund's request, the attorneys at financial institutions remained deluged with one pressing matter after another. Waivers are not pressing matters and many waivers remain stuck in the process. To obtain a waiver requires consistent pressure on the business front and legal resources to follow through on the process. In some instances even this has not been enough.

As investors of hedge funds conduct their due diligence, fund managers are routinely asked if they have tripped any A TEs and whether they have received waivers. Unsigned waivers were red flags for potential investors which has led to frustration for many managers who have received the waivers in principle but are stuck in a legal backlog.

As a result, in new negotiations the market is seeing "Use It or Lose It" or "Fish or Cut Bait" clauses being proposed by hedge funds. These provisions typically provide that if a financial institution has not exercised its rights to terminate an agreement for some time period (typically 30 days to 90 days), then that institution will be deemed to have waived that ATE. While this provision on its face seems like a good solution to the problem facing funds in obtaining waivers, it can take months, in some instances more than a year, for both parties to feel comfortable with the stability of a fund in times of stress. When asked about this provision, one fund manager's response was that he didn't want to force a situation where a broker feels the need to terminate due to a fear of losing its protection.

Another provision that seemed more of a reasonable middle ground for some managers builds in a right to request a waiver or termination after some time period has elapsed that if unanswered, is deemed to have been waived. This places the right to request a waiver in the hands of the hedge fund who will only send the request once there is a verbal agreement from their counterparts. This also allows the financial institution to provide a waiver without additional legal involvement. Hedge funds should work with their attorneys to carefully develop these provisions in a manner that makes them most comfortable with the result and limits unwanted surprises in times of stress.

A question I am asked regularly is: What are the benefits to investing the time and legal resources to negotiate better A TE provisions?

To the extent financial institutions felt under collateralized with respect to hedge funds or their transactions in the past stressful environment, funds were asked to post additional collateral. Typically, under the terms of an ISDA and/or prime brokerage agreement with a term commitment, a hedge fund is within its rights to decline such a request for some time period. While they may have a right to decline the request, many hedge funds worked with financial institutions to provide them with comfort by supplying them with additional collateral as well as increased transparency.

Hedge funds that negotiated strong ATEs that were not tripped maintained a place at the bargaining table. They remained in a position to resist the first and initial knee jerk reactions for increased collateral requirements and eventually agreed to more reasonable increases over time. Strong ATEs provided a more stable financing and trading platform and these managers were better able to manage their business and the capital they put to work.

Hedge funds should consider their portfolio, investor profile and other similar factors to determine the type of net asset value, key man, and other triggers that best suit their funds and be ready to thoughtfully and consistently articulate these decisions to their investors.

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