THE FUND ADVISOR – COLUMN 1: KNOW YOUR ISDA AGREEMENT

By Devi Koya and Elizabeth Schubert, McDermott Will @ Emery LLP
Monday, January 31, 2005

The ISDA Master Agreement is not just a form.

This is the first installment of the Fund Adviser, a column that will address legal issues commonly faced by hedge funds. Prominent among those issues are agreements with other parties. When effecting various trading strategies, a hedge fund will need to enter into many types of trading relationships with market counterparties. These trading relationships typically require the hedge fund to enter into many trading agreements, including International Swaps and Derivatives Association Master Agreements, repurchase agreements, prime brokerage agreements, securities lending agreements, electronic trading agreements and netting arrangements. Since any hedge fund that wants to enter into any derivative transactions will typically be required to enter into a Master Agreement published by the ISDA and because the ISDA Master Agreement contains many concepts and terms that are found in most trading documents, the focus of this column will be on this ISDA Agreement. In addition to an introduction to ISDA documentation, some of our subsequent articles will discuss in more detail, the specific provisions and issues arising out of this Master Agreement.

When a hedge fund enters into a derivative trading relationship with a market counterparty, the derivative transactions typically will be subject to an ISDA Master Agreement, the Schedule to the ISDA Master Agreement, the Credit Support Annex and the Confirmation. The economic terms of each of the trades entered into between the fund and the dealer are not addressed in the ISDA Master Agreement. Instead, the ISDA Master Agreement establishes the credit and legal architecture for the trading relationship between the hedge fund and its counterparty. For example, the ISDA Master Agreement establishes the events that give a party the right to terminate the agreement and establishes the mechanics of how to terminate and determine the value of each derivative transaction. The parties also agree to the governing law and jurisdiction and provide each other with all of the necessary representations for entering into derivative transactions within the framework of the ISDA Master Agreement. Establishing these, and other rights with respect to the other party's performance, is the primary purpose of the ISDA Master Agreement. The Credit Support Annex, which also is developed by ISDA, establishes the collateral relationship between the parties. The CSA establishes the amount of unsecured exposure that one party will have to the other before it will be required to post collateral. In addition to other rights and obligations, the CSA also establishes the type and the amount of collateral that each party will be required to post to the other and the time frame within which the transfer of collateral must occur after demand.

Notwithstanding the title of this article, the ISDA Master Agreement is, in fact, a form document developed by the International Swaps and Derivatives Association to streamline the negotiation of the documents governing derivative transactions. The ISDA Master Agreement is customized and modified by the Schedule to the ISDA Master Agreement. The schedule typically is about 10 to 20 pages long and highly negotiated. Generally, a market counterparty will tailor most of the terms of a schedule based on the type of end user. A hedge fund end user may be asked to make representations relating to its compliance with certain anti-money laundering and ERISA laws and establish the authority of its investment adviser to enter into transactions on its behalf. Sometimes, legal opinions also are requested to establish a party's capacity and authority. A hedge fund also typically can expect to see certain additional termination events such as net asset value drops, changes to the fund's investment manager and other events that trigger a right to terminate the ISDA Master Agreement. These points and any document delivery requirements should be carefully negotiated by a hedge fund so that its executives are comfortable with its obligations and the instances in which its derivative transactions may be terminated.

The CSA is a part of the ISDA Master Agreement and also is a form document. The CSA governs collateral arrangement between the parties in connection with their trading relationship and the terms of the CSA are negotiated and further customized by the paragraph 13 to the CSA. The collateral terms in the CSA typically will be determined based on the size and strength of each of the respective counterparties. For example, a start-up fund with a low net asset value may be required to post collateral to the full extent of a dealer's exposure to it and may not receive any collateral from the dealer even when the positions move in the fund's favor, while a larger, more established fund may be able to negotiate more bilateral collateral terms that can require both parties to post collateral depending on their exposure.

The ISDA document structure provides that the ISDA Master Agreement, the Schedule, the Credit Support Annex and Paragraph 13 all form part of and become one agreement, the ISDA Master Agreement. When a trade has been entered into between two parties, the terms of the trade are documented in a trade confirmation that is subject to the terms of the ISDA Master Agreement. The confirmation contains the specific parameters of a trade, whether it is a commodity option transaction, an interest rate hedge, a credit default swap or some other derivative transaction. The confirmation also will specify that it is governed by the terms of the ISDA Master Agreement.

Sometimes parties that want to begin trading prior to negotiation of an ISDA relationship will sign a confirmation with the understanding that once an ISDA Master Agreement is signed, the confirmation will be governed by this Agreement. Before entering into a trade confirmation without an ISDA agreement in place, an end user should evaluate whether its ability to negotiate certain credit terms in its ISDA with a particular dealer may be impaired once it already has open trading positions with that dealer.

A party should carefully consider the terms of the ISDA Master Agreement to which it agrees to be subject. Irrespective of the volume of trading that is expected by the hedge fund with respect to a counterparty, a termination event or an event of default under one ISDA Master Agreement can have a domino effect on other trading agreements with that counterparty as well as the fund's other trading agreements with unrelated third parties. Since the ISDA Master Agreement as well as other trading documents generally have default or termination provisions that are triggered by default or termination under any other trading document, the termination of one agreement can affect all of a hedge fund's other agreements and trading relationships.

To summarize, ISDA documents, though they seem like form documents, should be carefully negotiated. The credit provisions in one ISDA Master Agreement establish the overall credit relationship between the parties. If a hedge fund does not carefully negotiate its credit terms, it may be faced with the unexpected termination of its transactions when it most needs those transactions to remain in place. The termination of one ISDA Master Agreement, irrespective of the importance of that relationship, can have a significant effect on all of a fund's other trading relationships. A fund should think carefully and seek counsel to ensure that it fully understands the credit and legal terms of its trading documentation.