

CLIENT ALERT

Coronavirus Crisis (COVID-19)

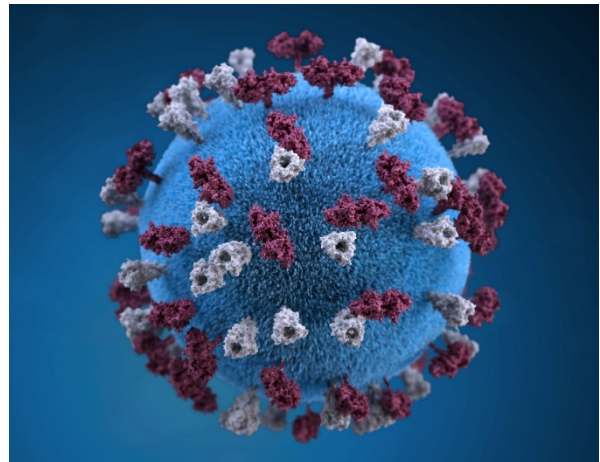
Key Concerns for Hedge Fund and Asset Managers with respect to Trading

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INTRODUCTION

The outbreak of the novel Coronavirus (COVID-19) has led to extreme market volatility and the first bear market since the Great Financial Crisis of 2008. Beyond the market impacts, it has created the most impactful global social disruption since World War II: individuals across the globe are entering lockdown mode by isolating themselves at home; public gatherings, conferences and events the world over are being cancelled; and business are moving to their business continuity plans and requiring personnel to work remotely. All of these factors are significantly affecting the business and operations of Hedge Fund and Asset Managers (“**Managers**”).

In this update we highlight important considerations for Managers with respect



to maintaining continuity of their trading operations. We focus in particular on legal and operational considerations with respect their legal arrangements governing trading: Prime Brokerage, ISDAs, Futures Clearing, OTC Clearing, Repo, Securities Lending, Custody, etc. (“**Trading Agreements**”).

Review Trading Agreements

There are risks lurking within Trading Agreements which lie dormant in the normal course of business. In times of markets stress (and crisis/state of emergency as we currently have), these risks often come to the forefront and become real issues. Managers need to stay ahead of these to avoid disruption in trading, removal or reduction in credit lines, increase in margin requirements and losses resulting from being forced into liquidating assets.

NAV Triggers

Many Trading Agreements contain default or termination events linked to declines in the Net Asset Value of a fund (“**NAV Triggers**”). Given recent volatility, it is vital for Managers to review the NAV Triggers contained in their Trading Agreements. This is necessary to confirm whether NAV Triggers have been hit, as well as to anticipate which ones might be hit in the future.

If NAV Triggers have been hit in an ISDA Master Agreement, there is a contractual obligation to notify the counterparty promptly upon becoming aware of such a decline. Managers should act swiftly and request amendments to the ISDA or provide waiver letters such that these events cannot be used against them in the future. Waiver letters are particularly important if the ISDA Master Agreement was not negotiated to include a fish or cut bait provision (a clause which forces a party to terminate within a prescribed period or forever lose its right to terminate based on the event’s occurrence).

Margin Requirements

Greater volatility will lead to greater movements in margin/collateral calls. Managers should consider revisiting how margin is determined/calculated under their Trading Agreements and what circumstances might lead to additional margin being required or result in an end to any committed margin arrangement from their prime brokers/counterparties.

Availability of Credit Lines

We can expect that through this crisis, availability of credit will tighten, and liquidity will dry up (it has already started). For Managers with term commitments in place with Prime Brokers it is important to revisit those arrangements and understand what circumstances might lead to an end to the Primer Broker’s commitment to extend financing. See our article on [Prime Brokerage Agreement Negotiation](#).

Asset Control

Managers who traded through the 2008 financial crisis, experienced first-hand what can happen when a prime broker fails. Clients of Lehman Brothers in the US lost assets since Lehman was using a practice known as arranged financing, often used to provide higher

leverage to hedge funds.¹ In the event of a PB insolvency, the chances of the fund incurring losses via arranged financing are increased and the recovery of assets is more complicated.

Although there is not yet any sign of weakness of financial institutions in this crisis, now is the best time for Managers to revisit their prime brokerage arrangements to understand where assets are held and the risks associated thereto in the event of the failure of a large institution.

Notices and Operational Processes

Managers should review how notices (e.g., margin calls, exchange of trade information, and legal notices) are provided for under Trading Agreements. It may have been years since these agreements were put in place and, in the normal course of business, Managers may have made operational or personnel changes which are not reflected in the Trading Agreements.

Moreover, with implementation of BCP plans and remote working, this may also impact usual operational processes such as meeting margin calls or settling payments.

Missing notices or margin calls/payments presents a significant operational risk as it can result in default under Trading Agreements.

Force Majeure Events/Clauses

There are situations where either party to the agreement can invoke *force majeure* as an excuse for non-performance. Although the current Coronavirus outbreak could create situations where force majeure is applicable, Managers must be diligent to take all necessary measures to perform their obligations.

The **2002 ISDA Master Agreement** offers bilateral protection by permitting either party to excuse themselves for the non-performance of their obligation if the event is beyond their control and, after using all reasonable efforts, cannot overcome such prevention, impossibility or impracticability. We will explore what constitutes reasonable steps, impossibility, and impracticability in a future piece.

Please note that the 1992 ISDA Master Agreement does not contain *force majeure* provisions, unless the parties have amended the agreement.² The 2002 ISDA Master Agreement incorporated a *force majeure* provision in the wake of the tragic September 11th attacks.

Under most prime brokerage agreements, prime brokers limit their liability in cases of *force majeure* where the fund suffers losses due to the primer broker's non-performance or failure. It is important for a Manager to communicate with their prime broker to assess what areas (if any) may be impacted by the current crisis. Managers should anticipate situations where their prime broker could fail to perform its obligations in reliance on this provision.

¹ Such arrangements, though they can increase the ability to run leverage, change the counterparty risk and regulatory environment that the fund faces vis-à-vis a U.S. broker dealer subject to 15(c)(3)(iii) 140% rehypothecation, to a UK entity which has no regulatory rehypothecation limit.

² This can be amended bi-laterally or via the ISDA Illegality/Force Majeure Protocol.

Other Considerations

BCP: Contact PBs and Counterparties

All service providers (prime brokers, counterparties, fund administrators, legal counsel, auditors, technology and systems providers) should be contacted to understand what BCP plans they have in place and if they will be able to continue to provide the same level of service. Where gaps may arise, it is important for Managers to foresee this and have alternative arrangements in place with other service providers. Managers should anticipate potential issues and mitigate the impact by taking precautionary measures.

Market Disruptions

Consideration should also be given to how market disruption events may affect valuations and margin requirements. The SEC has, at its discretion, the authority to suspend trading of any security for up to 10 days, and suspend trading on any national securities exchange for a period of up to 90 calendar days.³ Exchanges also have circuit breaker provisions which halt trading if the market dives below certain thresholds.⁴ In the event that the markets continue to experience extreme volatility, managers must carefully consider whether they might be locked into certain positions for an extended period of time and ensure that they have enough spare capital to accommodate margin accounts.

The CME has announced that it will close its trading floor and move solely to its electronic network, CME Globex.⁵ The NYSE is preparing for the possibility of taking similar action.⁶ Managers should assess their capability to access these markets electronically should the case arise.

³ Section 12(k) of the Securities and Exchange Act of 1934, must be of the opinion that it is of the public interest and for the protection of investors.

⁴ The S&P 500 will halt trading for 15 minutes if it experiences a 7% drop, another 15 minutes if it drops 13%, and will cease all trading activity for the remainder of the day if it drops below 20%.

⁵ <https://chicago.suntimes.com/business/2020/3/11/21175764/chicago-futures-market-close-trading-floor-because-coronavirus>

⁶ <https://www.wsj.com/articles/nyse-braces-for-coronavirus-with-potential-trading-floor-closing-11584009014> and <https://www.cnbc.com/2020/03/13/heres-what-would-happen-if-coronavirus-forced-the-nyse-to-close-its-trading-floor.html>

Contact

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About the Firm

HedgeLegal is a boutique law firm specialized in trading documentation. HedgeLegal has extensive experience negotiating a wide array of trading agreements: Prime Brokerage, Term Commitment/Lock-Up, ISDA, Equity Master Confirmation Agreements, Futures Clearing, OTC Clearing, FX PB, Repo, Custody, etc.

For more information, please visit www.hedgelegal.com or contact info@hedgelegal.com. Subscribe to our mailing list at www.hedgelegal.com.

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