May 14, 2020

Valuation

How Fund Managers Can Mitigate NAV Triggers' Impact on Trading Agreements

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With the outbreak of the coronavirus and the subsequent social upheaval, markets have become increasingly volatile. That volatility has resulted in the first bear market since the 2008 financial crisis and has negatively affected both equity and debt markets.

Some funds have put up negative performance figures, while others have become – or may soon become – subject to redemptions from investors in need of liquidity. Both consequences have materially increased the occurrence of and likelihood that net asset value (NAV) decline triggers (NAV Triggers) will be tripped by funds. Once those triggers are breached, hedge funds and their managers will find themselves in the precarious position of being subject to termination by their swap dealers, prime brokers and other counterparties (together, Counterparties).

This article unpacks the components of NAV Triggers and highlights important negotiation points and current market practices. The article also recommends actions that managers should take in consideration of recent events to protect their trading lines, investors and businesses.

For more on valuation by private fund managers, see "Failure to Consider Relevant Market Inputs When Valuing Assets May Draw SEC Enforcement Action Against Fund Managers" (Apr. 20, 2017).

NAV Triggers Explained

NAV Triggers are provisions included within various trading agreements – including the 1992 and 2002 ISDA Master Agreements (ISDA MAs); repurchase agreements; prime brokerage agreements; and futures clearing agreements (together, Trading Agreements) – at the behest of a Counterparty's credit officers. NAV Triggers essentially provide that, when a fund's NAV or its net asset value per share (NAV/share) has declined to a certain threshold over a particular period, then the Counterparty has certain remedies or rights at its disposal, such as the right to terminate transactions, demand additional margin or even put the fund in default.

The Counterparty's rationale for including those provisions is that a fund's decline in NAV may serve as an early warning sign that the fund is in distress. Without NAV Triggers, a Counterparty normally only has access to recourses such as terminating transactions once the fund defaults under the agreement (for instance, through a failure to pay or deliver). NAV Triggers afford Counterparties greater freedom to manage credit risk without needing to wait for the fund to breach the usual obligations under the agreement.

For managers, there are compelling arguments that NAV Triggers are wholly unreasonable. Those debates are nuanced by (i) the type of agreement in question; (ii) the fund's trading activity; and (iii) its credit profile. As a general matter, when one considers that most transactions (for instance, under an ISDA MA) are heavily collateralised by using both initial and variation margin that are exchanged on a daily basis, the rationale for the inclusion of NAV Triggers weakens.

Regardless, managers must accept that some level of NAV Triggers will be required by nearly all Counterparties. What therefore becomes important is to properly negotiate the NAV Triggers to limit their impact, as well as to ensure that the NAV Triggers are clear and simple to monitor.

Negotiating to Limit the Impact of NAV Triggers

NAV Triggers are almost always present in ISDA MAs and have increasingly been incorporated into other Trading Agreements. Counterparties will propose terms in the initial draft with a generally broad starting point skewed in their favour.

Parties negotiate NAV Triggers. They vary by Counterparty, however, and success in negotiating them will depend in part on each manager's bargaining power. There are, however, certain minimums that all managers should be able to obtain for their funds.

Managers should seek to streamline NAV Triggers across their various Counterparties. Doing so will allow a manager to effectively monitor NAV Triggers to manage risk and notify Counterparties of breaches in accordance with their contractual undertakings. For example, the default position in the template ISDA MA requires notification of any breach of a NAV Trigger. In certain cases, failure to notify may also lead to more significant ramifications than those for breaching the NAV Trigger itself.

For more on negotiating ISDAs, see "Best Practices for Fund Managers When Entering Into ISDAs: Negotiation Process and Tactics (Part One of Three)" (Jan. 12, 2017).

Negotiating Key Terms

There are four key components to a NAV Trigger provision. The first three are organic and affect every provision directly. The fourth – the fish-or-cut-bait provision (FOCB) – is highly recommended to be included as a matter of general application.

A summary of the key terms appears as Figure 1 below, and a more detailed explanation follows.

Figure 1. NAV Triggers Summary Table

Period	Decline Threshold Range in %	Minimum Thresholds Buy-Side should achieve	Typical Calculation Method Employed
Monthly	10% - 25%	15%	NAV/Share
Quarterly	20% - 35%	25%	NAV/Share
Annually	30% - 45%	35%	NAV
Floor	40% - 60%	50%	NAV

1) The Period Over Which the Decline Occurs

NAV Triggers are typically calculated over the following periods:

1. monthly;
2. quarterly;
3. annually; and
4. a floor from the highest NAV since the date of the Trading Agreement. That is not a period in the strictest sense but offers a minimum NAV that a fund needs to stay above.

Those periods are typical and rarely discussed; however, parties often clash as to when the period starts and ends. Start and end dates will either be a rolling period, which can start and stop on any day, or a "point-to-point" period, which starts and stops on the last business day of any given month, quarter or year.

It is vital that managers negotiate point-to-point periods and avoid rolling periods. The reason is simple: a rolling period can be triggered on any day, including an intra-month period. Because most funds produce monthly NAVs, there are practical implications and challenges to being able to monitor that intra-month valuation.

More importantly, the rolling period leaves the manager much more vulnerable to intra-month volatility and thereby increases the likelihood that the trigger will be breached. For example, during the recent volatile month of March 2020, it is possible that an equity long/short manager's intra-month NAV would have dipped below a NAV Trigger threshold (*e.g.*, 15% decline), only to recover as the equity markets rallied into month-end.

2) Decline Threshold

The decline threshold is normally expressed as a percentage. For example, a 15% decline in any given one-month period. Figure 1, above, outlines the range in thresholds typically seen, along with the minimums that the buy-side should achieve. The decline thresholds are heavily negotiated terms, and a manager's success will be driven by the size, credit profile and riskiness of the fund.

For NAV floor triggers, Counterparties often suggest the addition of a fixed dollar amount. It is not unusual to see the following language in trading agreements: ". . . NAV declines by the greater of 50% from highest NAV or $[X]m."

3) Method by Which NAV Is Defined and Determined

The important issue here is whether the NAV Trigger is:

- a performance-based trigger (*i.e.*, NAV/share), which excludes subscriptions, redemptions and withdrawals; or
- a trigger that takes into account any change to NAV, which would therefore include changes based on investor activity.

Managers should insist on performance-based NAV/share triggers whenever possible. Typically, that is granted for the monthly and quarterly triggers but not for the annual and floor triggers.

It is easy to see why performance-based triggers are preferable. For example, it is more likely for a fund to experience a 15% decline in a singular month as a result of large redemptions than a performance-related decline over the same period. As the annual NAV Triggers are usually around 35% to 40% and based on total NAV, only a large redemption would cause a trigger.

Moreover, redemptions and withdrawals may be entirely unrelated to the fund's performance, such as an investor's need for liquidity. Finally, those redemptions may not impede the ability of the fund or manager to continue to effectively operate and meets its obligations under the Trading Agreements.

4) FOCB or Deemed Waiver Provisions

This final concept is something managers must add to Trading Agreements to protect the fund. Without an FOCB provision, once a NAV Trigger is breached, even if a Counterparty does not act on it in the short term, it remains a termination event (TE) or an Event of Default (EoD) throughout the life of the Trading Agreement. That means that a Counterparty could come back at some later date (*e.g.*, in times of market stress or if the relationship is strained) and use that earlier NAV Trigger against a fund, regardless of the fund's then-current NAV.

See "Best Practices for Fund Managers When Entering Into ISDAs: Negotiating Event of Default and Termination Event Provisions (Part Two of Three)" (Jan. 19, 2017).

FOCB provisions put a limit (typically between 30-90 days) on the amount of time a Counterparty can wait to act upon a TE or an EoD. Failure to act results in the Counterparty forever waiving its rights to act with respect that event. The FOCB concept extends beyond simply NAV Triggers.

In negotiating that provision, managers should be mindful to explicitly state that the waiver applies to all TEs and EoDs. The notification procedure should be clearly detailed and allow for notifications to be sent via email. The notification period should begin to run from the moment the email is sent to avoid litigation in case a party chooses to argue that it was never opened or received. Without a provision permitting delivery by email, managers may be subject to providing notice via post or to multiple addresses, which can make the process cumbersome, particularly if there are multiple Trading Agreements with numerous Counterparties in place.

Furthermore, the current market environment surrounding the coronavirus is bringing into question the reliability of any post office being able to effect delivery. Also, most Counterparties are working from home and may not have access to their offices' mailrooms. Managers facing a Counterparty's refusal to accept email notification should use the current situation as a negotiating tactic and push harder for email delivery.

Limiting Trading Agreements Containing NAV Triggers

As alluded to earlier, NAV Triggers are nearly always present in ISDA MAs, but they are increasingly found in other Trading Agreements, such as prime brokerage, futures clearing and repurchase agreements.

See our three-part series on how fund managers can mitigate prime broker risk: "Preliminary Considerations When Selecting Firms and Brokerage Arrangements" (Dec. 1, 2016); "Structural Considerations of Multi-Prime or Split Custodian-Broker Arrangements" (Dec. 8, 2016); and "Legal Considerations When Negotiating Prime Brokerage Agreements" (Dec. 15, 2016).

There is no need for NAV Triggers to be included in those other agreements because the Counterparty's overall credit exposure is typically lower than its credit exposure under an ISDA MA. A prime broker and repurchase agreement Counterparty should be over-collateralised, and the underlying instruments are usually less volatile than OTC derivatives under an ISDA MA, resulting in less overall credit risk.

If a Counterparty remains insistent that those provisions are to be included, managers should accept the NAV Triggers, provided that a breach of a NAV Trigger only results in the possibility of an increase in margin requirements.

Consequences of Breaching a NAV Trigger

The consequence of a fund breaching a NAV Trigger will depend on the terms specifically negotiated with the Counterparty in the relevant agreement. Those consequences include the following potential penalties.

1) Termination of Transactions and Liquidation of Positions

Under the ISDA MA, NAV Triggers are added by Counterparties as an additional TE, and in other Trading Agreements, they may be specified as an EoD. The implications and remedies available to a Counterparty will therefore differ but, in all cases, will grant the Counterparty the right to terminate transactions or liquidate positions.

Under the ISDA MA, the termination will occur at the Counterparty's side of the market (*i.e.*, the Counterparty will alone determine the value for closing out the transactions). That has dual negative consequences for the fund:

1. The fund will lose exposure to the underlying transaction itself.
2. The termination of the transaction will occur in a potentially unfavorable way, which can lead to additional losses.

Under a prime brokerage agreement, for instance, the Counterparty (*i.e.*, prime broker) will be able to liquidate all fund positions, which could be very damaging depending on the portfolio's liquidity and the prevailing market conditions at the time the close-out occurs. One can expect that liquidation would usually occur in times of stress, so even the fair market value, determined in a commercially reasonable manner, would likely not be representative of the position's intrinsic value.

2) Margin Increases

In some agreements – namely prime brokerage margin lock up or term commitment agreements, as well as certain futures clearing agreements – NAV Triggers may be used as margin "commitment termination events" rather than TEs or EoDs. Once a NAV Trigger is breached, the Counterparty may increase margin without being subject to any negotiated margin limits or margin methodology.

Although not as bad as a TE or EoD, rapid increases in margin may also be devastating to a fund that is dependent on leverage, forcing it to hastily liquidate positions to meet the margin call or, worse, miss the margin call and then be placed into default for a failure to pay.

3) Cross Default

Counterparties seek broad cross-default rights in their Trading Agreements. Managers must therefore be mindful of how NAV Triggers breached in one agreement may create defaults under other agreements.

Care should be taken when negotiating cross-default provisions, as their scope is varied. They may capture EoDs or even TEs from only third-party agreements; agreements only with the same Counterparty; or agreements with the same Counterparty and its affiliates. They may also include threshold amounts over which the default must occur or specific transaction types to which it applies.

Cross-default provisions should generally be avoided, as they have unintended consequences and import events of default from one agreement that may not be appropriate in another. Moreover, those provisions allow Counterparties to be selective about which agreements they terminate and which they keep open.

Managers should always seek to remove cross-default provisions. Should the Counterparty insist, a reasonable compromise may be to accept a cross-acceleration provision. The key difference between the two provisions is that a cross-acceleration provision requires not only an EoD or TE to occur under the other agreement, but also the Counterparty to that agreement to exercise its rights and terminate its respective transactions. In other words, cross acceleration requires that there be a more serious event that has resulted in termination of the relationship, rather than an event (say a NAV Trigger breach under the ISDA MA) that remains unacted upon.

Action Items for Managers

Managers that have suffered negative performance or have received or anticipate receiving investor redemptions must act immediately. The best line of defense is to be proactive and understand their situations.

If NAV Triggers have been breached, a manager generally has a contractual obligation to notify its Counterparties. Either way, it should be getting ahead of that to explain its story; seek waivers or amendments; and limit the risk that a termination will be forced upon it.

Assess Agreements

Managers should data mine and review their Trading Agreements to determine if any NAV Triggers have been breached, will be breached or might be breached. Each scenario merits taking the steps outlined below and beginning the discussion with their Counterparties' credit officers.

Obtain Waivers and Notify Counterparties

Managers with FOCB provisions should notify Counterparties of any NAV Trigger breaches in accordance with the terms of their agreements. That will start the applicable clocks running.

Where no FOCB provisions are present, waivers should be sought, which will extinguish any rights the Counterparties may have under their NAV Triggers. Managers obtaining waivers should also be mindful to refer to waivers of any cross-default rights.

Managers should be proactive and provide the Counterparties with draft waivers, either drafting them themselves, if they have the necessary expertise, or with the assistance of external legal counsel. Being proactive will help expedite the process, because a Counterparty's credit department, even if it approves a waiver, will likely turn to its legal group and ask for guidance. In the current environment, teams are being stretched thin, and a simple waiver is less likely to catch the attention of a Counterparty's legal department. It is crucial to make it easy for a Counterparty to comply with a waiver request.

Seek Amendments

Although a waiver might be available, an amendment might have a longer-lasting effect. A waiver will protect against a NAV Trigger that has been breached, but it will not prevent future NAV Triggers from being breached given the new NAV or NAV/share level that a fund may face. For instance, if investor redemptions cause an annual NAV Trigger to be breached at March 2020 month end (by comparing the NAV at March 2019 month end), come April 2020 month end, it is likely that the same annual NAV Trigger will be breached again unless there has been a new injection of capital or extremely positive performance.

In other words, a waiver is a one-time, get-out-of-jail-free card, whereas an amendment is a permanent, fundamental change to the NAV Trigger's terms. Therefore, along with the waivers described above, managers should be proactive and draft amendments to increase the likelihood of success and expedite their implementation.

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