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Managing the Risk of Complex Derivatives Documentation

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With the explosive growth in the volume and sophistication of derivatives products, industry participants must maintain appropriate risk controls. Increasingly, documentation risk is being addressed through the use of widely accepted templates and through master documents. This approach is not new to the industry, but the accelerated pace at which the practice is moving forward, the complexity of products, and the manner in which documentation is developed present unique risks to hedge funds.

Trends in Documentation

As the volume of derivatives trading continues to expand and technology improves the speed at which transactions are effected, it becomes increasingly important to narrow the time lag between the parties' agreement on terms of a transaction and the completion of documentation. Templates and master documents help parties manage the documentation process by seeking agreement on most documentation terms before transactions are entered into. A limited set of transaction specific terms are then negotiated at the time of each transaction.

Templates and master documents for derivatives products date back at least twenty years. The International Swaps and Derivatives Association (ISDA) published its first Code of Standard Wording, Assumptions, and Provisions for Swaps in 1985 and its first master agreement in 1987. ISDA began developing simple templates for product specific confirmations, and the industry has been moving towards master confirmations for particular products and in some cases for multiple products. The broad scope of master confirmations and the complexity of individual products and templates have resulted in progressively longer and more detailed documentation.

The use of templates and master documents has affected the way in which dealers staff their documentation function. Dealers divide up documentation responsibilities into segments (such as the basic master agreement, a single product specific confirmation, or a particular master confirmation) and staff each segment with more junior personnel than would be required if a full set of documentation were individually prepared for each transaction. As a result, the sophistication of the people creating products or preparing templates or complex dealer forms is often far superior to the sophistication of more junior personnel with the day-to-day responsibility for documentation.

Industry participants can expect these trends in documentation to accelerate. The recent dialogue between the Federal Reserve Bank of New York and major derivatives dealers regarding derivatives documentation resulted in a commitment from those dealers to develop forms of master confirmations for certain equity derivatives products. The major dealers also agreed to expand electronic processing of confirmations, a practice which depends upon using widely accepted forms of documentation.

Impact on Hedge Funds

While few can dispute the importance of efficiency in documentation and the contribution of templates and master documents towards achieving that efficiency, hedge fund managers should be cautious that the funds they manage are not unduly disadvantaged by the industry's current approach to documentation. Product development in derivatives generally follows market demand from the buy side, but documentation is developed by the sell side. With the exception of Managed Funds Association's (MFA) current participation with the major dealers in the development of master equity derivatives confirmations, there is often little input from the buy side in the preparation of

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industry-wide templates or master documents and none in the preparation of a dealer's form. Documentation may become "standard" in the market, not because all sides of the market agree on how issues should be handled, but because dealers have reached consensus on the issues. Junior documentation personnel within a dealer are unlikely to appreciate that dealer provisions have not been accepted by all parties and may be unwilling to consider a change which is contrary to the standard adopted by their employer.

For a fund whose strategy is heavily dependent on derivatives trading, it is particularly important to be aware of the ways in which dealer documentation is disadvantageous to funds. Issues arising under templates or under master documents can have a broad effect on the fund. In addition, as suggested earlier, product innovation and preparation of documentation are separate functions. Some dealers known for their customer service on the product side are inflexible on the documentation side.

Since documentation is usually prepared by the dealer or based on dealer generated templates, dealers have a decided advantage over their fund counterparties. The dealers are familiar with the document, and their organizational structure will already be consistent with the requirements specified in the documentation. In addition, the fund manager may have to review documents under time pressure, and with the scope and complexity of documentation it may not be a simple exercise to determine the implications of particular circumstances on the fund's outstanding transactions or on its operations. As noted above, the psychological impact on the dealer's documentation personnel of an industry accepted or dealer developed document may hinder the fund manager's ability to negotiate changes to the document.

The growing complexity of dealer generated documentation makes it more difficult for a hedge fund manager to verify that the product reflected in the documentation is the desired product. Because the salesperson is not likely to be involved in developing the product documentation, the risk increases that there will be a mismatch between the salesperson's description of the product and the true features of the product. A fund manager seeking synthetic exposure to a portfolio of assets, for example, may be presented with a product which hedges only the downside in the portfolio. If the documentation is complex, the discrepancy may not be evident without close review. Whether or not the salesperson described the product properly, however, the dealer will determine the parties' rights and obligations, including the timing and amount of payments and the

collateral requirements, from the documents signed by the parties and not from the salesperson's description. It is therefore in the fund's interest for the manager to assure that the documentation is consistent with the expected product.

Another dealer advantage to be considered by hedge fund managers, particularly in connection with master documents, is the degree of dealer discretion. Derivatives documentation may contain initial terms which have been agreed to by the parties, but the dealer may have discretion to unilaterally change the terms. By way of example, the dealer may have the right to change the timing of payments, collateral requirements or fees. The changes may become effective immediately, and the fund's only option with respect to new terms which are unfavorable may be to terminate the transaction or the relationship. The time period during which the fund can terminate affected transactions may be limited, putting the fund at a disadvantage if the manager needs to search for a replacement facility. In some cases, the dealer may also have the right to unilaterally terminate transactions or the relationship.

How Can Hedge Funds Manage the Risks?

A number of steps can be taken by hedge fund managers to manage the risks presented by complex documentation based on dealer templates and master documents. The suggestions below complement and expand the recommendations included in MFA's recently released *Sound Practices for Hedge Fund Managers*.

- Careful review of documentation is essential, even if the fund manager does not plan to negotiate many changes or does not expect much success in negotiation. The fund manager should request draft documentation as early as possible, as more lead time in reviewing the documents will allow the fund manager to properly assess the impact of the product and documentation terms on the overall business and operation of the fund. Key issues to be looked at include the following:
 - Does the documentation describe the product or products the fund expects to obtain? Review should ascertain whether the product, as documented, introduces or hedges the portfolio risks anticipated by the manager. Are there any features which were not described by the salesperson? Those features should be identified and clarified before documents are executed.
 - What is the degree of dealer discretion, and what rights does the fund have if it disagrees with a dealer's application of its discretion? In the course of negotiating the

documentation, the fund manager can ask the dealer to eliminate its discretion for at least a period of time. Alternatively, the fund manager can press for disincentives to unfavorable changes by the dealer in the terms of the arrangement. In addition, a fund may be able to lock in terms while its manager evaluates alternative products or relationships.

- Is the fund adequately protected when circumstances are not favorable? How hard does the dealer have to work to maintain value for the fund in times of distress, and how much discretion does the dealer have to value a transaction at zero? The fund may be able to gain some input into the valuation process.
- Are the operational features of the documentation consistent with the fund's operations? If not, can the dealer accommodate the fund's operational constraints? These issues may be heavily debated as each party seeks consistency across all of its trading relationships.
- Does the product documentation negate or otherwise conflict with the ISDA Master Agreement or other documentation between the parties? Because of the segregation of documentation functions within a dealer, these conflicts are not uncommon. The fund manager should identify and resolve the discrepancies before completing documentation for the new product.
- The fund manager will need a flexible approach in negotiating documentation. Dealers prefer their documentation personnel to be the point persons for all negotiations. The fund manager should expect that dealer personnel handling documentation will not be responsive to some critical issues for the fund and that the fund manager may need to seek resolution outside the dealer's established documentation process.
- The fund manager should create working guidelines so that people responsible for the day-to-day operations and monitoring of derivatives products act consistently with the requirements of the documentation. Carefully prepared guidelines are critical, particularly where documentation is complex, trading volume will be high, or a product has unusual features. At

the least, guidelines should describe the product, including step-by-step action points and decisions, indicating the persons responsible for particular actions and decisions, and specifying the individual or individuals to be notified in case of problems or issues not addressed by the guidelines. The fund manager should undertake a periodic check of the guidelines to identify areas which require modification or additional scrutiny.

Beyond the efforts of individual hedge fund managers in the negotiation of documentation, buy side input as dealers develop documents will benefit all hedge funds. Without a coordinated effort from the buy side, dealers will continue to be at an advantage. MFA's involvement in preparing equity derivative master confirmations is a major step towards leveling the playing field, and hedge fund managers should support similar input in the future. Hedge fund managers should also take advantage of any users' guides prepared by MFA to advance their understanding of product documentation.

Conclusion

Derivatives products and documentation are growing in complexity, and the pace at which transactions are affected is also increasing. As these trends continue, dealers have an advantage over hedge funds in documentation of transactions. With appropriate planning, hedge fund managers can take steps to manage the resulting documentation risk. ©

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