ALERTS

Trading Agreements — Buy-Side Considerations (COVID-19)

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The COVID-19 pandemic is forcing nations, businesses and individuals to assess short and long-term risks and develop plans to minimize disruptions and ensure continuity of business operations. The risks facing global financial markets as a result of the crisis are forcing hedge fund managers to actively manage their trading relationships and continuously evaluate varied risks in the face of ongoing market uncertainty. These trading relationships are typically governed by one or more trading agreements, including ISDA master agreements, prime brokerage agreements, master repurchase agreements, futures agreements and FX master agreements, and all of these agreements may include provisions that could negatively impact hedge funds over the course of this crisis.

Pandemic-caused market conditions (such as reduced liquidity, increased redemptions and operational gaps) may increase the risk of additional contractual liabilities under a fund's trading agreements. For example, if significant redemptions occur with respect to a fund, the resulting decline in the fund's assets may trigger a termination event under the fund's ISDA Master Agreement that is linked to a decline in the fund's net asset value over a specified measurement period. Additionally, if the fund experiences lags in its operational capacity, significantly reduced liquidity, a demand for increased margin or other collateral requirements from a prime broker or other trading counterparty, or an election by a prime broker or other counterparty to increase financing costs or impose additional operational burdens, the fund's ability to meet its payment obligations in a timely manner may be jeopardized. Were a prime broker or other trading counterparty to elect to terminate the relevant trading agreement, a fund

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may be subject to cross-default or "default under specified transaction" provisions that could effectively result in a cascading series of terminations of all of a fund's trading relationships with all of its counterparties.

As financial markets continue to evolve in the face of the coronavirus pandemic and the resulting market volatility and uncertainty, hedge fund managers must carefully analyze all of their trading agreements in order to have a clear understanding of the consequences adverse market conditions could have. When analyzing these issues, managers should be aware of a number of common terms in trading agreements that could have an immediate adverse impact on hedge funds.

Force Majeure and Material Adverse Change/Effect

ISDA master agreements, prime brokerage agreements and most other commonly-used trading agreements, contain a "force majeure" provision. "force majeure" is an event or circumstance outside the control of a party that prevents, or makes it impossible for, the party to fulfill its responsibilities and obligations under a contract. Under the 2002 ISDA Master Agreement, a force majeure event occurs where a force majeure or act of state occurs after a transaction is entered into, and the office where a party that makes or receives payments (or the party itself, or its credit support provider) is unable perform its obligations to do so (or it becomes impossible or impracticable to do so) and could not, after using all reasonable efforts, overcome such prevention, impossibility or impracticability (though without requiring such party to take a material loss). If a termination event is designated due to a force majeure event, a party may be temporarily relieved from payment and delivery obligations under the ISDA master agreement, and after the expiration of a waiting period, both parties may have the right to terminate outstanding transactions (in which case the standard ISDA master agreement has market-based close-out mechanics which can be used following the termination of the trade).

Other agreements, such as prime brokerage agreements, may have varying styles of force majeure provisions. Prime brokerage agreements are not standardized so the exact language used would require a close reading. Managers should carefully review the force majeure provisions of each prime brokerage agreement, as each agreement will provide the

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prime broker with different rights and remedies. Prime brokerage agreements typically list a number of "extraordinary events" which generally limit the prime broker's liability, and which may also limit the prime broker's liability as to losses on specific trades.

Trading agreements may also include termination rights that arise upon the occurrence of a "material adverse change" or "material adverse effect" (as defined in the relevant agreement). These termination rights may be broader in scope than force majeure and may allow a counterparty to terminate a trading agreement on the basis of the counterparty's subjective determination that a material adverse change or material adverse effect had occurred with respect to a fund, a manager or general market conditions. Funds may be required to provide notice to counterparties of the occurrence of a material adverse change or material adverse effect to its counterparties. The occurrence of a material adverse change or material adverse effect (or the failure of the fund to notify the relevant counterparty) could be used as the basis for the counterparty to terminate the trading agreement. Whether a particular event rises to the level of a material adverse change or material adverse effect is ultimately a question of fact and can be the source of contentious negotiations, and even litigation, between a fund and its counterparties.[1]

Events of Default and Termination Events

All trading agreements contain various events of default (such as payment failures), termination events (such as NAV declines) and other provisions which could give rise to a termination of the outstanding trades or even the relationship itself.

While the occurrence of a pandemic is not likely to be a specific event of default in any trading agreement, the pandemic, and its knock-on effect in the financial markets and the global economy generally, may ultimately create the circumstances that will lead to a fund's failure to comply with its obligations under its trading agreements. For example, if a margin payment is due and a hedge fund is unable to make a payment due to inoperability by its administrator, in the absence of a force majeure or other cure provision, then this would likely constitute a breach of the agreement. Similarly, most trading agreements require a daily mark-to-market exchange of collateral, and failure to timely deliver the required collateral would likely be an event of default. The fund may have an

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obligation to deliver financial statements, but could be unable to do so, again causing a default. Similarly, if market conditions cause a decline in NAV, if the manager (or a key person) is compromised with COVID-19, if lags in operations resulting from the virus cause a delay in delivery of financial statements and NAV reports, these could each be a termination event. In current market conditions, hedge funds will likely face significant pressure from a variety of sources, including volatility, reduced liquidity and operational failures resulting from increased trading volumes, all of which could create conditions under which the likelihood of default by a fund is significantly increased.

Business Day Determinations and Market Disruptions

Payments and deliveries (as well as related notification obligations) under trading agreements are typically only required to be made on business days. Whether a day is a valid business day depends on the terms of the underlying contract and is usually tied to the locations of the counterparties. Typically a business day is any day, other than Saturday and Sunday, on which commercial banking institutions are open in the specified jurisdictions. However, business days will vary across jurisdictions, and as governments generally have the authority to direct the closure of banks, exchanges and financial markets in a crisis, a significant disruption to a country's economy or population may result in an extended closure of banks and markets, preventing a hedge fund from completing required payments or deliveries or otherwise complying with its obligations under a trading agreement. Extended closure of banks and markets could adversely affect the ability of parties to a trading agreement to calculate amounts payable or determine valuations and may prevent a hedge fund from exercising valuable options or other rights under trading agreements. Each of these events, and other enumerated events in the various product specific definitions published by ISDA may have direct or indirect implications on trading based on the pandemic.

Counterparties to Trading Agreements Have Broad Powers

In addition to the issues described above, fund managers should be aware that their funds' counterparties may take actions that are unexpected, or even outside of a counterparty's control, but that have significant,

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adverse effects on their funds. Although banks, broker-dealers and swap dealers are large institutions that are highly regulated and that may act cautiously, reasonably and even predictably in "normal" market conditions, they do have responsibilities to their shareholders and regulators. What a manager may have believed to have been a "pattern of conduct" or "course of dealing" with a particular counterparty over the course of a long trading relationship may change suddenly and without notice, and a counterparty may change its operational practices, including exercising rights under its trading agreements that it may have refrained from using in the past, but chooses to exercise in a crisis.

For example, many agreements contain an optional termination right that can be exercised even in the absence of a default or termination by the counterparty. The counterparty could choose to start terminating trades under such an optional termination provision which could cause disruptions in a fund's trading strategy as it may be difficult to replace a terminated trade under current market conditions. The counterparty may also have the right to amend trading agreements in its own discretion (perhaps after providing notice to the fund).

If market conditions worsen significantly, a fund's counterparties may simply stop accepting new trades. Most trading agreements are "uncommitted" and do not require a prime broker or swap dealer to enter into any transactions; additionally, the ability of a hedge fund to enter into a transaction relating to a loan, security, commodity or other asset will usually be subject to the prior approval of its counterparty (given in its sole discretion). Alternatively, a fund's counterparties could simply raise rates or collateralization requirements to the point that the fund is unable to enter into new trades (or even continue existing trades) profitably. Trading agreements, especially prime brokerage agreements, give a fund's counterparty broad discretion to vary the terms and parameters of the agreements and trading. In the case where a fund has a "lock-up" agreement in place with the prime broker under the prime brokerage agreement, some of these parameters may be "locked" such that the rates, collateral and ability to trade could remain static for the term of the lock-up. However, some of these "lock-up" agreements give the prime broker the ability to terminate based on market forces (such as widening credit spreads or other events).

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[1] *See* "Assessing Material Adverse Change Clauses and Other Deal Certainty Considerations Under and After COVID-19," *SRZ Alert*, March 16, 2020, available here.

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