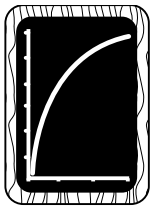

LEARNING CURVE®

Six Key Points To Consider When Negotiating ISDA Master Agreements

Given the current turmoil in the financial markets, it is now more crucial than ever for dealers and hedge funds to consider the following six key points when negotiating **International Swaps and Derivatives Association** Master Agreements. In many, if not most, dealer/hedge fund derivatives portfolios, either party may be the payer or receiver of a net payment amount. Nonetheless, dealers typically view themselves as the potential non-defaulting party and focus their ISDA Master Agreement negotiations on the financial deterioration of the hedge fund counterparty.

Most hedge funds concentrate their ISDA Master Agreement negotiating efforts on minimizing the circumstances that could lead to an event of default on their part. Hedge funds seek to avoid the possibility of a liquidity crunch based on a temporary dip in their net asset value or a change in their investment management or guidelines. A mutually successful ISDA Master Agreement negotiation is one that results in an agreement that meets the needs of the dealer and the fund, both at execution of the ISDA Master Agreement and over time. While each negotiation must consider a myriad of factors, the following six key points should be considered in each dealer/hedge fund negotiation.

1. **Cross-Default**. The ISDA Master Agreement cross-default provision, Section 5(a)(vi), requires a default under "Specified Indebtedness," defined as an obligation in respect of borrowed money. Many dealers seek to expand their cross-default protection against hedge fund counterparties to include "Specified Transactions," (generally, defaults under other derivatives transactions) because, among other reasons, many hedge funds do not incur traditional bank debt but obtain financing by engaging in derivatives transactions. Unlike bank debt, however, where it is clear which party owes what amount of money, many derivatives contracts require both parties to make payments on payment dates so that there may be a legitimate dispute as to the amount owed and even as to which party is required to make the net payment. Thus, the ISDA Master Agreement distinguishes between traditional cross-default, which may be triggered by a party's default to any lender in respect of borrowed money, and what is termed "Default Under Specified Transaction," Section 5(a)(v), which is triggered by a party's default only to its counterparty or other specified entities generally related to the counterparty.

2. **Net Asset Value Related Termination Triggers**. The ISDA Master Agreement Schedule templates provided by most dealers to their hedge fund clients include as Additional Termination Events a variety of NAV-related provisions. These may include (a) declines by certain specified percentages of the hedge fund's NAV over periods of one, three or twelve months, (b) a decline below a specified NAV amount, (c) a specified NAV percentage decline below the hedge fund's highest historical year-end NAV or (d) an increase above a specified percentage of the ratio of the dealer's net exposure to the fund under all outstanding transactions, over the fund's NAV. A dealer's credit department will approve a trade's tenor and notional amount based in part on the size of the fund and would like the option of declaring an event of default and "pulling the plug" if the hedge fund's NAV were to fall precipitously or below a specified floor. Based upon the hedge fund's market strategy, however, redemption policies or other relevant factors, certain of these events may trigger an event of default even when the hedge fund is operating as anticipated. In order to satisfy the needs of the dealer and the hedge fund, the dealer needs to understand when, for example, redemptions should be included or excluded in the NAV calculation or when, due to certain "one off" events, the hedge fund's highest historical NAV is an unrealistic benchmark, and the fund needs to understand that sometimes size really does matter. Hedge funds also should consider whether a ratings-based termination event applicable to the dealer is appropriate so that the fund could terminate its outstanding trades if its dealer counterparty were to experience financial distress.

3. **Change in Investment Management and Investment Guidelines Termination Events**. Dealers want to ensure that the investment strategies of their hedge fund counterparties will be effectively and fruitfully implemented. Dealers obtain this assurance through their relationship with, and from the reputation of, the hedge fund's investment manager, particularly in the case of newly formed funds. For this reason, most ISDA Master Agreement Schedule templates presented by dealers to hedge funds include, as an Additional Termination Event, the replacement of the fund's investment manager. From the hedge fund's perspective, this provision may be overly broad because a new investment manager may

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be just as qualified as, or even more qualified than, the one being replaced. Similarly, dealers desire assurances that the transactions required to implement the hedge fund's investment strategies are within the fund's investment guidelines. Dealers address these concerns by including in their ISDA Master Agreement Schedule templates a provision permitting the dealer to terminate the outstanding trades if the fund's investment guidelines or other core fund documents are amended. Again, this kind of provision may be overly broad because it covers amendments that may have no adverse effect on the ability of the hedge fund to perform its transactions with the dealer or otherwise to successfully implement its strategies. If the dealer understands the workings of the hedge fund and its relationship to its investment manager, appropriate provisions can be drafted that extend to the dealer the assurances it requires while, at the same time, do not place an undue burden on its hedge fund counterparty.

4. **Delivery of Financial Information**. Part 3 of the ISDA Master Agreement Schedule sets forth the information delivery requirements for the respective parties. Because hedge funds' financial statements are not publicly available, a dealer normally will require the hedge fund to deliver annual and quarterly financial statements as well as monthly NAV reports within specified time periods. The dealer's timely receipt of monthly NAV reports is requisite to its ability to know whether an NAV-related termination event has been triggered. The hedge fund needs to ensure it is not agreeing to an overly ambitious timetable for the delivery of the financial information, particularly when the financial statements require sign-off by, or input from, persons unrelated to the hedge fund or located in foreign jurisdictions.

5. **Collateral Provisions**. Most dealers are unwilling to incur an unsecured exposure to hedge funds. Accordingly, ISDA Credit Support Annexes delivered by dealers to their hedge fund clients typically specify a zero collateral threshold amount applicable to the hedge fund, but specify a threshold applicable to the dealer of more than USD1 million. This collateral threshold disparity may be appropriate at the time the ISDA Master Agreement is executed, but hedge funds should consider requesting ratings-based collateral thresholds so that the collateral terms applicable to the dealer will be subject to change if the dealer's ratings decline. Hedge funds should also be concerned about the conditions precedent to the collateral delivery and return obligations. According to Paragraph 4(a) of the New York law version of the CSA, a secured party is not required to return collateral to the pledgor if a default or "Specified Condition" (for example, an Additional Termination Event) were to occur with respect to the pledgor. This means that a dealer secured party could determine not to close-out based on a default or Specified Condition with respect to its hedge fund counterparty and still retain collateral it otherwise would be required to return to the hedge fund as pledgor based on the derivatives portfolio's mark-to-market valuation.

6. **Other Agreements Between Dealer and Hedge Fund**. The persons negotiating an ISDA Master Agreement on behalf of the parties must consider whether there are other trading documents in place between them. A hedge fund's derivatives trading relationship with a dealer may also extend to prime brokerage services, portfolio margining and repurchase and securities lending transactions and, if so, the documentation required by the dealer would consist of, in addition to an ISDA Master Agreement, the agreements covering these other relationships. Whether other agreements between the dealer and the hedge fund are already in place when the ISDA Master Agreement is being negotiated or the ISDA Agreement is just one of a number of agreements being negotiated at the commencement of a new dealer relationship, the person negotiating the ISDA Master Agreement should evaluate the consistency among similar provisions in all the agreements and determine which provisions govern when there are inconsistencies. Nothing is gained by the hedge fund if, for example, its carefully drafted Additional Termination Events are overridden by the default section of the prime brokerage agreement.

Generally speaking, derivatives market participants negotiating ISDA Master Agreements expect these agreements to be in place for years and try to anticipate what adverse events may affect the creditworthiness of their counterparties over time. Traditionally, the focus of most hedge funds has been defensive; they try to limit the circumstances that could allow their dealer counterparty to close-out their trades due to an event of default or termination event. While hedge fund counterparties face special challenges when negotiating against highly-rated dealers, they should seek to avoid overly broad provisions that can expose them to unnecessary default scenarios. In addition, in the context of today's volatile markets, where "even the mighty may fall," all derivatives market participants need to remember that the creditworthiness of any counterparty may significantly deteriorate over time and may need to negotiate ISDA Master Agreements with a new set of assumptions.

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*This week's Learning Curve was written by **Sherri Venokur**, member of the firm and chair of **Lowenstein Sandler**'s derivatives practice group, and **Richard Bernstein**, associate in the investment management group.*