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Europe

What Risks – And Opportunities – Does the Euro Zone Crisis Present for Hedge Fund Managers? An Interview with Richard Frase of Dechert

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The euro zone crisis is intensifying, and hedge fund managers must be prepared to address the myriad risks (and prospective opportunities) that are presented by the crisis. The Hedge Fund Law Report recently interviewed Richard Frase, a Partner at Dechert LLP, who shared his perspective on euro zone risks and how hedge fund managers should prepare themselves to mitigate such risks. Specifically, the interview covered: European counterparty risks, including risks posed by prime brokers, sub-custodians and trade counterparties; euro-related risks, including a discussion of hedging strategies and approaches with respect to euro-denominated funds or share classes; euro zone-related fund disclosures, including general euro zone economic risk factors, counterparty risks and euro-related risks; approaches to valuing euro-denominated assets; and investment opportunities presented by the euro zone crisis. This article contains the full text of our interview with Frase.

Counterparty Risk

HFLR: What steps should a hedge fund manager take to inventory any credit risks or collateral risks it faces in its relationships with prime brokers?

Frase: There are various ways of trying to manage the prime broker situation. One way is to control the level of rehypothecation that is used. Another way is to transfer free assets to a separate account, which I think is written into the U.S. rules but is relatively new in the U.K. market. A number of the prime brokers have set up bankruptcy remote affiliates which can be used to transfer assets away from the actual leverage provider. Another option is to simply have two prime brokers so you can transfer your assets from one prime broker to another if you have a problem.

In the Irish and Luxembourg structures, there is normally a depository so you can transfer from the prime broker to the depository if you thought that was necessary. There is another approach which is a variation on that where the prime broker drafts its charge over the assets very tightly so that if it does suffer a problem, then the amount that is owed between the parties is very rapidly quantified and can be paid out quickly. Whatever is left should be free assets.

HFLR: Are there measures that hedge fund managers should take to mitigate the credit risks posed by European sub-custodians that maintain hedge fund assets?

Frase: What I would personally like to do is to give the client a direct right against the sub-custodians, but I have been told by principal custodians that this is impractical. If you are talking about a sub-custodian that is located in Greece holding Greek securities, it may be difficult to do anything about that. Clearly, using an international bank with a branch in Greece might work better than a local Greek company. If you can put the assets outside Greece in a safer environment and that fits within the custody and settlement arrangements, that would be an obvious way of going. We would start by suggesting that managers, if they want to address this sort of issue, would need to talk through with their custodians about what the custodian was actually capable of doing on that front.

HFLR: What types of provisions should hedge fund managers consider adopting in their ISDA agreements and other trading agreements to protect themselves from credit and collateral risks posed by European counterparties?

Frase: The basic things that you can do with counterparty agreements are to call for collateral and/or you can put provisions in the agreement which crystallize a right to terminate. You also need to watch the definition of euro because there is a risk that payment might suddenly be redenominated into a different currency, which would be something that the fund would want to resist. You would probably maintain that payments in the wrong currency were not valid payments at all under English law. Clearly, if you have contractual provisions addressing this situation, that does help. A material adverse change clause would probably be helpful for instance. These clauses usually come up in banking documents stating that it would be an event of default if in the opinion of the non-defaulting party there has been a material adverse change in the position of the borrower.

HFLR: How should hedge fund managers re-evaluate their relationships with trade counterparties that are subject to credit rating downgrades from rating agencies?

Frase: If there is a question as to whether they will be downgraded again, you could deal with that by controlling your exposure to that counterparty. Collateral is good if you can get it, as is risk spreading. Clearly some funds and managers are more capable of getting collateral than others. With a downgraded investment bank, everyone is going to try to get collateral out of it so that may not be wholly successful. You can also look for parent company guarantees and that might help a bit.

HFLR: In light of the recent partial nationalization of Bankia in Spain: How should hedge fund managers go about evaluating the risk of nationalization of banks where their assets are custodied and what measures can managers take to protect assets custodied at banks that are candidates for nationalization?

Frase: Nationalization doesn't feel great, but, on the other hand, most of the nationalization of banks that has been going on has actually propped the banks up. Depending what the nationalization means, it might actually be reassuring, particularly if the bank isn't going to be able to recapitalize itself any other way. It does depend on the specifics.

If we were talking about a run on the bank followed by the state taking over control, it would probably be coupled with some kind of freeze in payment. That would obviously be worrying but one would have to look at what was actually going on.

Euro-Related Risks

HFLR: What are some of the more effective measures that hedge fund managers are taking to hedge euro currency risks?

Frase: The basic thing would be to reduce your exposure to euro currency risk but that depends on what you are doing and what you need to hedge. For example, with a dollar denominated fund with a euro hedge class and a currency hedge to keep the euro moving in tandem with the dollar fund, you need to run that hedge because that's how it works.

If you are having trouble putting the hedge on or if the value of the hedge is starting to look very disproportionate to the value of the portfolio in the class, then you might start thinking about possibly closing it down.

HFLR: What specific steps should hedge fund managers that have euro-denominated funds or share classes take in evaluating whether they should redenominate such funds or share classes?

Frase: I think it would be fairly drastic to get rid of your euro class. It will vary a bit depending on the base currency, however. If you have a euro based currency, and you are investing in European assets, there is not much incentive to change anything. If you have a dollar denominated fund with mostly U.S. investors but with a euro class, that might be a bit more sensitive. But there would have to be some sort of fundamental mismatch between the currency and the investments that made it dangerous or that made it difficult to put on the hedge.

If you had a currency class which was denominated in euros and which defined the euro as "the currency, for the time being, of Ireland" you may want to change that because that would automatically get converted into pounds if Ireland pulled out of the euro. Mostly, it is a good idea to put in a definition of euro.

HFLR: If a hedge fund manager determines that it wishes to redenominate its euro-denominated funds or share classes, what specific steps should it take to effect this redenomination, particularly where the fund offering documents are silent as to the prospect of currency redenomination?

Frase: That would depend on what your constituent documents allow you to do. In some cases, it may be possible to do this without getting investor or class approval. Even there you would normally want to give the investors advance warning and a chance to redeem their securities: good practice for any major change affecting a fund.

If you could not do it via a decision of the board of directors, then you would need to look at whatever the articles of association required in terms of a majority.

HFLR: Alternatively, how should hedge fund managers go about determining whether to wind down euro-denominated funds or share classes?

Frase: If it was the assets that were the problem because of some illiquidity or difficulty in pricing, then you are looking at a suspension of redemptions, applying a redemption in kind mechanism and then possibly setting up a special purpose vehicle for the problem assets which would be liquidated in a controlled manner.

Fund Disclosures

HFLR: What specific disclosures should hedge fund managers consider adding with respect to any proposed investments in European assets or with exposure to the euro?

Frase: Typically a description of the European economic risk flagging risks such as market disruption, value of investments, risk of a country leaving the euro zone, risks affecting the exchange rate of the euro, sovereign debt risk, risk of default on debt, risk of imposition of capital controls and probably a concluding statement that the potential consequences are impossible to predict.

Valuation Issues

HFLR: What types of valuation procedures should hedge fund managers adopt to ensure that they can appropriately value investments denominated in euros or a replacement currency?

Frase: This sort of legal issue tends to focus on making sure you have clear procedures; that the procedures are objective; and that they are not biased towards a particular redemption date or a particular set of redemptions. If you do switch your basis of valuation because of changing market circumstances, you should explain why you are doing that to investors and why it's appropriate.

Opportunities

HFLR: What are the two or three biggest opportunities that you see for hedge fund managers in the European sovereign debt crisis, or specifically in the plight of Greece?

Frase: Buying bank assets is becoming more of an opportunity when banks are having to redeem or reduce their gearing. Buying distressed debt also presents opportunities.