

Energy Trading Contracting with Hedge Funds
by
Jeremy Weinstein¹
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In the volatile and rapidly evolving world of energy trading, hedge funds are becoming increasingly significant market participants. There has been a lot of press over the past ten years, most of it negative, on the vast sums, outsized leverage, secrecy, lack of regulatory oversight, and spectacular market losses that are said to characterize hedge funds. Nevertheless, each of these alleged negatives can have an associated positive for a potential over-the-counter trading counterparty. For example, a hedge fund taking a huge bet offers its counterparties market liquidity. Although as private entities they do not file public reports of their financial condition, hedge funds often have very precise knowledge of their current finances. Many hedge funds have sophisticated quantitative support and can offer highly customized products in addition to liquidity. However, potential hedge fund counterparties seeking to take advantage of these opportunities should take certain steps to avoid being part of the next headline. This article will discuss how to approach the unique characteristics of hedge funds when considering a trading relationship for over-the-counter bilateral trading of physical and financial energy products. As “scary” as the following lists and discussions might appear, the fact is that there are relatively simple ways for a party who has decided to trade with a hedge fund to understand and approach the risks involved.

A potential counterparty will want to use all the usual devices when dealing with any market participant. These include good due diligence, proper contract drafting, and effective trading position and collateral management. All of these operate together to provide a mutually sliding scale in what a relationship will eventually look like. To some extent, the depth of requisite due diligence and related contract representations and covenants can be inversely related to the depth of the reservoir of credit protection provided. The less the initial and continued transparency offered, the greater the need for robust credit support through low collateral thresholds, a larger independent amount² or other instruments for protection against risks of significant market movements in the period between a call for collateral and its arrival, or its non-arrival.

¹ Jeremy Weinstein is an attorney in Walnut Creek, California, with the Law Offices of Jeremy D. Weinstein, a professional corporation. Email: jweinstein@prodigy.net. Special thanks are due to Dede Russo, General Counsel and Chief Compliance Officer of the Saracen Group of Companies for her insight and assistance in developing this article.

² Parties to private, over-the-counter derivative products can give each other leeway with regard to posting margin cash collateral on their net mark to market positions, by requiring it only above a set “collateral threshold.” Such thresholds can be seen as free, unsecured lines of credit and are – in bilateral contracts such as the collateral annex to the International Swaps and Derivatives Association Master Agreement and the Edison Electric Institute Master Power Purchase and Sale Agreement – set at levels tied to a party’s credit rating. An independent amount is a dollar amount that is added to a counterparty’s mark-to-market position when calculating a collateral posting requirement. The independent amount can also be documented to work as a deposit that remains posted. See International Swaps and Derivatives Association, User’s Guide to the 1994 ISDA Credit Support Annex, Appendix C.

Due Diligence

No matter how deep the credit protection well, there is some due diligence and continued reporting that is always appropriate. And no matter what the due diligence, there is no substitute for correct documentation, and good position and credit management during the course of performance of the relationship. A counterparty should also do its own internal due diligence to know that it can control and manage its own positions with the hedge fund. Due diligence items include:

Where is the Hedge Fund? A party's word is not worth much if one cannot do anything about it not being kept. An entity domiciled in a foreign jurisdiction where one would nominally not want to have to go to enforce or obtain a judgment presents issues that can be addressed in how the relationship is established. But addressing these issues does not require the counterparty to retain a major international law firm with offices in that jurisdiction. For example, one can seek to obviate the need for legal process altogether by a position fully collateralized with a large independent amount or other deposit (with the money on-shore) that is properly monitored and maintained throughout the life of the relationship. Additionally, the hedge fund can be asked to provide legal enforceability opinions of reputable counsel that it retains. Additional questions for resolution include creditor distribution rules and liquidator recovery rights in the domicile of the entity. Determine:

- Where are the fund contracting party, and the investment manager, domiciled?
- If the entities are foreign, is there an opinion of counsel that can be relied on to support the enforceability of the negotiated arrangement? Has ISDA (the International Swaps and Derivatives Association) published a netting opinion for the jurisdiction?
- Are there sufficient domestic assets, such as posted collateral and an independent amount, to ensure payment in the event of default?
- Is there a domestic entity, or domestic reachable assets, supporting the obligations?
- Are contract provisions providing for domestic dispute resolution, consent to jurisdiction, and domestic service of process appropriate?

Who Is Your Counterparty? Know your counterparty. Questions about fund structure to consider include whether the hedge fund is the contracting party or whether the hedge fund uses a "master feeder" structure. In a master-feeder structure, a contract with the master entity will not be with the feeder entities that have the money. If the master fund is a foreign entity, review whether guaranties from one or more of the feeders would be appropriate or useful; in the case of foreign feeders, matters relating to legal and practical enforceability of the guaranty of the off-shore entity should be considered. One should also verify that the Investment Manager is authorized by the fund to enter into the contemplated trading relationship, and determine if representations and covenants related to the Investment Manager's relationship with the fund should be included in the documents. More than one entity may need to be party to the hedge fund side of the trading agreements. Depending on the structure of the hedge fund and the contemplate trading relationship, additional representation and covenants may be added to standard form trading agreements.

The Entity's Relationship with its Investors. Hedge funds are generally partnership-like entities, with rules about when investors may take out their money. One will want to know that the investors cannot pull money out in a manner and with a rapidity that leaves the fund without cash to honor its obligations. Although United States bankruptcy and fraudulent conveyance law would protect counterparties in the case of a U.S. entity precipitously distributing to U.S. persons with U.S. assets subject to U.S. jurisdiction, this should not be relied upon. Representations can be made in the documentation, but a breach of those representations would be just another characteristic of the same unsecured claim against the hedge fund. Therefore, review the documentation itself to understand the rules of the game, and the ability of those involved to waive or change those rules. If a hedge fund is unwilling to provide these materials, consider additional representations or covenants to provide notices by the fund relating to investor redemption requests, but fully adequate collateral is the only substitute for not seeing and understanding the rules with your own eyes. When reviewing the materials, consider the following questions on the restrictions on investor redemptions:

- Can redemptions that would result in breach of a financial covenant (to a bank or counterparties) be restricted by the fund manager or general partner?
- Does the fund have soft and hard lock-ups? "Hard" lockups are absolute; in "soft" lockups, an investor, if permitted to withdraw during the lockup period, pays a fee, often 1% to 5%, of the amount to be withdrawn.
- Does the fund have a "gate"? A gate is a right of the fund manager to limit withdrawals on any withdrawal date or period (such as monthly or quarterly) to not more than a stated percentage of a fund's net assets, often 10% to 25%, depending on how frequently investors have a right to withdraw capital.
- What are the timing requirements for redemption? For example, some funds required 45 days' notice before the end of a quarter.
- Are there holdbacks on investor redemptions?

Typically, there are substantial penalties for early withdrawal. Alarm bells should sound if apparently knowledgeable investors have been willing to pay those penalties to get out.³ Information about investor withdrawals should be evaluated before entering onto a contract for a longer term commitment (in other words, longer than the requirement for a withdrawal). Once a relationship is established, the impact of withdrawal during the course of performance can be addressed by adding specific covenants to trading agreements requiring notices of such events or collateral triggers if certain conditions are met. For example, consider if it is appropriate to request notice if the gate is triggered, or when certain withdrawals exceed 25%, or if net asset value, inclusive of withdrawals, declines by more than a percentage.

Financial Condition. A counterparty will want to know that the money in the fund will not be depleted before it gets paid or the collateral exhausted. Lack of regulatory

³ For example, one money manager "took one look at" Amaranth when it inherited a position in the fund over the summer of 2005 and demanded redemption of the client position, later stating that the fund had "bad risk management" and that the problems at the fund "were anything but unforeseeable." "Investor paid out extra penalties to quit Amaranth," The Times, Oct. 13, 2006.

oversight of the fund's relationship with its investors⁴ means fewer outsiders to detect and report dichotomies between the financial statements and reality. Some hedge funds are rated by credit rating agencies. Before relying on ratings, know what exactly is rated (for example, does the rating apply to the fund itself, or to an obligation or bond issued by the fund) and what was relied on by the rating agency. Although many hedge funds are not rated and not required to report to third parties, most hedge funds report to their investors. The information in these reports, and their periodicity, varies, but most include net asset value. Hedge funds may be willing to provide counterparties information similar to what they provide their investors. In addition to considering the timing of provision of financials, one also needs to understand their scope and reliability. However, funds might be quite wary of providing their counterparties with too much information, lest they in the process disclose information from which outstanding positions can be divined. In reviewing fund financial information consider:

- Is AUM (assets under management) reported? How?
- Is the NAV (net asset value) reported? How?
- How often is the information reported?
- What is the timing of providing NAV, and how much lag is there?
- Who determines NAV? Is it an internal source, external source or both?
- Does the fund use a third party auditor, a fund administrator, or both?
- Are the auditor and fund administrator reputable? Is the fund willing to allow a counterparty to talk with them directly?
- Does the fund or its administrator have documented pricing policies and procedures relating to valuation of fund assets?
- Is the fund willing to provide the counterparty a copy of these policies?
- Are reputable pricing sources used to arrive at values?
- Does the fund reasonably address valuation of hard-to-value positions?
- Are the cash and funding liquidity positions of the hedge fund in the face of losses and collateral needs, assuming that all other counterparties and exchanges require full cash collateralization of positions, readily discernable, and do they appear adequate?

Risk Management. The volatility of the reported financials will depend on how well the hedge fund prepares itself against a world of constant change. Two critical factors in that regard are the hedge fund's risk management and its measurement and monitoring of its leverage. Leverage translates into rapid and substantial changes in position value from market changes. Counterparties can assess whether the particular hedge fund has plans in place designed to protect itself (and its investors) from large losses, and further assess the likelihood of the fund's following those plans. Items to be aware of when reviewing the hedge fund's risk management include:

⁴ Initial forays into regulation through SEC rulemaking have met with limited success. *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), struck down Securities and Exchange Commission regulation that would require many managers of hedge funds above a certain size to register as investment advisors under the 1940 Act by eliminating a pre-existing safe harbor. The Hedge Fund Study Act (H.R. 6079), requires a President's Working Group on Financial Markets (PWG) study to make recommendations in a final report regarding efforts the hedge fund industry or regulators should undertake to improve practices.

- Are the risk management policies current and do they conform to or exceed industry standards? Standards for such policies are widely available and always improving.⁵
- What risk measures are used (for example, Value at Risk (VAR) and stress-tests to the portfolio through simulated market events), and are they current with market standards?
- What are the fund's own procedures for managing the credit risk presented to it by its other counterparties?
- What sorts of measures of leverage are used, and are there multiple, risk and market adjusted measures of leverage?⁶ Do measures of leverage adequately account for the varying risks of those leveraged positions?

Compliance Infrastructure. After reviewing the hedge fund's rules of its relationship with its investors, and rules of its relationship with the markets, one can assess the likelihood of the fund's compliance with those rules by looking at the fund's compliance culture, commitment, and infrastructure. Factors to review include:

- Does the hedge fund have a chief compliance officer? If so, is the officer independent of the traders?
- Does the fund have written compliance policies, both with respect to its investor requirements, market positions and, in the world of energy trading, applicable federal energy market behavior rules?
- Does the fund have a written code of ethics?
- Does there appear to be a "compliance culture"?
- Does the fund have the infrastructure, back office, and the resources and commitment to avail itself of external resources, that it will conduct itself in accordance with all of these policies and codes? Consider visiting its offices and interviewing the right people to see and hear for yourself.

Real-Time Capability. A hedge fund trading real-time physical energy products that potentially could go to delivery should be able to make that delivery. Counterparties should determine if the hedge fund seeking to trade such products can cope with curtailments and other events that might happen in real-time, or plans in all circumstances simply to pay liquidated damages on a delivery failure. Factors to review include if the fund is trading real-time or day-ahead products:

- Does the fund have the schedulers and other support staff necessary to handle events that may take place in real time?
- If they are selling a product that requires transmission, do they know how to get it?
- Does the fund's over-the-counter contracting process seem to be well managed and understood by the fund itself?

⁵ See generally, Managed Fund Association, 2005 Sound Practices for Hedge Fund Managers (2005), available at <http://www.mfainfo.org/images/PDF/MFA2005SoundPracticesPublished.pdf> . These update the 2003 Sound Practices, which updated original practices produced in response to a 1999 recommendation by the President's Working Group on Financial Markets that hedge funds establish a set of sound practices for their risk management and internal controls.

⁶ See Appendix 1 of Managed Funds Association, 2005 Sound Practices for Hedge Fund Managers.

- Is the hedge fund committed to energy trading in general? Limiting the tenor of the transactions to a discernable commitment may be wise, as no fund is in the business of giving out a good price in order to “test the waters.”

Documentation.

An over-the-counter trading relationship will typically be founded on an ISDA or EEI (Edison Electric Institute) Master Agreement, or an ISDA Master Agreement with ISDA/EEI Power Annex.⁷ These industry standard forms can and should be customized for the particular relationship established or existing between parties. In the case of an energy trading relationship with a hedge fund, certain documentation considerations are important and counterparties are advised to consult with an experienced trading attorney to ensure appropriate, up to date documentation. However, no excellence in documentation will protect against poor due diligence or poor credit or position management. A good trading attorney can also provide advice on many of the appropriate requisites at the inception of the relationship in the due diligence process, and as the relationship continues.

Representations. If a party intends to rely on certain factors learned in the due diligence process, among appropriate agreement terms, consider including, along with representations from the fund attesting to key aspects of the findings of the due diligence process above, covenants not to change them without notice.

Credit Support Documents. The outcome of the due diligence review process will advise a counterparty on whether it should require further credit support, such as guaranties, letters of credit, deposits, or other posted collateral in addition to what is provided under the collateral exchange provisions of the trading agreement itself. As the domicile of the counterparty is where one would expect the insolvency proceedings to take place; one’s documentation with the counterparty should not put one in the position of having to participate in foreign insolvency proceedings in order to be made whole. The bottom line is that with a foreign entity, one does not want to ever have to go to a bankruptcy proceeding of a foreign jurisdiction to collect. A good trading attorney can advise a counterparty considering a trading relationship with a hedge fund domiciled in a foreign jurisdiction that good documentation alone cannot adequately mitigate this risk and can show that potential counterparty how to structure a credit relationship that is accurately documented to manage this risk via effective position and collateral controls and management.

Collateral Thresholds; Independent Amount. In the case of an unrated fund, since there is no rating to begin with, and hence no drop through a loss of investment grade to trigger a further collateral posting requirement or an additional termination event, counterparties should consider zero thresholds, or in some cases requiring additional credit support, such as an independent amount, and documenting, at agreement formation, how the independent amount is to be calculated. The independent amount could be a fixed dollar amount, around which trading exposure is closely monitored to ensure its adequacy, or the independent amount could float based on the market position and other factors related to the open trades. Other items that might be considered in negotiating and

⁷ See Weinstein, “Practical Considerations Regarding Electricity and its Regulation When Using the ISDA/EEI Power Annex,” Futures & Derivatives Law Report, Jul./Aug. 2006.

documenting collateral requirements could be characteristics of the fund itself, but any such use should be informed by the timing, quality, and independence of the reports of such characteristics. Effective use of collateral thresholds requires that the counterparty monitor and mark to market the value of its positions with the hedge fund. Since hedge fund's sophistication enables them to offer products that are highly customized or otherwise illiquid or not easily capable of being marked to market, the parties should consider specifying in their agreement proxy mark-to-market mechanisms for purposes of collateralization to ensure that there is sufficient collateral.

Conclusion.

Despite hedge funds' reputation for secrecy, leverage, and losses, counterparties interested in taking advantage of what hedge funds have to offer can do so if they fully inform themselves and take a few further relatively simple steps. In addition to drafting appropriate provisions that can be added to standardized trading agreements such as the ISDA and the EEI Master Agreements, a good trading attorney can assist potential counterparties of hedge funds in the due diligence process and recommend methods of monitoring the relationship. Hedge funds that wish to successfully negotiate over the counter trading relationships should also consider issues and concerns their counterparties might have and be prepared to address such issues in the context of establishing such relationships. In most cases, hedge funds can improve and expedite development of counterparty relationships by assembling due diligence materials they would be prepared to provide and drafting additional representations and covenants that they would be willing to agree to add to standard trading agreements. A good trading attorney can assist hedge funds in this process and in most cases the hours spent by the hedge fund in advance of negotiations will greatly reduce the amount of time required later to consummate a successful trading relationship.