Trading Agreements and NAV Termination Triggers – Avoiding Unexpected Landmines

Contributed by David S. Mitchell, William C. Thum, Aaron S. Cutler and Eduardo Ugarte II, Fried, Frank, Harris, Shriver & Jacobson LLP

Counterparty credit and documentation risk, historically relatively mundane and technical subjects, have received ever-increasing investor focus given the tumultuous market events of the last two years. For hedge fund managers, as well as their dealer counterparts, losses on investments and escalating redemptions have proven once again the need to devote significant attention to the analysis, negotiation and tracking of trading agreement terms in order to avoid any unexpected minefields to be found therein.

In an effort to maintain liquidity while addressing their exposure to dealer credit risk, managers have pursued the twin goals of tightening protections against dealers and at the same time working to avoid potential landmines related to ever declining net asset values (NAV's or NAV). Once thought to be relatively straightforward, trading agreement termination triggers related to NAV declines have proven challenging in view of the lack of consistency and the unexpected consequences of expansive cross-default clauses. Insulating funds from liquidity pressures caused by such triggers, while at the same time pursuing more aggressive credit terms with dealers, has required a deep understanding of the workings of trading agreements and related documents, and nuanced drafting and negotiation skills.

In the face of declining fund performance, existing NAV triggers have received close scrutiny and have generated a host of problems, including poorly worded clauses that don’t track how NAV is typically calculated, a wide variation in approaches across dealers as terms have evolved over time, the unexpected impact of broad cross-default clauses, the complexities of monitoring performance against such triggers and the difficulties of obtaining waivers once triggers are breached. Poorly drafted clauses leading to unexpected early terminations of outstanding transactions can also have a detrimental effect on performance and on investor relations. From a dealer perspective, drafting ambiguities can seriously undermine the credit protections expected to be provided to them by the NAV triggers.

These issues call for greater consistency in approach and drafting, careful attention to related cross default clauses and a streamlined method for reaching agreement on waivers of, and amendments to, existing NAV triggers.

What is an NAV Trigger?

Historically, dealers have insisted on adding termination triggers linked to NAV declines to hedge fund trading agreements as a form of early warning with respect to a fund’s continuing ability to pay and perform. In the ISDA Master Agreement and related prime brokerage documentation, NAV triggers may allow the dealer to take protective action to reduce exposures to the hedge fund, ranging from calling for additional collateral to closing out trades.

Typically, a fund’s NAV is defined as total assets minus total liabilities. In the most common format, NAV triggers are tied to the fund’s results as reported in the monthly NAV statement issued to investors. It is a fairly straightforward way for a dealer to monitor credit risk with respect to its hedge fund counterparties, and can serve to address declines in both fund trading and investor sentiment toward the fund.
Indeed, investor withdrawals and redemptions can compound already significant NAV declines arising from poor performance. Although investor redemptions can stem from fading confidence in the fund, they can also relate to more benign factors, such as an investor’s need for liquidity to buy a house, finance a child’s education, or any number of non-market motivations. It is also important to consider that a hedge fund may have a flat or improving NAV, even in times of poor performance, if investor subscriptions keep pace with, or exceed, trading losses.

Termination triggers related to NAV are generally added as an Additional Termination Event in the Schedule to the ISDA Master Agreement and as an event of default in related prime brokerage documentation. Such events are triggered when a fund’s NAV declines below a specified level over a specified period. NAV triggers have at least four common variables: 1) the decline threshold; 2) the period during which a decline is measured; 3) the starting and stopping point of such measurement; and 4) the NAV components measured.

In a basic example, an event triggered by a 30% decline in NAV in a one-month period is breached if the fund’s current month-end NAV reflects a decline from the fund’s prior month-end NAV of at least 30%, i.e., a $10,000,000 hedge fund has declined to $7,000,000.

Problems with NAV Triggers

NAV triggers used in trading agreements across dealers present a tremendous diversity in approach. Examples include NAV triggers that measure fund performance at periodic intervals (e.g., one-month, three-months or twelve-months); from a high-water mark; against the prior calendar/fiscal year-end; and/or against an overall floor. NAV components measured may address trading performance only, or may include the impact of investor redemptions, withdrawals and/or subscriptions.

In addition, typical cross-default clauses are used to import termination triggers (including NAV triggers) specified in other agreements, whether between the parties or involving third parties. Dealers insist on such clauses to level the playing field by taking advantage of better terms agreed to by the fund with other dealers. Depending on the scope of the clauses, they can effectively serve to reduce such triggers to the lowest common denominator agreed to by a hedge fund with other dealer counterparties.

Period-end NAV triggers vs. Any-day NAV triggers

To test if a fund’s NAV has breached a trigger, at least two starting points for the test are possible including 1) a prior month-end NAV level (Period-end NAV trigger) or 2) a prior NAV level on any day (Any-day NAV trigger) - such as the highest NAV level achieved during the relevant time period. Similarly, the end point of the test can be 1) the current month-end NAV level or 2) the current NAV level on any day.

For example, a three-month Period-end NAV trigger tests the current month-end NAV against the month-end NAV level of the third previous calendar month. A three-month Any-day NAV trigger may test the current NAV against the highest NAV achieved since the end of the third previous calendar month.

Whereas the Period-end NAV trigger is relatively straightforward, the Any-day NAV trigger can present a number of complexities. At issue is whether the trigger addresses the high point achieved at a month-end prior to the starting point or that achieved on any day during the relevant period. Likewise, the end point could test the NAV level at the current month-end or at any day.

As funds typically report NAV on a month-end basis in a statement distributed to investors, referencing the month-end numbers greatly simplifies the analysis. Given the difficulty associated with obtaining reporting with respect to interim (any day) estimates of NAV, and that such
estimates may not be prepared in accordance with generally accepted accounting principles, NAV triggers referencing daily NAV, either as a starting or end point, may be unworkable.

Even if interim (any day) estimates are contractually agreed to be actionable, the requirement to calculate, report and monitor daily performance, while at the same time calculating the impact of redemptions, withdrawals and subscriptions, presents enormous challenges.

Targeting Trading Performance or Investor Activity (or both)

An additional complexity with respect to NAV triggers relates to the components of NAV that are measured. The definition of NAV for purposes of the NAV trigger can either 1) include the impact of any investor redemptions, withdrawals and subscriptions or 2) exclude such elements, in each case occurring within the measured period.

If the NAV definition in the trading agreement includes redemptions, withdrawals and subscriptions, then the dealer is testing fund trading performance as well as the impact of investor activity. Effectively, money flowing in and out of the hedge fund to investors is relevant for the analysis. If the NAV definition excludes redemptions, withdrawals and subscriptions, then the dealer is only testing fund trading performance.

Typically, tests only targeting trading performance are used when evaluating NAV over short periods (one, three or even twelve month periods). Tests looking at both trading performance and investor activity are generally used over longer periods or with respect to over-all floors.

Imprecise drafting with respect to such variables can produce unexpected consequences. Considerable attention has recently focused on NAV definitions which specifically exclude the impact of redemptions and withdrawals, but remain silent with respect to subscriptions. While it is possible the drafters had intended to target trading performance, the drafting suggests a hybrid approach. In such situations, for the purposes of the test, the fund effectively benefits from the addition of any investor subscriptions during the relevant period while at the same time deducting any investor redemptions and withdrawals.

NAV Floors

NAV floors are used to establish a threshold below which a termination is triggered. Two approaches are typically used: 1) a fixed threshold amount (Hard Dollar NAV Floor) or 2) a floating threshold determined through use of a formula (Calculated NAV Floor).

A Hard Dollar NAV Floor is triggered if the fund's NAV declines below the specified floor amount. A Calculated NAV Floor uses a variety of approaches including: tiered floors, floors based on a decline from a year-end NAV level, or floors based on a decline from a high-water NAV level since fund launch.

The tiered approach includes a table of NAV values with a corresponding NAV floor threshold. For example, a tiered approach may specify that if the fund's NAV is between $100,000,000 and $300,000,000, the Calculated NAV Floor will be $30,000,000. NAV floors based on year-end NAVs or high-water mark NAVs specify a threshold trigger calculated from the particular starting point.1

Impact of Cross Default Clauses

As noted above, dealers often insist on adding cross default clauses to trading agreements to benefit from termination triggers agreed to by a fund in other agreements with the dealer and/or in agreements with other dealers.

1. "NAV Floors"
In both the 1992 and 2002 versions of the ISDA Master Agreement, such clauses include Default Under Specified Transactions (DUST) (at Section 5(a)(v)) and Cross Default (at Section 5(a)(vi)). While DUST typically targets defaults involving other derivatives trading agreements between the parties and related entities, the Cross Default clause targets defaults exceeding a threshold involving borrowed money owed to third parties. Similar clauses appear in dealer prime brokerage agreements and elsewhere.

Where the standard ISDA clauses have been amended to include defaults involving derivative transactions with third parties, NAV triggers occurring in such agreements may be imported to closeout outstanding trades under the ISDA. Where the ISDA agreements have also been amended to require parties to provide notices of Events of Default or Potential Events of Default, a fund could find itself obligated to provide Dealer A with notice of its breach of an NAV termination trigger with Dealer B - even if the NAV trigger agreed with Dealer A has not yet been breached.

**NAV Trigger Issues and Solutions**

Ambiguous drafting, triggers linked to interim (any day) NAV, mixed approaches to the inclusion/exclusion of investor activity and expanded cross default clauses all demonstrate the need for a greater degree of precision and consistency with respect to the drafting of NAV termination triggers.

Adding to the complexity is the scenario where different agreements (sometimes with the same dealer) have different definitions of NAV and different NAV termination triggers, so that multiple variables need to be considered when monitoring triggers against monthly NAV performance. These differences in approach add to the complexity of a fund’s efforts to monitor its trading agreement NAV triggers as it seeks to maintain its overall liquidity, as well as respond to a dealer’s efforts to manage credit risk.

**Consistent Terms**

While tailored approaches are required in the context of different fund sizes, levels of management expertise, trading strategies, etc., going forward, a more consistent structure in terms of drafting, definitions and approach is useful to allow funds to monitor liquidity risks and dealer counterparties to address credit risk more efficiently.

Given that hedge fund NAV is typically calculated on a month-end basis and distributed to investors in a monthly statement, references to interim estimates of NAV present serious practical complexities in terms of production and tracking which compromise their utility as actionable termination triggers. For these reasons only NAV calculated as of the close of business on the last calendar day of each calendar month should serve as a practical trigger.

More compelling is an approach involving a combination of Period-end NAV triggers including: 1) short-term triggers (e.g. declines over one, three and twelve months) targeting trading performance, excluding the impact of redemptions, withdrawals and subscriptions; and 2) overall floor triggers addressing both trading performance and investor activity, including redemptions, withdrawals and subscriptions.

Great care needs to be given to the drafting of cross default clauses to ensure that where defaults on other derivative transactions are to be imported, the acceleration of the other trading agreement must be required (and not merely a breach of the NAV trigger in the other trading agreement). The added requirement for acceleration of the underlying agreement is meant to ensure that the termination event merits a serious response. Moreover, it is critical that an appropriate default threshold is specified, preferably based upon the net amount outstanding after acceleration of the other trading agreement (after application of any collateral or other credit support) to ensure that only significant defaults are imported.

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Most importantly, funds are advised to request limitations on the rights of dealers to act in response to any breach of an NAV trigger. Absent careful amendment, once an NAV trigger is breached, a dealer may be able to exercise its remedies without limitation.

While a dealer may initially elect to continue trading with a fund, absent a limitation on the period of time within which the dealer must act to terminate the transaction, a dealer may wait to terminate trades when the market moves against the fund. For this reason, it is recommended that the parties agree to a specific period within which termination rights must be exercised or, absent such exercise, a deemed waiver of such event occurs.

**NAV Trigger Breaches - Possible Solutions**

Once existing NAV triggers (and related cross default clauses) have been identified, the hedge fund should develop an appropriate strategy to monitor the triggers against ongoing NAV performance. In the event breaches or potential breaches arise, specific steps should be taken to minimize the impact.

To avoid potential collateral calls, trade terminations and/or the importing of an NAV trigger breach caused by a cross default clause, among the possible approaches, a hedge fund may request the dealer to: 1) execute a letter confirming the waiver of its rights with respect to such breach; 2) agree to amend the NAV trigger as suggested above; and 3) agree to a deemed reset of all past NAV levels to the current NAV level.

**Waiver Letters**

Waiver letters for NAV trigger breaches can serve three purposes: 1) to provide a dealer with proper notice of the breach; 2) to obtain the dealer’s agreement to waive the breach; and 3) to agree to a deemed reset of historic NAV levels to the most recent NAV level. A deemed NAV reset can be extremely helpful as it can effectively serve to wipe the slate clean, and thereby avoid subsequent NAV trigger breaches based upon declines from previously higher NAV levels. It can also avoid the need to obtain NAV waiver letters to address future breaches related to historical NAV levels.

While a dealer may express reluctance to sign a waiver and may be prepared to continue to trade notwithstanding the breach, obtaining a waiver is critically important. It can avoid the situation where the dealer would otherwise have the right to terminate all trades based on the breach of the NAV trigger. In addition, a waiver may also be required to avoid investor disclosure issues related to dealer termination rights that may arise upon the NAV trigger breach. Accounting rules may require a fund to disclose such termination rights to its investors given the possible negative impact which such rights could have on the fund’s overall liquidity.

Care should be taken to ensure the NAV waiver letter is delivered to the dealer in accordance with any notice requirements in the relevant trading agreement. Note that Section 6(b)(i) of both the 1992 and 2002 versions of the ISDA Master Agreement requires the relevant party to provide the other party with notice of any Termination Event “promptly upon becoming aware of it.” The letter should be broadly drafted to address the impact of a breach of an NAV trigger on any trading agreement (whether directly or indirectly through application of any cross default rights).

**Amendments to NAV Triggers**

When addressing an NAV trigger breach, it may also be appropriate to target appropriate amendments to the NAV triggers and related cross default clauses as noted above. This point is particularly relevant with respect to Hard Dollar NAV Floors which may not be addressed by NAV level resets and where a new floor can be agreed appropriate to the then-current NAV level.
Conclusion

Hedge funds aiming to protect trading liquidity need to pay careful attention to NAV triggers in their trading agreements with dealers. Whether dealer remedies include trade termination rights or additional collateral calls, NAV trigger breaches can have a severe impact on fund liquidity. Broad cross default clauses may allow the NAV trigger breaches to be imported across trading relationships. Such events may also need to be disclosed to investors.

Given the seriousness of the potential consequences, it is imperative that hedge funds develop a robust approach including careful attention to drafting, close monitoring of NAV triggers and prompt resolution of any breaches through the use of waivers, resets and amendments. It is particularly important to address these issues in the current environment of market volatility and investor unease.

Mr. Mitchell, Mr. Thum, Mr. Cutler and Mr. Ugarte are attorneys in the Asset Management Group of Fried, Frank, Harris, Shriver & Jacobson LLP. Mr. Mitchell is a Partner resident in the New York, NY office and Mr. Thum is Senior Derivatives Advisor resident in the New York, NY office. Mr. Cutler and Mr. Ugarte are both Associates in the Washington, DC office. This article reflects the views of the authors, and does not constitute legal advice. Mr. Mitchell can be reached at david.mitchell@friedfrank.com, Mr Thum can be reached at william.thum@friedfrank.com, Mr. Cutler can be reached at aaron.cutler@friedfrank.com, and Mr. Ugarte can be reached at eduardo.ugarte@friedfrank.com.

1 We refer to NAV triggers to include both NAV triggers and NAV floors collectively, unless we note otherwise.

2 In Part 4 of the Schedule to both the 1992 and 2002 version of the ISDA Master Agreement, parties generally specify the requirement for a fund to provide a statement of the fund’s month-end NAV level within a specified period following such month end. The length of the period depends on the outcome of the parties’ negotiation.