What are the legal obligations of hedge fund managers?

Lessons from recent hedge fund liquidations

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MotherRock and Amaranth Advisors, two of the most active hedge funds in energy trading, liquidated their holdings after experiencing large losses in natural gas derivatives trades last year. After the subprime mortgage market debacle in February and March 2007, a few hedge funds active in that market may face a similar fate.

Hedge funds are largely unregulated, so they have no legal obligations of a regulatory nature, unless it can be established that criminal activities or fraud has been committed. But other legal risk exposures do exist. As ill-defined as such legal risks may be, they create exposures that are difficult to measure. Otherwise, Amaranth would not be exploring settlement options with investors who agree not to sue.[1]

One of the fund investors, the San Diego County Employees Retirement Association, has sued Amaranth for securities fraud, claiming that "the fund, against its own espoused investment policies, effectively operated as a single-strategy natural-gas fund that took very large and highly leveraged gambles and recklessly failed to apply even basic risk-management techniques and controls"[2] It is important to note that Robert Jones, Amaranth's former chief risk officer, is one of the four people named in the lawsuit.

In this article we explore some of the legal obligations facing hedge fund managers, particularly legal risk management failures that could force a firm into liquidation. We also identify some procedures (or lack thereof) that will create legal exposures when failures occur.

Hedge fund managers can best manage the legal exposures they face from the government, counterparties and investors when legal risk management is an integral part of their overall enterprise risk management process.

Legal risk is also tightly linked with compliance and reputational risk, both of which are critical for the long-term success of any hedge fund.

Although hedge funds are essentially unregulated, the aftermath of 9-11 and the illegal drug trade has generated anti-terrorist and anti-money laundering legislation that imposes obligations on all money managers. Consequently, hedge fund managers must establish appropriate policies, procedures and controls designed to detect and report instances of those activities. For example, due diligence programs need to exist that can identify the nominal and beneficial owners of accounts, including the source, purpose and expected use of funds.

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[1] "Amaranth tests the lawsuit waters". CNNMoney.com, March 24, 2007: 12:55 AM EDT.
[2] The case is "San Diego County Employees Retirement Association v. Nicholas Maounis, Charles Winkler, Robert Jones, Brian Hunter and Amaranth Advisors LLC, U.S. District Court, Southern District of New York (Manhattan)." For more information, see Bloomberg (2007)

Despite the limited legislation affecting hedge funds, recent failures in financial and energy markets have created regulatory efforts to hold companies responsible for maintaining reasonable standards for a firm's risk management policies and procedures. Legislation such as Sarbanes-Oxley, which applies to public entities, defines specific obligations and holds management responsible for violations. Yet some of the basic guidelines described in such legislation can be regarded as reasonable practices for all companies. There is an expectation that companies maintain internal controls that meet basic audit standards, which promote accurate financial reporting for investors. Lack of adequate policies and procedures when a failure occurs can create legal exposures from investors and regulators alike.

Legal risk management also applies to documentation risks of contracts used to document the relationships between trading counterparties. The first step to establishing a trading relationship is to ensure that each party has the capacity to engage in the business of trading. Especially with regards to trading swaps, derivatives and options, this step is critical. Without well-defined authorizations by the governing board, an out-of-the-money firm may dissolve trades without payment. The due diligence process with a counterparty should ensure that the types of trades that will be conducted with the counterparty are covered by their risk policies and procedures (e.g. Are there limitations that may exclude selling calls on electric power?). These authorizations should be consistent with the information disclosed to investors to reduce potential lawsuits from investors seeking restitution for undisclosed trading activities.

The documentation between trading counterparties is also an integral part of credit-related policies and procedures. Exposures can be greatly reduced by executing master agreements that govern the trading relationship, instead of using long-form confirmation statements for each individual transaction. A single master agreement will allow the netting of transactions between the parties to reduce day-to-day exposures. Also, in the event of bankruptcy, the parties' respective exposures are set off against each other, which a bankruptcy trustee would otherwise separate into immediate receivables and deferred payables. Upon concluding the bankruptcy proceeding, the deferred payables would ultimately be paid at a fraction of the original obligation amount, if at all.

Master agreements also provide a tool for day-to-day credit risk management. The negotiation of master agreements for trading energy, swaps and derivatives is primarily based on each party's respective creditworthiness. The credit support provisions of the master agreement will define the terms and the amount of credit exposure each party will accept. The parties may establish thresholds or credit limits that entitle the exposed party to request collateral to cover the amount in excess of the threshold.

In order to successfully use such credit provisions, both parties must implement compatible valuation methods, proper trading controls with limits and collateral management systems. Inadequate trading controls that do not prevent or alert risk managers to escalating collateral exposures that exceed the party's ability to transfer the required collateral, per the existing agreement, will cause an event of default. Such events of default can trigger other collateral calls or events of default with other counterparties, who exercise the provisions in their master agreements that allow them to manage their exposures to failing entities. The specific master agreement provisions intended to protect counterparties in the event of default will ruin the firm that lacks an adequate risk management process.

Conclusion

The complexity surrounding regulatory and compliance issues for OTC energy derivatives and physical trades requires the assistance of experienced professionals with knowledge of specific state and federal regulations as well as in-depth knowledge of the energy OTC and physical trading agreements such as those from ISDA and EEI.

Proactive management of legal risk, including documentation risk for OTC derivatives and physical trades, can give funds an advantage when dealing with potential lawsuits or with liquidity problems that could force the liquidation of the fund. Another benefit from active management of legal risk is the ability of the fund to recover their collateral from counterparties who default or are forced to liquidate.

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OTC Legal and Black Swan Risk Advisors provide legal risk management and risk advisory services to hedge funds, energy trading operations, and investors. The firms collaborate to provide an integrated approach to the risk management process.