HEDGING HEDGE FUNDS

FINANCING HEDGE FUNDS

HEDGE FUND investors are presumed to understand the significant risks of betting on this asset class in their quest to achieve above-market performance. While the strategies pursued by hedge funds vary widely, their offering materials almost without exception make plain the risks to which investors may be exposed. In contrast, the risks that financial intermediaries are prepared to assume in their dealings with hedge funds are quite limited. Whether in extending loans to hedge funds, executing derivative or other trades with hedge funds or using hedge funds as reference assets for derivatives or structured products, broker-dealers seek to minimize exposure to hedge fund volatility, performance and credit risk. Our integrated team, drawn from our derivatives, capital markets, tax, ERISA and secured finance practices, collaborates closely with our investment bank clients to structure offerings, financings and trades with, or related to, hedge funds that mitigate risk without sacrificing the intended economics.

In developing revolving credit facilities for hedge funds, with advances made at the fund-of-funds level, we and our clients face a multifaceted exercise in risk mitigation. Covenant structures must be carefully calibrated to account for changes in net asset value below (sometimes many tiers below) the fund-of-funds level. Credit support arrangements must be sufficiently sensitive to capture mark-to-market changes in collateral values. This, in turn, requires a thorough grasp of the limitations on redemption rights at various tiers below the fund of funds. These basic concerns are compounded by the offshore and multi-jurisdictional nature of many such facilities. We help our clients structure variable funding notes, total return swaps and other derivative financing structures employing customized covenants, monitoring mechanisms and custodial arrangements to mitigate risk.

Managing hedge fund risk and exposure is no less an issue when our clients execute derivatives or other trades, or issue structured products, referencing hedge fund interests. Often, our financial institution clients are intermediating between parties seeking a derivative or structured exposure to hedge fund risk and other parties prepared to offer this exposure, such as the fund, its sponsors and others who may already be long the target exposure. Parties seeking exposure may wish to acquire a position comparable to a direct interest in a fund or instead may desire a highly structured instrument or derivative customized to offer varying degrees of fund participation and principal or notional protection. From the intermediary's perspective, the risk management exercise is largely the same: ensure the offered exposure is hedged properly to avoid unanticipated basis risk between the two sides of the transaction and establish credit support mechanisms to enhance the long-term viability of offsetting hedges. We negotiate the documentation creating the hedge fund exposure and offsetting hedges in order to minimize basis risk. This task can be particularly challenging given the illiquidity of hedge fund interests and the "gap" risks that are a routine consequence of hedge fund redemption regimes. Working to align fund redemption mechanisms and the offsetting hedges is a critical aspect of how we help clients achieve their risk management objectives.

We are acutely aware that when it comes to financing hedge funds or intermediating hedge fund linked exposures – whether because of problematic redemption mechanics, potential misaligned hedges, fluctuating collateral valuation, uncertain tax treatment or multi-jurisdictional difficulties – the question for our clients isn't whether to invest in a hedge fund, but rather how to hedge against the risk of inadvertently doing so.