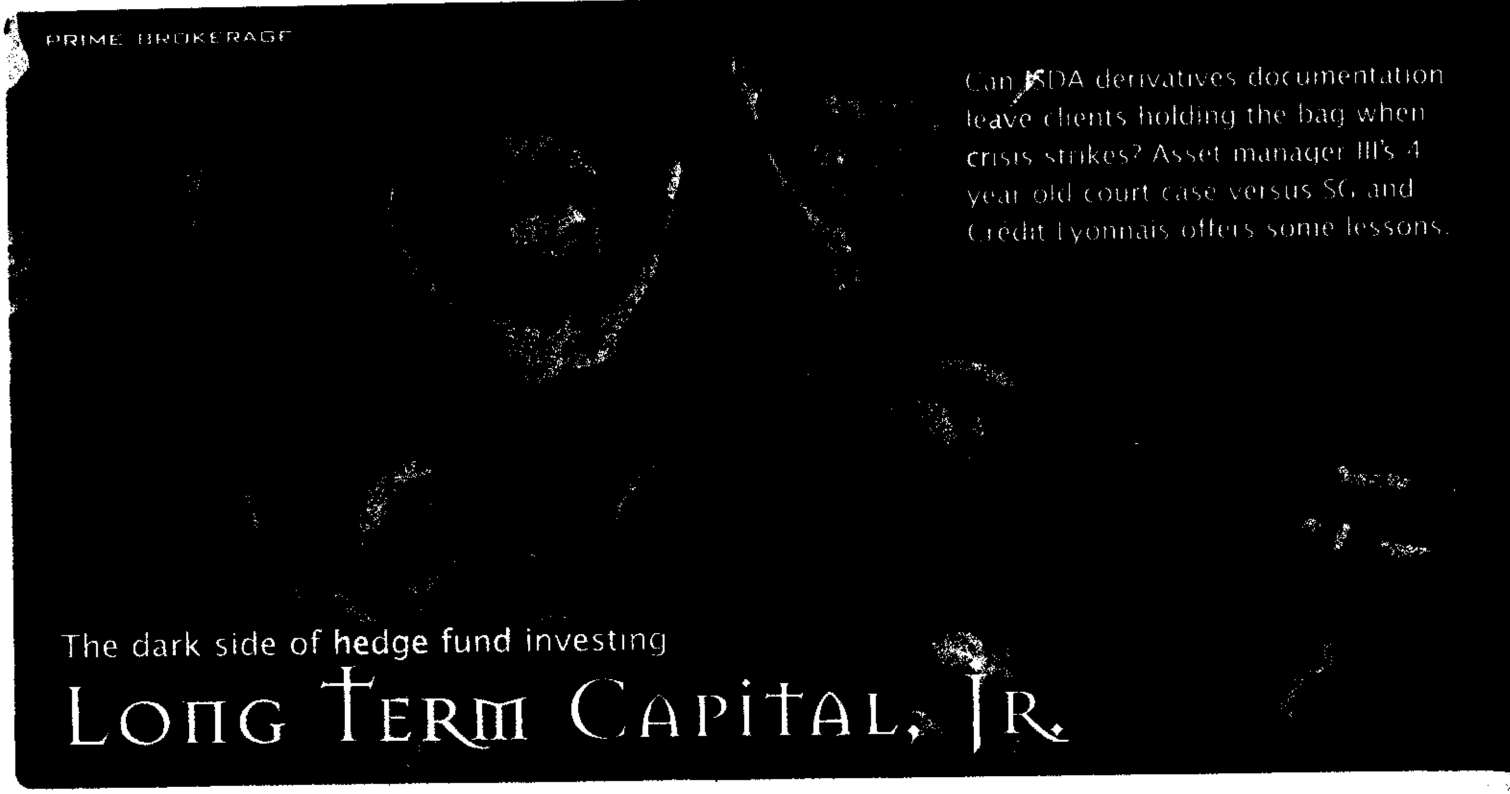

Can ISDA derivatives documentation leave clients holding the bag when crisis strikes? Asset manager III's 4 year old court case versus SG and Crédit Lyonnais offers some lessons.

The dark side of hedge fund investing

Long Term Capital, Jr.

Everyone has heard of the Long Term Capital debacle. Fewer have heard of what transpired to the High Risk Opportunities Fund (HRO Fund) managed by Illinois Institutional Investors (III), and what has subsequently followed as a multi-billion dollar court case.

This is a court case that currently sports the high profile David Boies as the principal attorney representing the receivers of the fund. Boies has specifically filed a $1 billion lawsuit in New York State Supreme Court against each of Société Générale and Crédit Lyonnais, claiming these large French banks unjustifiably forced his fund client into receivership. The banks have enlisted their own high-powered law firms to defend themselves. The various motions and counterclaims already fill a small trunk.

To truly understand the case, one must first turn back the clock to the spring of 1997. The place: Palm Beach, Florida. The firm: Illinois Institutional Investors(III), a well regarded investment advisory group that is still up and running today. It was first started by a group of Wall Street traders, among them Warren Mosler—head of a small broker/dealer named Adam, Viner & Mosler, and a somewhat outspoken economic thinker. Coming into 1997, Mosler, together with his partners, had successfully built their fund management business to control over $1.5 billion in fixed income assets using various "defined risk" techniques. Their track record of performance was steady and strong.

Then, in early 1997, prodded, in part, by customer interest, they opened a more aggressively managed fund by the name of the High Risk Opportunities Fund. This fund was set up to have much broader latitude to leverage up attractive global fixed income opportunities using a variety of financial instruments and derivatives. The fund had a stated goal of annual returns in excess of 25%, and for this, investors were willing to pay away 25% of the fund's gross trading profits as an incentive fee to III Offshore Advisors (a subsidiary of III) as well as administrative fees and other expenses. Over time, approximately $500 million rolled into this fund's coffers.

It didn't take long for the principals of the HRO Fund to become attracted to Russian debt. Short-term GKO and OFZ debt were both yielding north of 30% at the time, and the traders at III spotted a potential arbitrage. They could buy total return swaps to replicate the investment return of these GKO/OFZ instruments, and then hedge away the currency risk of the investment by separate and less costly Non-Deliverable Forward (NDF) transactions. Since the risk of currency devaluation was the principal reason the GKO/OFZ yields were so high to start with, the advisors to the HRO Fund thought they had a well-hedged position. Barring a currency default, they would collect a positive carry differential between the two derivative transactions, and in the event of a currency default, they would be covered.

But they assumed wrong—principally by making two fatal mistakes. First, the HRO Fund traded with multiple counterparts, thereby exposing the Fund to cross-margining liquidity problems. Second, the Fund's principals and lawyers may not have examined, in a particularly careful fashion, the ISDA documentation underlying the derivatives trades they started to establish. These mistakes have, in turn, led to directly today's litigious proceedings.

Specifically, when III's traders bought $360 million of paired GKO total return swaps and NDF trades, they bought the GKO total return swaps from one set of counterparties (including Bankers Trust, Citibank, Credit Suisse First Boston, Lehman Brothers, Merrill Lynch, and Salomon Brothers), while they used a second set of counterparties to establish the NDF hedges (including Deutsche Bank, ING, Morgan Stanley, Société Générale, and Crédit Lyonnais). The HRO Fund executed reciprocal margin agreements with the vast majority of these financial institutions, such that if market movements caused one counterparty to develop significant credit risk against another, margin, in the form of cash or liquid securities would be exchanged. Such margin agreements are regularly arranged via a Credit Support Annex to a more standardized International Swap's Dealer Association (ISDA) Master Agreement.

Perhaps the decision to use a wide variety of counterparties stemmed from III's goal not to make their perceived arbitrage too obvious to others. The wide discrepancy in pricing between GKO total return swaps and the NDF market could easily have diminished if one or two banks had piggy-backed III's play. Or perhaps it was merely unintentional. Whatever the case, the word on the street was that these trades were lay-ups because a default would never happen. Behind the scenes, both World Bank and IMF officials were telling various bankers (and the bankers, in turn, told their customers)

ILLUSTRATION: CHRISTOPHER BUZELLI

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that the OECD nations would never allow Russia to default on its external debt obligations. Such an outcome would simply be too horrific and not be allowed to happen. On the back of such assurances, not only did III feel comfortable with its exposures, but so too did many, otherwise conservative, banking institutions similarly positioned. Even the late Edmund Safra of Republic National Bank of New York allowed his extremely credit-sensitive bank to take on substantial exposure to such trades.

Notwithstanding all the behind-the-scenes promises, pressure on Russia's external balance of payments mounted steadily into early August 1998. As a result, the Russian Federation, together with the Central Bank of Russia, finally felt forced to issue a Joint Statement on August 17, 1998. In this Statement, among other changes, a new higher corridor was established for the Russian ruble to float, and a temporary moratorium was imposed on all foreign payments of financial loans or debt to non-residents of Russia. It was a de facto devaluation and temporary external debt default at the same time.

The worst had happened to the HRO Fund. Not only did the value of their GKO/OFZ total return swaps start to decline dramatically against them, but the Russian ruble started to collapse as well. From approximately a 7-1 ruble-dollar peg, pre-August 17th, the dollar-ruble exchange rate quickly vaulted to the top of its new corridor at 9.5 rubles. By September 1st the ruble had gone through the upper boundary of this corridor to stand at 12 rubles against one dollar; and by September 4th it took 17 rubles to buy one dollar.

Hold Those Wires

But the HRO Fund's currency exposure was hedged with NDF derivatives, right? Well, as it turned out for the Fund, not really.

In practice, as soon as the crisis hit, the HRO Fund had to start answering calls for added collateralization of its GKO/OFZ total return swaps. CSFB was the firm pushing HRO's managers the hardest on this front. In turn, Mosler and his associates started to call the Fund's NDF counterparts asking that these institutions deliver margin due the Fund on a range of NDF contracts struck between 6.29 and 8.20 rubles. These contracts were now moving deeply in-the-money.

But, at least two NDF banking counterparts, Société Générale and Crédit Lyonnais, were not particularly keen at releasing any margin. Although, in the days immediately after August 17th, SG did send $44 million in T-bills over to the HRO Fund's accounts (bringing total margin posted by SG to HRO Fund up to approximately $76 million at that time), the bank never responded with any further margin transfers thereafter, even as the ruble continued to decline dramatically in value. Indeed, Société Générale quickly claimed that if any further margin was due, it was the HRO Fund that now owed margin back to SG due to the higher volatility of the ruble market and various added costs SG was now going to have to bear to make good on its obligations post the Russian Joint Statement.

Crédit Lyonnais, meanwhile, claimed that, while their Master ISDA Agreement with the HRO Fund made no explicit provision allowing good faith margin to be withheld by the bank in the case of an extraordinary "Exchange Risk" in Russia, Crédit Lyonnais' individual deal confirmations did make such reference, and thus, superceded the ISDA Master Agreement. These deal confirmations read that:

"The payment obligations of CLNY pursuant to this Transaction shall be deferred or reduced on account of fees, taxes, commissions or similar charges or costs imposed due to an Exchange Risk...until CLNY determines, in its reasonable discretion, that such Exchange Risk no longer exists."

Exchange Risk in the confirmation was then further defined to mean: "the promulgation or imposition of any law, order, decree, or any other government action by any Russian governmental authority which prohibits, restricts, limits, or otherwise imposes any charges or costs upon the ability of market participants located in Russia to (I) transfer USD to parties located outside of Russia, (ii) obtain USD in a lawful market located in Russia or (iii) convert Rubles into USD."

SG had similar language in its Master ISDA with the HRO Fund stating that if SG "or any of its affiliates" anywhere in the world somehow became impaired by a governmental action in Russia, that any such added costs incurred by SG to make good on its NDF obligation could be passed on to the HRO Fund. Because SG New York covered its exposure with SG-Vostok, who was now impaired by the Russian Joint Statement, SG New York had effectively lost its entire offset to the HRO Fund trades. The bank was potentially out several hundred million dollars. Martin Levion, the head of the SG group that had established these trades with the HRO Fund, was potentially in big trouble.

But, much as President Clinton, in 1998, had ascribed new meaning to the word "is" within the American lexicon, Levion had the ISDA verbiage card up his sleeve. If SG could use the nitty gritty verbiage of the ISDA agreement to pass these massive costs onto the customer—the HRO Fund—then many of Levion's problems would go away. Levion, a derivatives trader with Salomon Brothers roots, likely knew this already. Yes, $76 million in collateral had been wired out the door to the HRO Fund, and this margin wasn't likely coming back, but losing $76 million was better than losing $300 million. Levion had an escape clause to fall back on.

Moreover, within the SG documentation, SG specifically provided that any collateral posted to the HRO Fund was "non-rehypothecatable," or, in layman's terms, not eligible to be re-delivered as margin to any other institution. So it was possible that SG could even sue to get its $76 million back. In point of fact, the bank has since filed a counterclaim suit against the HRO Fund for the return of this margin.

One Ruling after Much Slow Motion

It was at this stage that events stood for many months into last summer:

motions and counter-motions piling up between the assorted lawyers. Since then, New York State Supreme Court judge, the Honorable Ira Gammerman, has issued a partial ruling. In proceedings held July 10, 2001, Gammerman concluded that "whether Société Générale posted its collateral or not, the money was unavailable for High Risk to use to meet its obligations to any counterparty, including Credit Suisse...Accordingly, I don't think it can be said that High Risk's liquidation flows directly from, or was the probable result of, any failure on the part of Société Générale to post margin." He thus dismissed HRO's suit against SG claiming that the bank unnecessarily pushed it into receivership.

Boies thus continues to fight against SG only on a second claim. This latter motion disputes the "nil" termination value that SG eventually put on the HRO Fund's NDF contracts. Two days after the HRO Fund was put into receivership, on September 2nd, all parties agreed to a final Termination Date for the contracts to take place on September 4, 1998. At the time, the ruble was standing at 17 rubles to the dollar—two to three times the forward rates that HRO had on its NDF contracts. But, by highlighting the specific language of the ISDA documentation, SG put forward "Market Quotations" from several third parties for the value of these contracts at next to nothing. HRO is obviously incensed at such a valuation.

Boies's suit against Crédit Lyonnais also remains fully outstanding.

Bottom Line

The eventual outcome of this case obviously remains in the judge's hands. Morally, the HRO Fund is likely owed something, but legally, the actual contractual verbiage would appear to support the French banks.

The greatest lesson to the story is that when "systematic risk" strikes, fund managers better have read and executed their ISDA Master Agreements, Credit Support Annexes, and actual Trade Confirmations ever so carefully.

In the HRO Fund instance, III managers clearly thought that they were buying currency devaluation insurance, when, in reality, they were buying a derivatives contract full of very specific nitty gritty language and legal loopholes—loopholes that, to date, have prevented both the Fund and its subsequent receivers from collecting on anything. It was a bit like having bought insurance against one's factory burning down, and then being told—after an actual fire—that the insurance contract was invalid because the contract required a night watchman to have been on duty. We can just hear the insurance salesman saying, "What a shame that you didn't notice that provision."

From SG's and Crédit Lyonnais's perspective, of course, no one forced III's managers into signing these documents or doing these flawed trades.

If there are ongoing derivatives problems in the global capital markets, the specific verbiage of a NDF Credit Support Annex will likely not be the central issue to a future hedge fund's survival or demise. But there is a high probability that the language around a credit default swap or a credit-enhanced note might be. Will a "force majeure" event yield some other piece of paper as worthless as III found its NDF contracts? Maybe the current Enron situation has already brought more of these documentation issues to the table.

ISDA documentation is certainly not as standard as one might first be led to believe. In the end, lawyers create loopholes, and then exploit them. Unfortunately, the III High Risk Opportunities Fund learned this the hard way, and asset allocators placing money with other derivatives-oriented hedge funds should do so fully cognizant of this risk.❖