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Managing the Risk of Complex Derivatives Documentation

By Willa Cohen Bruckner, JD, Partner, Alston & Bird LLP

WITH THE EXPLOSIVE GROWTH in the volume and sophistication of derivatives products, industry participants must maintain appropriate risk controls. Increasingly, documentation risk is being addressed through the use of widely accepted templates and through master documents. This approach is not new to the industry, but the accelerated pace at which the practice is moving forward, the complexity of products, and the manner in which documentation is developed present unique risks to hedge funds.

Trends in Documentation

As the volume of derivatives trading continues to expand and technology improves the speed at which transactions are effected, it becomes increasingly important to narrow the time lag between the parties' agreement on terms of a transaction and the completion of documentation.

Templates and master documents help parties manage the documentation process by seeking agreement on most documentation terms before transactions are entered into. A limited set of transaction specific terms are then negotiated at the time of each transaction. Templates and master documents for derivatives products date back at least twenty years. The International Swaps and Derivatives Association (ISDA) published its first Code of Standard Wording, Assumptions, and Provisions for Swaps in 1985 and its first master agreement in 1987. ISDA began developing simple templates for product specific confirmations, and the industry has been moving towards master confirmations for particular products and in some cases for multiple products. The broad scope of master confirmations and the complexity of individual products and templates have resulted in progressively longer and more detailed documentation.

The use of templates and master documents has affected the way in which dealers staff their documentation function. Dealers divide up documentation responsibilities into segments (such as the basic master agreement, a single product specific confirmation, or a particular master confirmation) and staff each segment with more junior personnel than would be required if a full set of documentation were individually prepared for each transaction. As a result, the sophistication of the people creating products or preparing templates or complex dealer forms is often far superior to the sophistication of more junior personnel with the day-to-day responsibility for documentation.

Industry participants can expect these trends in documentation to accelerate. The recent dialogue between the Federal Reserve Bank of New York and major derivatives dealers regarding derivatives documentation resulted in a commitment from those dealers to develop forms of master confirmations for certain equity derivatives products. The major dealers also agreed to expand electronic processing of confirmations, a practice which depends upon using widely accepted forms of documentation.

Impact on Hedge Funds

While few can dispute the importance of efficiency in documentation and the contribution of templates and master documents towards achieving that efficiency, hedge fund managers should be cautious that the funds they manage are not unduly disadvantaged by the industry's current approach to documentation. Product development in derivatives generally follows market demand from the buy side, but documentation is developed by the sell side. With the exception of Managed Funds Association's (MFA) current participation with the major

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Zero Tax on Long-Term Capital Gain and Dividend Income

By Taryn A. Pomerantz

BEGINNING IN 2008 THROUGH 2010, a zero tax rate will apply to most long-term capital gain and dividend income that would otherwise be taxed at the regular 15 percent rate or the regular 10 percent rate. This new rate is only available for a noncorporate taxpayer who has a net capital gain or qualified dividend income. The amount of income tax allowed to be taxed at zero percent depends on filing status, taxable income and what portion of taxable income consists of long term capital gain and dividends.

Long term capital gains are realized on stock that is held for more than one year. Stock held for one year or less is treated as short term capital gains. Short term capital gains are taxed at ordinary tax rates and are not eligible at the reduced capital gains rate.

For individuals in the 25 percent or higher tax bracket, long term capital gains are taxed at a maximum of 15 percent. Individuals in the 10 to 15 percent income tax brackets are taxed at a zero percent rate for 2008 through 2010.

The filing status thresholds eligible for these rates for 2008 are as follows:

- $32,550 for single taxpayers and married taxpayers filing separate returns
- $65,100 for married taxpayers filing joint returns and surviving spouses
- $43,650 for heads of household filers

The reduced capital gains rate applies for both regular tax as well as alternative minimum tax. The lower tax rates however are not a tax preference item for alternative minimum tax. For alternative minimum tax purposes a noncorporate taxpayer's capital gains will be computed the same was as for regular tax purposes.

Individuals not benefiting from the zero percent tax rate include most children who are subject to the kiddie tax and whose parents are in higher tax brackets. The system was designed this way to discourage families from gifting appreciated stock, mutual fund shares and other securities to their lower income children who could then sell the securities tax free under the zero tax rate rules. If the earned income of a child over the age of 18 or is a full time student under the age of 23, exceed one half of his or her support, the kiddie tax rules do not apply and he or she will be able to take advantage of the zero percent rate for long term capital gains and qualified dividends.

These rates were set to expire at the end of 2008 but Congress extended the rates until 2010. There have been no further updates on whether Congress will make these rates permanent. MK

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Spotlight On:
Babs Oyedeji

When did you begin working at M&K and in what capacity?

I began working at M&K in late January of this year as a tax manager.

When you went to school, did you originally plan on being an accountant?

Initially, I had not planned on being an accountant. I was interested in a career in finance, but after the 1987 stock market crash, I wanted a related and equally challenging career that offered stability— which would be in demand even during downturns in the economy. After taking a few introductory classes in accounting and liking them, it was easy to make the choice to become an accountant.

How did you become focused in hedge funds?

I began my accounting career working on high-net-worth individuals and real estate entities. I just happened to assist a manager in conducting research on the ability of a small hedge fund to take the research credit. I was able to get an insight into the various trading teams and their trading methodology. I was intrigued by the way they made money from taking advantage of imperfections in the markets. After getting some exposure to some of the financial instruments the fund employed, and the related tax implications, I decided it would be a great, challenging area to focus on as it is not only important to learn about an instrument but more importantly its tax treatment. I enjoy dealing with some of the tax issues associated with hedge funds.

On a more personal note, do you have any plans for after tax season?

I plan on catching up on my reading and in general. I also hope to be able to train my two left feet into dancing Salsa, but I think I will have better luck reading.

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dealers in the development of master equity derivatives confirmations, there is often little input from the buy side in the preparation of industry-wide templates or master documents and none in the preparation of a dealer's form. Documentation may become "standard" in the market, not because all sides of the market agree on how issues should be handled, but because dealers have reached consensus on the issues. Junior documentation personnel within a dealer are unlikely to appreciate that dealer provisions have not been accepted by all parties and may be unwilling to consider a change which is contrary to the standard adopted by their employer.

For a fund whose strategy is heavily dependent on derivatives trading, it is particularly important to be aware of the ways in which dealer documentation is disadvantageous to funds. Issues arising under templates or under master documents can have a broad effect on the fund. In addition, as suggested earlier, product innovation and preparation of documentation are separate functions. Some dealers known for their customer service on the product side are inflexible on the documentation side.

Since documentation is usually prepared by the dealer or based on dealer generated templates, dealers have a decided advantage over their fund counterparties. The dealers are familiar with the document, and their organizational structure will already be consistent with the requirements specified in the documentation. In addition, the fund manager may have to review documents under time pressure, and with the scope and complexity of documentation it may not be a simple exercise to determine the implications of particular circumstances on the fund's outstanding transactions or on its operations. As noted above, the psychological impact on the dealer's documentation personnel of an industry accepted or dealer developed document may hinder the fund manager's ability to negotiate changes to the document.

The growing complexity of dealer generated documentation makes it more difficult for a hedge fund manager to verify that the product reflected in the documentation is the desired product. Because the salesperson is not likely to be involved in developing the product documentation, the risk increases that there will be a mismatch between the salesperson's description of the product and the true features of the product. A fund manager seeking synthetic exposure to a portfolio of assets, for example, may be presented with a product which hedges only the downside in the portfolio. If the documentation is complex, the discrepancy may not be evident without close review. Whether or not the salesperson described the product properly, however, the dealer will determine the parties' rights and obligations, including the timing and amount of payments and the collateral requirements, from the documents signed by the parties and not from the salesperson's description. It is therefore in the fund's interest for the manager to assure that the documentation is consistent with the expected product.

Another dealer advantage to be considered by hedge fund managers, particularly in connection with master documents, is the degree of dealer discretion. Derivatives documentation may contain initial terms which have been agreed to by the parties, but the dealer may have discretion to unilaterally change the terms. By way of example, the dealer may have the right to change the timing of payments, collateral requirements or fees. The changes may become effective immediately, and the fund's only option with respect to new terms which are unfavorable may be to terminate the transaction or the relationship. The time period during which the fund can terminate affected transactions may be limited, putting the fund at a disadvantage if the manager needs to search for a replacement facility. In some cases, the dealer may also have the right to unilaterally terminate transactions or the relationship.

How Can Hedge Funds Manage the Risks?

A number of steps can be taken by hedge fund managers to manage the risks presented by complex documentation based on dealer templates and master documents. The suggestions below complement and expand the recommendations included in MFA's recently released Sound Practices for Hedge Fund Managers.

- Careful review of documentation is essential, even if the fund manager does not plan to negotiate many changes or does not expect much success in negotiation. The fund manager should request draft documentation as early as possible, as more lead time in reviewing the documents will allow the fund manager to properly assess the impact of the product and documentation terms on the overall business and operation of the fund. Key issues to be looked at include the following:

  - Does the documentation describe the product or products the fund expects to obtain? Review should ascertain whether the product, as documented, introduces or hedges the portfolio risks anticipated by the manager. Are there any features which were not described by the salesperson? Those features should be identified and clarified before documents are executed.

  - What is the degree of dealer discretion, and what rights does the fund have if it disagrees with a dealer's application of its discretion? In the course of negotiating the documentation, the fund manager can ask the dealer to eliminate its discretion for at least a period of time. Alternatively, the fund manager can press for disincentives to unfavorable changes by the dealer in the terms of the arrangement. In addition, a fund may be able to lock in terms while its manager evaluates alternative products or relationships.

  - Is the fund adequately protected when circumstances are not favorable? How hard does the dealer have to work to maintain value for the fund in times of distress, and how much discretion does the dealer have to value a transaction at zero? The fund may be able to gain some input into the valuation process.

  - Are the operational features of the documentation consistent with the fund's operations? If not, can the dealer accommodate the fund's operational constraints? These issues may be heavily debated as each party seeks consistency across all of its trading relationships.

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IRS Filing Date for Foreign Account Holders is Rapidly Approaching

By Philip F. Strassler, CPA and Suzanne LoBiondo, CPA

EVERY "U.S. PERSON" having a financial interest in or signature authority, or other authority, over a foreign financial account, subject to a certain threshold during a calendar year is required to file an information report with the U.S. Treasury Department by June 30th of the following year.

What is meant by financial account?

A financial account includes bank, securities, securities derivatives or other financial instrument accounts. Equity interests in such accounts where the assets of the account are held in a commingled fund are included in this definition. Also included are savings, demand, or checking, deposit, time deposit or any other account maintained with a financial institution or other person engaged in the business of a financial institution.

A financial account is maintained in a foreign country even if it is at an affiliate of a U.S. bank or other U.S. financial institution. It should also be noted that any financial account maintained with a branch, agency or other office of a foreign bank or other institution that is located in the United States, Guam, Puerto Rico and the Virgin Islands is not considered a foreign financial account for the filing requirements discussed within this article.

What is the IRS Form that must be filed?

The foreign financial reporting form required to be filed is TD F 90-22.1, Report of Foreign Bank Account and Financial Accounts. The form is filed separately with the IRS in Michigan and is not included as part of an annual income tax return filing. The June 30th filing date for the FBAR form cannot be extended, even if the taxpayer's income tax return is on extension.

Who is considered a U.S. Person required to file Form TD F 90-22.1?

A U.S. person includes a U.S. citizen or resident, a U.S. partnership, a U.S. corporation or U.S. estate or trust. The filing requirement is triggered only if the aggregate value of all foreign accounts in which the U.S. person has the requisite financial interest in or authority over, exceeds $10,000 at any point during a calendar year.

A U.S. person has signing authority over an account if such person can control the disposition of money or other property in the account by delivery of a document containing his or her signature. Other authority exists in a person who can exercise comparable power by direct communication to a bank or other person whom the account is maintained, either orally or by some other means.

Owning an account jointly with another party may also trigger a filing requirement if the valuation threshold exists.

How is the account valued for purposes of the $10,000 filing requirement?

The reporting requirements are based upon the value of the account which is measured by the largest amount of currency that appears on account statements issued during the year. In order to determine if the $10,000 threshold is met, foreign currency must be converted into US dollars using the official exchange rate at the close of the calendar year.

If the account holds non monetary assets, such as other securities, then the valuation is based on the fair market value at the end of the calendar year, or if withdrawn, at the date of withdrawal.

If a holder owns multiple accounts, each account must be valued based on the above descriptions in order to determine compliance.

Are there exceptions to these requirements?

Officers or employees of a bank account subject to certain Federal Reserve or FDIC supervision need not report such authority if that person has NO personal financial interest in the accounts.

Officers or employees of domestic corporations whose equities are listed upon national exchanges, or with assets exceeding $10 million and 500 or more

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shareholders, need not file if that person has NO financial interest in the account, and has been advised in writing by the CFO of the corporation that the corporation has filed a current report which includes such account. A military banking facility is not considered an account in a foreign country.

A corporation which owns directly or indirectly more than 50% interest in one or more other entities will be permitted to file a consolidated report on TD F 90-22.1 on behalf of itself and such other entities.

If such a group of corporations owns an interest in 25 or more foreign accounts, the reporting corporation need only note that fact on the form.

What are the penalties for non-compliance?

Prior to the American Jobs Creation Act of 2004, there was no penalty for non-willful failures to file form TD F 90-22.1. The Act authorized the Secretary of the Treasury to impose a maximum civil penalty of $10,000, effective October 22, 2004. The penalty may be waived if there is reasonable cause for the failure to report, and if any income from the transaction was properly reported. The Act also increased the willful failure to file penalty to the greater of $100,000 or 50% of the amount of the transaction or the account not reported. Prior to the 2004 Act, the minimum penalty was $25,000, and the maximum was $100,000. The minimum is now $100,000. If a taxpayer has not complied with the above rules, they should consult their tax adviser.

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Derivatives Documentation

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- Does the product documentation negate or otherwise conflict with the ISDA Master Agreement or other documentation between the parties? Because of the segregation of documentation functions within a dealer, these conflicts are not uncommon. The fund manager should identify and resolve the discrepancies before completing documentation for the new product.

- The fund manager will need a flexible approach in negotiating documentation. Dealers prefer their documentation personnel to be the point persons for all negotiations. The fund manager should expect that dealer personnel handling documentation will not be responsive to some critical issues for the fund and that the fund manager may need to seek resolution outside the dealer's established documentation process.

- The fund manager should create working guidelines so that people responsible for the day-to-day operations and monitoring of derivatives products act consistently with the requirements of the documentation. Carefully prepared guidelines are critical, particularly where documentation is complex, trading volume will be high, or a product has unusual features. At the least, guidelines should describe the product, including step-by-step action points and decisions, indicating the persons responsible for particular actions and decisions, and specifying the individual or individuals to be notified in case of problems or issues not addressed by the guidelines. The fund manager should undertake a periodic check of the guidelines to identify areas which require modification or additional scrutiny.

Beyond the efforts of individual hedge fund managers in the negotiation of documentation, buy side input as dealers develop documents will benefit all hedge funds. Without a coordinated effort from the buy side, dealers will continue to be at an advantage. MFA's involvement in preparing equity derivative master confirmations is a major step towards leveling the playing field, and hedge fund managers should support similar input in the future. Hedge fund managers should also take advantage of any users' guides prepared by MFA to advance their understanding of product documentation.

Conclusion

Derivatives products and documentation are growing in complexity, and the pace at which transactions are affected is also increasing. As these trends continue, dealers have an advantage over hedge funds in documentation of transactions. With appropriate planning, hedge fund managers can take steps to manage the resulting documentation risk.

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Willa Cohen Bruckner is a partner with Alston & Bird LLP and focuses on derivatives, structured products and alternative investments. Alston & Bird's 800 attorneys provide a full range of services to domestic and international clients conducting business throughout the world. Alston & Bird ranked 5th in the U.S. on The BTI Consulting Group's first "Masters of the Deal" list of firms excelling in transactional relationships. Ms. Bruckner can be reached at 212.210.9596 or willa.bruckner@alston.com.

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