

THE LONG VIEW

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Brexit: practical steps hedge fund COOs can take right now

Following notice by the UK of its withdrawal from the EU, there remains continuing uncertainty as to the eventual outcome.

For hedge funds and other financial market participants, much of the discussion relates to the possible loss of passporting rights. But there has been little conversation about the potential impact to hedge funds at the portfolio level.

This article highlights some practical steps hedge fund COOs can take now in preparation for 29 March and any other key dates which may follow.

Categorising portfolio positions

Positions in a portfolio executed before Brexit (existing positions) and those executed afterwards (new positions) are likely to face different regulatory analysis and treatment.

However, the categorisation of these positions is more nuanced. Within the category of existing positions, trades containing certain features or event triggers, such as swaptions or rolls, as well as certain novation or close-out mechanisms, may expose them to the risk of re-characterisation as new positions, thereby changing the regulatory analysis.

COOs should consider identifying trades in existing portfolios with anticipated rolls, 'material' amendments to the terms of the transaction, possible novations, unwind mechanisms and those susceptible to portfolio compression or netting by novation, before determining how the analysis might change and how the resultant risks can be mitigated.

PB and dealer reorganisations – scope

Many prime brokers are reorganising their businesses and transaction flows in contemplation of the loss of passporting rights by their UK entities. To the extent the fund is required to face a different entity in the prime broker or dealer group, it is prudent to consider whether this

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will be for new positions only or existing positions as well. If the former, it is worth considering what ought to be done about existing positions at risk of recharacterisation as new positions.

In addition, if new positions are booked against a different prime broker group entity to the existing positions, then it is worth making enquiries as to whether this will impact the expected recognition of any risk offset between positions for margin purposes or will cause any unintended operational consequences e.g. in relation to payment netting.

PB and dealer reorganisations – transfer mechanism

If the reorganisation involves the transfer of existing positions to a different dealer group entity, it is worth considering in advance the legal, operational, tax and accounting implications of the mechanism selected by the dealer to move the positions

across to its replacement entity. For example, close-out and re-booking may produce a different result than a novation.

Assessment of the new dealer entity

Although it is likely that the dealer will have selected a group entity that meets general requirements, such as a jurisdiction with enforceable netting and set-off rights, there may be some residual differences, such as a different regulatory regime for the protection of customer assets or a comparatively weaker creditworthiness. In this regard, it is worth noting that approval from the High Court for some of these business transfers has been forthcoming, notwithstanding that the replacement entity is less well capitalised.

It follows that the court's expectations in this regard may not meet the fund's commercial expectations or risk tolerances and so a court-approved reorganisation should not be assumed to be a substitute for risk assessment by the COO. Options such as parent company guarantees in respect of the new entities should be considered.

Is a prospectus update required?

If the fund's prime broker is restructuring and/or the fund's risk is changing, we would recommend assessing whether the offering documents of the fund need to be updated to ensure that investors are fully informed and are in receipt of adequate disclosures.

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