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COUNTERPARTY RISK

Former AQR Counsel Discusses Regulatory Initial Margin Requirements

By Robin L. Barton, *Hedge Fund Law Report*

Lowenstein Sandler recently announced that Boris Liberman has joined the firm as a partner in the investment management group. Liberman provides strategic advice to U.S. and international hedge funds, mutual funds, managed accounts, sovereign wealth funds and other asset owners regarding all aspects of implementing their investment and trading strategies. He has substantial experience with both U.S. and non-U.S. laws and regulations that impact the trading of securities, commodities, derivatives and other asset classes, and he is proficient with the multitude of agreements required by market participants in order to invest in and trade such assets.

Previously, Liberman served as senior counsel for 12 years at AQR Capital Management LLC, where he counseled the trading, research, compliance, portfolio implementation and business development teams. From his years in-house at that global investment management firm, as well as his time in private practice representing funds and private equity clients, Liberman has acquired wide-ranging experience in dealing with all aspects of investment strategy implementation, encompassing all types of activity and structures. He also gained specialized knowledge of relevant rules and regulations impacting trading documentation globally.

The Hedge Fund Law Report recently spoke to Liberman in connection with his move. In this article, Liberman discusses his new position, his experience at AQR, the upcoming deadlines for the regulatory initial margin requirements and steps affected fund managers should take now to comply.

For insights from another Lowenstein partner, see our three-part series on encryption for fund managers: "Basics of Its Use and Challenges for Implementation" (Feb. 27, 2020); "Legal and Regulatory Framework" (Mar. 5, 2020); and "Policies and Procedures; Role of Legal and Compliance; and Third Parties" (Mar. 12, 2020).

New Position

HFLR: What made you decide to return to a law firm after spending almost 13 years in-house?

Liberman: I initially wanted to do something entrepreneurial and launch my own shop. Based on my time at AQR, I could clearly see how someone with my skill set could help clients in a unique way.

As I was talking to dealers and my network generally, however, Lowenstein kept coming up as a possible proper fit because it has this entrepreneurial spirit and was trying to bring in more insider knowledge. I didn't know anything about Lowenstein beyond the name. Then, I started talking to Benjamin Kozinn, Peter Greene and others within the investment management and fund regulatory and compliance teams, and it became apparent to me with each conversation that the firm would be a good fit for my skill set, which is a strategic addition to the practice that was already established and very successful. So, that's why I made the move.

[For insights from Kozinn, see our two-part series on valuations: "Crises May Require Deviation From Usual Procedures" (Nov. 5, 2020); and "Five Steps to Take When Deviating From Usual Procedure" (Nov. 12, 2020). For commentary from Greene, see our three-part roadmap to big data: "Its Acquisition and Proper Use" (Jan. 11, 2018); "MNPI, Web Scraping and Data Quality" (Jan. 18, 2018); and "Privacy Concerns, Third Parties and Drones" (Jan. 25, 2018).]

HFLR: Tell us about the scope of your practice at Lowenstein and the types of clients you're going to be representing.

Liberman: The scope of my practice is really anything related to the strategic implementation of clients' investment and trading strategies in a very sophisticated way. As to the type of client, it ranges from startup hedge funds to very significant players currently in the marketplace, as well as some asset owners, such as pension plans and sovereign wealth funds. It's a diverse client list.

HFLR: Can you explain what you mean by "strategic implementation?"

Liberman: Sure. Once an entity is formed, the entity has a strategy that it needs to implement. For example, the buying and selling of certain instruments requires legal agreements to be negotiated. One of the things that I had seen in my previous role was that the documents that underlie the buying and selling of instruments such as derivatives and swaps are not just about legal issues. Those agreements are complex and really touch on a variety of functions within, say, a hedge fund, such as the treasury function, operations, legal, compliance and trading. All of those aspects of the agreement underly the relationship that the fund may have with the dealer. Because of my previous experience, I have had an incredibly diverse view of all kinds of different issues related to these agreements, which can impact clients as they try to implement particular strategies with dealers.

[See "Five Steps for Proactively Managing OTC Derivatives Documentation Risk" (Apr. 25, 2014).]

Experience at AQR

HFLR: You were senior counsel at AQR for more than a decade. What exactly did that job entail?

Liberman: I was responsible for trading agreements across all asset classes and all structures that AQR managed for its clients, including hedge funds, mutual funds and managed accounts. AQR had a lot of diverse entities, and whatever strategies those entities ran on behalf of clients, they all required trading agreements to be negotiated with dealers.

HFLR: How do you think your in-house experience is going to benefit you now that you're outside counsel?

Liberman: The biggest difference between in-house counsel and outside counsel is that, sometimes if you're outside counsel, you don't see the entire business process or how things connect to each other. If you don't understand precisely how the various functions have to work together in a particular firm, that may impact the advice that you're giving clients. My experience at AQR allows me to understand better the inner workings of pretty much any investment management shop, so I can ask questions that the client may not even know to ask itself.

Regulatory Initial Margin Requirements

HFLR: Why were the regulatory initial margin requirements imposed several years ago? What prompted the entire regulatory framework to be put in place?

Liberman: After the financial crisis of 2008, global regulators did a lot of different things – Dodd-Frank is one example that everybody knows. There have been others, including the regulatory initial margin requirements. What regulatory initial margin really speaks to is a desire that, for a particular type of activity between specific trading counterparties, there should be a guaranteed pool of margin posted as a matter of regulation. Previously, initial margin was an option to be agreed upon between a dealer and a buy-side participant. Now, if both sides of the trading relationship qualify to be included in the regulatory initial margin framework, then both of them need to post initial margin to accompany over-the-counter (OTC) derivatives transactions.

[See our two-part series on a decade of Dodd-Frank: "Why and How the Regulations Brought Private Funds Into Compliance" (Dec. 3, 2020); and "Enforcement, the Volcker Rule and a Report Card on Its Efficacy in Hindsight" (Dec. 17, 2020).]

HFLR: That framework is taking effect in stages, correct?

Liberman: Yes, it is being phased in, and that process started in 2016. Today, it is primarily an issue for dealers. But, in 2021 and especially 2022, a much larger number of buy-side entities will be in scope of the framework and will need to be in compliance if they want to continue with their OTC trading activity. Several groups, including the International Swaps and Derivatives Association (ISDA), have drafted documents to assist in the transition.

[See our three-part series on "Best Practices for Fund Managers When Entering Into ISDAs": Negotiation Process and Tactics (Jan. 12, 2017); Negotiating Event of Default and Termination Event Provisions (Jan. 19, 2017); and Negotiating Collateral Arrangements (Jan. 26, 2017).]

HFLR: The compliance date for phase five was originally supposed to be September 1, 2020, but because of the pandemic, that was bumped back to 2021, right?

Liberman: Correct, and the compliance deadline for phase six is now September 1, 2022.

HFLR: Which entities are being scoped into the framework as of the 2021 and 2022 deadlines?

Liberman: In 2021, they are the counterparties that each have more than $50 billion in average aggregate notional amount – what's called the

"AANA calculation." In 2022, the AANA threshold is $8 billion. Those amounts are in U.S. dollars for the U.S. and in euros for Europe. Each one of the jurisdictions that has promulgated the framework is trying to capture entities that have significant OTC trading exposure.

HFLR: What kinds of hedge fund managers are going to be impacted by the framework and thus need to be aware of those new upcoming compliance dates?

Liberman: They can be running all different kinds of strategies. As long as there is fairly significant ISDA trading activity, a fund may be included in either phase five or phase six. To figure out whether a fund is scoped into the framework, the manager needs to calculate its uncleared notional OTC derivatives trading activity within a certain period of time to determine its AANA on a per-fund basis. So, if the manager has X number of different vehicles, it will need to calculate the AANA for each vehicle.

Hedge fund managers have to make this calculation for two reasons. One is so they can determine whether their funds – or a subset of funds – are going to be in scope. If they're not over a particular threshold, they need to know how close they are. The other reason is because their dealer counterparties are going to ask for their numbers. You may not be required to provide your exact AANA to a dealer, but you're going to need to tell the dealer if your AANA is above or below a particular threshold.

[For an overview of the framework, see our two-part series "A Fund Manager's Guide to the Initial Margin Rules for Uncleared Swaps": Part One (Sep. 27, 2018); and Part Two (Oct. 4, 2018).]

HFLR: Suppose a fund manager does that calculation and determines that one of its funds is, in fact, going to be scoped into this framework. What steps does the manager need to take now to come into compliance by the applicable date?

Liberman: If a hedge fund manager determines that a particular fund is in scope, then there are a fair number of things that the manager needs to do, both internally and externally in the marketplace.

HFLR: What should a manager do internally?

Liberman: Internally, the manager should create a working group that would include legal, operations, compliance, trading and portfolio managers to talk about what this means for its fund(s). These regulations place additional specific tasks on some members of the working group – some of whom have never had to deal with this stuff. Also, it may impact pricing and the manner in which a particular hedge fund is trading certain instruments.

HFLR: And externally?

Liberman: The manager certainly would need to reach out to its ISDA counterparties to have discussions about the particular fund that will be in scope. It will also need to reach out to multiple custodians to try to figure out who is going to be the custodian for its third-party or tri-party accounts, as well as to inform the dealers with respect to its preference as to the dealers' custodians. Then, the manager will need to negotiate a bunch of legal agreements.

[See "Steps Hedge Fund Managers Should Take Now to Ensure Their Swap Trading Continues Uninterrupted When New Regulation Takes Effect March 1, 2017" (Feb. 9, 2017).]

HFLR: In your experience, what are the most challenging elements of this process? What are the areas managers may struggle with when it comes to compliance with the initial margin rules?

Liberman: It depends on the kinds of systems that particular hedge fund manager already has. There could be several areas within the manager's world that may be impacted. Operationally, there are going to be things that need to be done that would require special attention. For the legal department, it's obviously a big lift. The manager also needs to understand how funds' trading activity may be impacted.

In addition, let's say an asset manager has 10 hedge funds that all trade with dealer X. Two or three of those funds are going to be in scope, but the rest of them may not be. So, the manager is going to have the reality of operating in this dual environment in which some funds are going to be under the regulatory initial margin framework and some will be in a business-as-usual environment. Being able to manage that is not easy.

HFLR: Is there anything that managers can do to make the process easier?

Liberman: Talking to both dealers and custodians now is the best way to make it as easy as possible to comply. Once your working group is in place and you understand what each function needs to do if a particular fund is in scope, you will then be able to identify any internal shortcomings and figure out, for example, which systems may need to be built out or augmented to meet the new requirements.

HFLR: If a fund is not going to be scoped in until September 2022, should the fund's manager be starting the process now?

Liberman: Some people would say that manager is already late. If you haven't done anything yet, you calculate your AANA and it's over $8 billion for a particular fund, you have got your work cut out for you. I have outlined some of the reasons for that already. In addition, custodians are an important part of this particular ecosystem, and the onboarding of custodians takes a long time from a legal standpoint, "know your customer" standpoint and systems standpoint. Ensuring that the dealer, buy-side and custodian all work seamlessly with each other is a lot of hard work.

So, the sooner buy-side entities start on this work, the better it is for everyone. It is vitally important to get help from somebody who knows all the functions and the market generally, and has relevant relationships with dealers and custodians.

HFLR: Is the regulatory initial margin framework relevant to the situation in which Archegos Capital Management recently found itself – *i.e.*, unable to make certain margin calls?

Liberman: Generally speaking, any kind of ISDA- or swaps-related trading would be tangentially related. Nothing is stopping dealers from requesting margin from buy-side participants – irrespective of their AANA calculations. All that regulatory initial margin really does is require parties that have a certain notional value of OTC instrument trading activity between them to post initial margin collateral to underpin that particular trading relationship.

The concept of initial margin for swaps activities is not new. It's not like buy-side entities did not post initial margin before regulators created this framework. It's just that now for some entities and some trading activities, both buy-side entities and dealers will be required to post initial margin.

HFLR: It's essentially insurance.

Liberman: In a way, yes.

[See our two-part series on how the final margin rules will affect hedge funds: "Increased Margin Requirements" (Feb. 18, 2016); and "Increased Trading Costs" (Feb. 25, 2016).]