Hedge Fund Alert
THE WEEKLY UPDATE ON FUND MANAGEMENT INTELLIGENCE

Hedge Fund Advisors Recommend Practical Steps to Avoid Volatility-Induced Margin Calls

While margin calls appear to have been plentiful amid the near 20% stock-market plunge since President **Donald Trump's** global tariff rollout last week, hedge fund managers would do well to ensure that lenders, typically prime brokers, aren't overstepping their rights in demanding that firms put up more capital.

That's the word from hedge fund advisors, who are recommending that clients check their documents closely and to not assume that contracts require them to pony up more security or sell assets instead.

In particular, for those hedge funds that have term financing – longer-term borrowing contracts spanning weeks, months or more – managers should ensure that any margin-call triggering provisions cited by their lenders are specifically spelled out in contracts. Only about half of firms have term financing, while the rest rely on daily margin arrangements with their prime brokers.

Provisions likely to be triggered could include when the CBOE Volatility Index hits a certain level or if the overall stock market drops by a certain percentage. But prime brokers, advisors said, won't always be correct about what's in a particular firm's contract when they make a margin call.

Vigilance by hedge funds is critical given the 15.1% drop in the S&P 500 Index this year through April 8 and the remarkable spike in the CBOE VIX index. The VIX hit 57.3 the same day, reaching a level that was exceeded only in late 2008, when the global financial crisis continued to rage, and in early 2020, when pandemic lockdowns sundered both equity and credit markets.

"Check your term commitments right away," said **Michael Katz,** a former co-general counsel at **Paloma Partners** and the founder of **Quadrangle Consulting,** the hedge fund document-management and contract advisory firm. "You have to know your contract rights."

It's unsurprising that prime brokers are staying on top of their clients given the massive gyrations in markets this year. But the attention also follows the 2021 blowup of **Archegos Capital, Bill Hwang's** former family office. The implosion of Archegos led to billions of dollars of losses for the prime-brokerage units of multiple banks and, ultimately, contributed to the demise of **Credit Suisse.**

Katz held an emergency briefing for about 150 clients in recent days to field questions from managers about steps to take should margin calls come.

Among the questions Katz fielded: Would a drop in a fund's net asset value constitute a lending covenant breach that can cause a prime broker to immediately cancel a term financing contract? Not really, Katz said. Most contracts permit a bank to call a fund in breach of that covenant only on one-, three- or 12-month time periods, and not between those periods.

The same timeframes applies to poor-performance covenants if those are also in a contract.

But if a bank does seek to end a fund's term commitment because of its bad performance or a drop in assets, Katz recommends that managers ask the prime broker to waive the breach.

Katz also recommends that hedge funds get term financing. Those that don't, or those that did have term arrangements and lost them due to performance or other reasons, must abide by the prospect of daily margin calls. "You really should have term financing if you use leverage," Katz said. "It isn't necessarily more expensive."

Alternative-investment-focused law firm **Seward & Kissel** also sent out a client note to investors about minding all of their trading agreements, including swaps and derivatives contracts. The firm likewise advised that managers prepare for investor inquiries about liquidity and that managers issue clear and consistent messages to all investors. Managers might also be required, via their agreements with investors, to issue letters to seeders and others if they hit certain drawdown levels, the law firm warned.

"For less liquid portfolios, be sensitive to the need for equal treatment of investors should certain of them seek to exercise a special early liquidation option," the firm wrote.

Despite a wave of media reports over the past several days about significant numbers of margin calls, sources said they were unaware of margin calls that made a real difference at any hedge fund operators.

To be sure, there could be blowups that haven't been publicly identified or that might yet play out, but many managers appear to have been reasonably well prepared for the huge drop in equity markets following Trump's "Liberation Day" announcement on April 2. That's in part, sources said, because managers had already pulled their gross exposure back and sold assets to take on significant cash cushions in the weeks and days leading up to the tariff unveiling.

Executives at several equity-focused prime brokers said their clients had not run into trouble. One said that he had made just a handful of margin calls, which he said wasn't that unusual, and no manager had failed to meet them.

There had been plenty of warning, well in advance of the recent rout. For instance, under the headline "The Market Isn't Going up 20%+ This Year…," **Neal Berger,** the founder of niche fund-of-funds firm **Eagle's View Capital,** wrote to his investors on March 25 that the global financial market was headed into a very bad stretch.

"Within this commentary, I'd like to discuss some macro thoughts given that this may be the most radical shift in the world order and consequently the markets within our lifetime," Berger wrote. Continuing that the market at the time of his writing was "done materially for the year," he said that reverberations from the magnitude and pace of change implemented by the new U.S. administration could not be overstated and had already caused material changes across the globe.

"Naturally, given the materiality and speed of the changes both within the US and abroad, the chances of a material misstep is substantial," Berger said. "As a result of the geopolitical strife, I am extremely bearish on the US markets (everyone is entitled to an opinion, right)." ■