

## LEVERAGE

# Three Asset-Based Financing Options for Private Funds: Total Return Swaps, Structured Repos and SPV Financing (Part One of Two)

By Fabien Carruzzo & Daniel King, Kramer Levin Naftalis & Frankel LLP

Traditional forms of financing – such as cash prime brokerage, securities lending and plain-vanilla repurchase agreements (repos) – continue to account for a large portion of the financing made available to private funds and asset managers. These types of financing arrangements, however, tend to be available only for more liquid assets, including equity securities and bonds, and are generally either callable on demand or committed for a short period of time, usually not exceeding six months. The leverage available on a fund's underlying assets may also be limited by regulatory constraints and capital considerations, especially those applicable to broker-dealers. As funds seek to use greater leverage; finance esoteric, illiquid assets; and obtain financing on a more committed and longer-term basis, bespoke financing arrangements have become increasingly popular.

Although many of these tailored products are highly specialized and unique to an asset class or financing objective, a large proportion of esoteric financing can be categorized into three buckets:

1. total return swap (TRS) financing;
2. structured repo financing; and
3. special purpose vehicle/entity (SPV) financing.

This article, the first in a two-part series, reviews the main features of TRS financing, and highlights the comparative advantages and disadvantages to private funds of using this structure, taking into consideration the flexibility, the complexity of the legal documentation and the level of asset protection afforded by the structure. The [second article](#) will provide a comparative overview of structured repo financing and SPV financing transactions.

For further discussion of financing available to private funds, see [“Types, Terms and Negotiation Points of Short- and Long-Term Financing Available to Hedge Fund Managers”](#) (Mar. 16, 2017); and [“How Fund Managers Can Mitigate Prime Broker Risk: Preliminary Considerations When Selecting Firms and Brokerage Arrangements \(Part One of Three\)”](#) (Dec. 1, 2016).

### *How to Structure a Total Return Swap*

#### *Entering Into a TRS*

A TRS is a derivative contract between the fund and a swap dealer (a bank) to exchange the return of the underlying (reference) assets that are being financed through the TRS.

At inception of the TRS, the bank providing the financing will purchase the underlying assets either from the fund or from a seller of those assets in the primary or secondary market. The bank will either hold the assets directly or set up a separate special purpose entity (SPE) to hold those assets. An SPE structure may provide tax, operational, accounting and control (i.e., voting) benefits to the parties that will ultimately be advantageous to the fund.

#### *TRS Economics*

In connection with the bank's purchase of the assets, the fund will generally provide some cash collateral in the form of initial margin, which is also referred to as an “independent amount” in swap nomenclature and constitutes a financing “haircut” on the underlying assets. The bank will typically use that initial margin to fund the acquisition of the assets, but the fund may request that the bank segregate the initial margin to provide greater protection to the fund in the event that the bank fails.

The bank will then pass the economics of the reference assets through to the fund in exchange for the fund paying a financing charge on the amount initially used by the bank to purchase the assets, as well as costs incurred by the bank in purchasing, maintaining and administering the assets. Those cash flows are netted and exchanged by the parties, typically on a monthly or quarterly basis.

For more on asset segregation for derivatives, see [“EMIR Offers Three Models of Asset Segregation to Fund Managers That Trade OTC Derivatives”](#) (Apr. 16, 2015); and [“A Practical Guide to the Implications of Derivatives Reforms for Hedge Fund Managers”](#) (Jul. 25, 2013).

When the TRS is terminated, either (1) partially because one of the reference assets pays down, is affected by a credit event or is sold (generally at the request of the fund); or (2) in whole at maturity of the TRS facility, the value of the reference assets will be measured (usually through a sale auction of the reference assets carried out by the bank). The fund will receive from the bank any appreciation in the value of the reference assets during the life of the TRS, or conversely, the fund will pay any depreciation in value to the bank.

The transaction will also be marked to market daily based on the value of the reference assets, and margin will generally be posted by both parties in light of the requirements imposed by the newly enacted uncleared swap margin regulations (unless the bank insists on one-way margining, for instance via a commensurate initial margin offset mechanism). In most cases, the amount of margin requested by the bank may be disputed by the fund, in which case the bank will request quotes from third-party dealers making a market in the reference assets, and the margin will be based on quotations provided by those dealers.

See our two-part series on the new swap-margin rules: "[Hedge Funds Face Increased Margin Requirements](#)" (Feb. 18, 2016); and "[Hedge Funds Face Increased Trading Costs](#)" (Feb. 25, 2016).

See also "[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).

### ***Documenting a TRS***

TRS transactions are documented using the International Swaps and Derivatives Association (ISDA) documentation architecture, including the credit support annex for margining. [1] The parties will negotiate credit-related terms, such as net asset value decline termination events and other termination events in the schedule to the ISDA master agreement.[2] Given the bespoke nature of these transactions, a confirmation is also used to set out the terms governing the TRS financing between the parties.

For more on ISDA documentation, see our three-part series "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). See also "[In a Total Return Swap to Which a Hedge Fund Is a Party, Which Governs: The ISDA Master Confirmation or the](#)

[Credit Support Annex?](#)" (Nov. 8, 2013).

### ***Key Features of a TRS***

TRS financings are highly customizable. They can provide for commitment terms with respect to reference assets, subject to certain asset and portfolio eligibility criteria designed to mitigate certain risks faced by the bank in providing the financing, such as liquidity and concentration risks. The bank will also generally cap the maximum amount of financing provided to a fixed dollar amount and require the fund to pay an unused line or other minimum utilization fees to ensure a minimum return on the bank's financing commitment and internal funding costs.

Portfolio criteria as well as unused line or minimum utilization fees typically do not apply during a so-called ramp-up period at the beginning of the financing to provide the fund with sufficient time to build up the portfolio of eligible assets. Similarly, those requirements do not apply at the end of the financing, during a so-called ramp-down period, to provide the fund with some flexibility to unwind the financing and sell or refinance the reference assets before maturity.

Other features that are common in TRS financing arrangements include:

- make-whole amounts payable by the fund to the bank in the event of an early termination of the TRS facility, and
- obligations to remove certain reference assets from the TRS facility, or for the fund to provide additional initial margin, if certain events occur affecting the value of the reference assets or their compliance with applicable asset and portfolio eligibility criteria.

In addition, for reference assets requiring active management, voting rights and information flow can be customized to ensure the fund maintains some level of control.

### ***Advantages of Using a TRS to Finance an Asset***

#### ***Synthetic Leverage***

A primary benefit of TRS financing that also differentiates it from other financing structures is its synthetic nature. The ability of the bank to directly purchase reference assets, and swap the economics of those assets with the fund, obviates the need for the fund to source the full capital needed to make an initial acquisition of the reference assets. Moreover,

for restricted assets or where confidentiality of ownership is a key consideration for the fund, a synthetic purchase allows the fund to obtain exposure to the reference assets, as well as most of the attributes of ownership, without appearing as the record holder of the reference assets.

See [“ESMA Report Highlights Funds’ Rising Use – and Potential Impact on Market Stability – of Synthetic Leverage From Derivative Instruments”](#) (Sep. 15, 2016).

### ***Cost-Effective and Operationally Efficient Structure***

TRS financing is flexible in terms of its documentation, economics and overall transaction management. TRS transactions rely on ISDA documentation infrastructure and legal opinions. This substantially reduces the amount of contractual documentation to be negotiated and legal opinions to be provided by the parties, as well as related transactional and legal costs.

Once negotiated, TRS facilities can easily be replicated to cover different reference assets with limited amendments to contractual terms and without the need to issue additional or bring down legal opinions. This is a key difference compared to repo structures where additional safe harbor opinions may be requested. Also, the fund can outsource the purchase and administration of the reference assets to the bank and leverage the bank’s back office capabilities in that respect.

### ***Swap Structures Minimize Certain Counterparty Risks***

Payment netting under the ISDA master agreement also enables both parties to structure the cash flows to minimize operational and counterparty risk. In terms of transaction management, the flexibility of voting rights and information flow allows the fund to assume control and management of the reference assets where required – including, for example, in the event of conversion rights, corporate actions and voting on default remedies – unless the bank is unwilling to accommodate those requests out of concerns that the TRS would lose its characterization as a swap.

Finally, swaps benefit from broad safe-harbor protection under the U.S. Bankruptcy Code. The safe harbor affords swaps the benefit of protections upon bankruptcy regardless of the type of underlying reference assets, as long as the TRS maintains certain characteristics. Because the bank will typically hold the underlying reference assets as a hedge and, immediately upon default by the fund, liquidate the assets as part of the early termination of the TRS financing, this broad safe harbor provides a fair amount of downside risk protection to the bank.

### ***Disadvantages of Using a TRS to Finance an Asset***

#### ***Curtailment of Voting Rights***

Although there is scope for flexibility in the documentation, potential issues may arise in connection with voting rights and information flow. Banks are frequently sensitive to surrendering voting control around certain key events, including default remedies and enforcement rights which may impact the value of the reference assets and increase risk for the bank.

In certain circumstances, the bank may also have an ongoing commercial relationship with the obligor of the reference assets that the bank may want to preserve. In addition, providing the fund with broad voting rights may impact the characterization of the TRS as a swap and the availability of the swap safe harbor under the U.S. Bankruptcy Code. Depending upon the nature of the reference assets, management in times of distress may be key to the fund’s overall recovery on the investment, and the bank’s lack of flexibility surrounding these rights may be critical to the viability of the financing.

#### ***Unavailability of Physical Settlement***

TRS transactions also do not typically provide for physical settlement, instead utilizing a cash settlement mechanism where the value of reference assets is measured upon maturity of the TRS financing and where capital appreciation or depreciation payments are made by the parties. This may limit the fund’s ability to get the assets back upon maturity of the TRS financing.

While cash settlement may be desirable when the fund is only seeking exposure to the underlying periodic performance of the reference assets, it may not be suitable for life cycle investments where the TRS financing does not run to the term of the underlying reference assets. Physical settlement can, however, be indirectly achieved by the fund participating, directly or through a third-party designee, in the auction that will be conducted by the bank to effectuate cash settlement.

#### ***Exposure to Bank’s Credit Risk***

Finally, because the bank holds title to the assets, the fund is exposed to the bank’s credit risk for the amount of initial margin posted by the fund to the bank at inception of the TRS, and for any other amount accrued but unpaid by the bank under the TRS, including income generated by the reference

assets and any capital appreciation, to the extent those amounts are not timely supported by variation margin.

This risk can be mitigated by requesting the bank to segregate initial margin. Doing so will likely increase the financing charge paid by the fund, however, because the bank will incur increased funding costs to acquire the reference assets.

[1] A copy of the credit support annex is available for download for a fee from the [ISDA website](#).

[2] A copy of the 1992 and 2002 master agreements are available for download for a fee from the ISDA website.

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In the ongoing pursuit to generate alpha, some hedge fund managers have increased allocations to more illiquid assets. Many of these assets, however, are not suitable for traditional forms of financing, including short-term margin and repurchase agreement (repo) financing, and can only be financed through bespoke financing arrangements.

While the tailored nature of these bespoke financing products can make it difficult to discuss them in general terms, a large proportion of these arrangements typically fall into three main buckets:

1. total return swap (TRS) financing;
2. structured repo financing; and
3. special purpose vehicle/entity (SPV) financing.

This article reviews the main features of structured repo financing and SPV financing, and highlights the comparative advantages and disadvantages to private funds of using these structures, taking into consideration the flexibility of the structures, the complexity of the legal documentation of each structure and the level of asset protection afforded by each structure. The [first article](#) provided an in-depth discussion of TRS financing.

For analysis of another type of lending facility, see our three-part series on understanding subscription credit facilities: "[Their Popularity and Usage Soar Despite Concerns Raised by Certain Members of the Private Funds Industry](#)" (Mar. 1, 2018); "[Principal Advantages and Key Points to Negotiate in the Credit Agreement](#)" (Mar. 8, 2018); and "[Key Concerns Raised by Investors and the SEC](#)" (Mar. 15, 2018).

### **Structured Repo Financing**

#### **Structure**

A repo combines the outright sale of an underlying asset (typically a security or a loan) by a seller to a buyer with a simultaneous agreement by the seller to repurchase the same or an identical underlying asset from the buyer at a future date.

Structured repo financing is somewhat less synthetic than a TRS because a repo involves a sale and purchase of the reference assets, which in turn generally requires the fund to own the reference assets before selling them to the bank under the repo.

#### **The Sale of Reference Assets by the Fund**

At inception of the repo, the bank providing the financing will purchase the underlying assets from the fund. Similar to the TRS structure, however, the assets can also be sourced by the fund from the primary or secondary market and transferred by the current holder directly to the bank with the sale deemed to occur between the fund and the bank under the repo.

The bank will either hold the assets directly or rehypothecate the assets to raise the necessary financing from its funding sources in the market. The underlying assets will generally be purchased by the bank at a haircut to their then-current market value. This haircut provides a cushion of credit support in much the same way as initial margin under a TRS. Similar to initial margin posted under a TRS, the amount of haircut creates exposure for the fund in the event of the bank's failure. This risk may be mitigated by requesting the bank to segregate the purchased assets, for instance at a third-party custodian, to secure the bank's obligations to the fund under the repo.

For more on asset segregation, see [“ESMA Opinion Resolves Inconsistent U.S. and European Asset Segregation Models, Thereby Facilitating Cross-Border Transactions by European Funds”](#) (Sep. 7, 2017).

### ***Structured Repo Economics***

Once the reference assets have been transferred to it, the bank will pass through the economics of the reference assets to the fund, and the fund will pay a financing charge to the bank, based upon the purchase price of those reference assets. The default position in standard repo documentation accounts for the financing charge through the differential between the purchase price and the repurchase price. It is not uncommon, however, particularly in longer-term repos, for the fund to pay the financing charge on a periodic basis – typically monthly or quarterly.

As with TRS, structured repos will be marked to market and margined daily based on the value of the reference assets, and margin will generally be posted by both parties. Typically, the amount of margin requested by the bank may be disputed by the fund, in which case the bank will request quotes from third-party dealers making a market in the reference assets, and the margin will be based on the quotations provided by those dealers.

When the repo is terminated, either partially or in whole, the fund will buy the assets back from the bank at a predetermined repurchase price.

### ***Documenting a Structured Repo***

Structured repos are generally documented on the [Master Repurchase Agreement](#) (MRA) or Global Master Repurchase Agreement (GMRA) infrastructure. It is important to note that the MRA and GMRA, while substantially similar, differ in several material respects as do the [2000](#) and [2011](#) versions of the GMRA. As with ISDA documentation, the master agreements for repos can also be customized through annexes and bespoke confirmations.

### ***Key Features of Structured Repos***

Repo financings are customizable to much the same extent as TRS financings and contain many of the same commitment terms and limitations on eligible reference assets. Similarly, in the event that the financing is unwound early by the fund or is otherwise terminated due to non-satisfaction of commitment terms, the repurchase price will typically reflect a premium or make-whole amount. For reference assets requiring active management, voting rights and information flow can be customized to ensure the fund obtains or maintains some control to the extent the underlying assets have not been rehypothecated by the bank.

### ***Advantages***

#### ***Form Documents Minimize Costs***

Similar to TRS structures, structured repos typically make use of standard industry documentation and legal opinions, substantially reducing documentation burden and, ultimately, transaction costs. Where certain features – such as limitations on rehypothecation, expanded voting provisions or segregation of reference assets – are negotiated by the parties, however, additional legal opinions may be requested by the bank, thereby increasing costs to the fund.

#### ***Customizability***

Structured repos can also accommodate a significant degree of customization, particularly in order to achieve the desired leverage on the reference assets. Credit enhancement features protecting the bank can be negotiated and include tightening the margining provisions (including additional margin for distressed assets), incorporating make-whole amounts for early termination and enabling the bank to unwind the financing in whole or in part based on the occurrence of certain triggering events adversely impacting the value of the underlying assets.

### ***Availability of Physical Settlement***

Another benefit of structured repos is the ability by the fund to force physical settlement and recover the reference assets at maturity of the repo to the extent the bank keeps those assets on its balance sheet or is able to source them back from the market. This increased certainty of recovering title to the reference assets makes structured repos useful for assets that the fund intends to retain and manage once the repo financing matures.

### ***Bankruptcy Law Mitigates Counterparty Risk***

Repos on certain reference assets, including mortgage loans and securities, benefit from U.S. Bankruptcy Code safe harbor protection, provided that the assets and the terms of the repo meet certain qualifying criteria. The safe harbor protection provides the bank with the necessary protection to liquidate the reference assets upon the fund's default without being subject to foreclosure restrictions or the automatic stay in a bankruptcy context.

### ***Widely Accepted by Market***

Finally, as structured repos are somewhat less synthetic than TRS transactions, they are generally viewed as less esoteric financing products. As a result, from a credit analysis perspective, a repo is often viewed in the same manner as a loan and can be an easier transaction for a credit committee to approve.

### ***Disadvantages***

#### ***Risk of Recharacterization As a Loan***

Although the outright sale of the reference assets has its benefits, there are also drawbacks to the transfer of title to the reference assets. Expanded voting rights passed through to the fund and limitations on the ability of the bank to rehypothecate the reference assets may adversely impact the availability of the U.S. Bankruptcy Code safe harbor protection and may increase the risk that the transaction be recharacterized as a loan. Recharacterization may also have capital treatment implications for the bank.

### ***Better Suited for Liquid Assets***

In addition, a repo transaction may become less attractive if the reference assets are subject to transfer formalities or restrictions on the purchase date and the repurchase date, as these tend to create additional burdens for the parties. As a result, structured repos are typically more effective where the reference assets are somewhat liquid and freely transferable.

### ***Protections Under Bankruptcy Laws Are Limited***

Finally, the U.S. Bankruptcy Code safe harbors for "repurchase agreements" and "securities contract" that cover structured repos are also narrower than the safe harbor for a "swap agreement," on which TRS transactions rely. Specifically, the safe harbors limit protection to transactions where the underlying reference assets are "securities" or "mortgage loans," and provide for certain other limitations relating to the maximum tenor of the repo transaction and the universe of protected market participants entitled to rely on the safe harbors.

### ***SPV Financing***

#### ***Structure***

SPV financing is less synthetic than both repos and TRS, as the SPV that is formed will physically hold the assets against which the bank will provide financing, which in turn allows the fund to retain a fair amount of control over the financed assets.

#### ***Establishing the SPV***

In a typical SPV financing transaction, the fund will contribute assets to an SPV created by the fund in exchange for equity in the SPV. The bank will extend financing to the SPV, typically in the form of a loan, although a note could also be issued by the SPV under an indenture. The SPV will then transfer the proceeds from the financing to the fund. The SPV is typically structured with certain features that make it "bankruptcy remote," such as one or more independent directors whose consent is required for the filing by the SPV of a voluntary bankruptcy petition or other bankruptcy-

like actions, as well as limited scope of operations and other separateness covenants. The financed assets are held directly by the SPV, subject to certain restrictions on disposition included in the organizational documentation of the SPV.

The bank will provide financing for the assets at a specific advance rate based on the market value of the financed assets (similar to a haircut in a repo). The financed assets will be pledged by the SPV to the bank to secure the financing, and the fund may also pledge the equity it holds in the SPV to the bank as additional collateral.

SPV financing can be structured in a variety of ways. In terms of control and management, the SPV can be established with the fund holding the equity, therefore retaining the management and control of the entity and the underlying financed assets (subject to negative covenants, the scope of which are often negotiated). Alternatively, it can be established as a third-party-owned vehicle (e.g., equity held by a charitable trust or administrative entity). Fund-owned structures are typically more suitable for assets requiring active management, whereas third-party-owned structures are better suited for assets that require little attention.

### ***SPV Financing Economics***

The SPV will pay the bank interest on the amount lent by the bank and will retain income generated by the reference assets. Those amounts are paid out at the end of the financing or can be periodically swept back to the fund during the life of the deal, subject to certain limitations imposed on the SPV's ability to make distributions to the fund during the life of the transaction to ensure that the bank is sufficiently collateralized by the underlying assets. If the underlying assets monetize, the SPV will generally have the obligation to repay a portion of the financing to the bank before it can make cash distributions to the fund.

At the end of the financing, the SPV will repay the loan either through cash generated by the redemption or sale of the underlying assets or through funding from the fund. The assets will be retained at the SPV or transferred back to the fund. The transaction will also be marked to

market daily based on the value of the financed assets, subject to dispute rights, with the SPV meeting its margin call obligations through funding from the fund.

### ***Documentation of SPV Financing***

From a form perspective, the financing may be structured with the bank lending to the SPV under a credit agreement, or the SPV may be structured as a debt-issuing vehicle with the bank purchasing a note from the SPV. Onshore SPV structures in the U.S. are most often set up with the bank lending to the SPV. Conversely, note-based structures are common offshore and have the added benefit of providing the bank with additional flexibility in terms of back-end financing. Banks often require the fund itself to provide a bad act guarantee pursuant to which the fund will indemnify the bank in the event of fraud, willful misrepresentation, misappropriation of collateral and other bad acts.

Back-end financing can take the form of syndicated or participated loans or, more commonly, through the bank selling the debt instrument issued by the SPV under a repo or TRS or, where the debt instrument is freely tradeable and/or cleared through The Depository Trust & Clearing Corporation (DTCC), by selling the instrument to its own clients.

### ***Key Features of SPV Financings***

As with TRS and repo transactions, SPV financings can be customized to include commitment terms, eligibility criteria for the asset portfolio, utilization requirements and make-whole payments where the financing is unwound early.

### ***Advantages***

#### ***Structure Minimizes Counterparty Risk to the Fund***

The predominant advantage of the SPV structure is that the financing is entirely segregated from the fund and the financing is therefore purely asset-based, subject to minimal limitations. Moreover, due to the assets remaining in a bankruptcy-remote entity controlled by the fund, the fund takes reduced counterparty and insolvency risk in the event the bank defaults or fails.



### **Customizable**

Another key advantage of the SPV structure is its typical existence as a bespoke, deal-specific structure. The establishment of a structure not bound by market-standard terms enables parties to customize the structure based upon perceived risks and the nature of the assets in question.

One key aspect of this flexibility is the ability to establish the SPV as a fund-managed entity, enabling the fund to retain voting control and manage the assets when required. These features make the SPV structure particularly well-suited for illiquid and esoteric assets.

### **Disadvantages**

#### ***Bespoke Nature of SPV Leads to Increased Costs***

One trade-off for the flexibility that SPV structures provide is the complexity and cost associated with establishing transaction-specific structures. In addition to entity formation documentation and credit agreements or note documentation, SPV structures often require true sale, bankruptcy remoteness and non-consolidation opinions. Moreover, for offshore SPVs, it is necessary to obtain local legal opinions. This complex documentation increases both the time and costs required to establish the structure.

#### ***Bankruptcy Remoteness of Structure Is Limited***

Finally, despite the general flexibility associated with SPV structures, there are some limitations to the housing of assets in a bankruptcy remote, separate entity. One common issue with SPVs is their inability to hold certain restricted assets, specifically those assets that require certain capital or liquidity requirements from any holder.

Another key limitation arises where the SPV must be maintained as a standalone, non-consolidated entity. This analysis is particularly stressed where the fund provides any form of credit support or guarantee to the SPV (outside of a standard bad-acts guarantee), including with respect to margin calls, which, in turn, may in each case negatively impact the non-consolidation analysis.

As a result, the structure may not be particularly suitable for assets that are subject to volatile price movements requiring frequent margin true-ups.

### **Conclusion**

Derivatives and structured products are key tools available to funds seeking alternative sources of financing. The structures and issues described in this series present a high-level discussion of the utility of these products, but the key point to note is that they all lend themselves to high degrees of customization. In order to achieve the most efficient financing structure possible and as part of the initial structuring discussion, funds should consider these products in tandem with the assets to be financed as well as the risks and benefits of each structure.

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