UNDERSTANDING TOTAL RETURN SWAPS

NICHOLAS TSAFOS, PARTNER AT EISNERAMPER, TALKS TO *HFMWEEK* ABOUT THE EMERGENCE OF TOTAL RETURN SWAPS AND OTHER ISSUES AFFECTING THE INDUSTRY

Nicholas Tsafos is an audit partner with more than 26 years of diversified accounting and auditing experience. His practice is primarily devoted to hedge funds, private equity funds, broker-dealers in securities, registered investment companies and investment advisors. He also works with public companies and public offerings as well as complex private companies.

HFMWeek (HFM): What are the key industry trends you are currently seeing?

Nicholas Tsafos (NT): Hedge funds have used total return swaps to obtain leverage for years. However, prime brokers are asking some of my clients to use total return swaps as opposed to buying actual equity securities. Prime brokers are encouraging hedge funds to do this because it is more beneficial from the broker's perspective, in terms of meeting their capital requirements under Dodd Frank and Basel III regulation.

The idea underpinning this advice is that a total return swap is going to give hedge funds the same features, from an investment perspective, as buying the securities directly. For example, if they were to buy Apple shares or they were to buy a total return swap that mimics the performance of Apple shares, in theory the hedge fund would see the same results. However, in reality it would be far more costly for the hedge fund to buy a total return swap rather than the actual Apple shares. A total return swap does not give the same tax consequences in some situations, it is not as liquid as directly purchasing shares and the amount of disclosure in the financial statements is far more significant. The increase in financial statement disclosures is due to the inherent valuation issues with a total return swap and counter party risks. In addition the investment adviser could be subject to reporting requirements under the Dodd-Frank Act.

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Some funds are responding to and accepting this advice from prime brokers. Others are more hesitant. But if a prime broker says to a fund that they will no longer service them. Due to the cost of capital based on the structure of these transactions they may be forced into doing it. It is a trend that is driven by regulation that prime brokers and banks have to follow. Therefore they are compelled to put pressure on the hedge funds they service.

For the typical US investor in a hedge fund, it is difficult to see any direct advantages deriving from opting for total return swaps over buying actual equity securities unless they want leverage. However, an advantage from this format may be seen if you are a non-US investor and the total return swap meets the tax requirements of a foreign jurisdiction. For example, I have a client fund that uses total return swaps for its Canadian investors. As a result their investors get very favourable tax treatment.

HFM: What is EisnerAmper advising clients in this respect?

NT: In terms of the financial statements perspective, at EisnerAmper we are advising our clients to think carefully and discuss with us before they begin using total return swaps. There are a number of questions they must consider. For example, is the fund looking at a standard return swap? What agreement is in place to ensure the fund has the proper disclosures? What nuances are in the agreement that might create additional risks? On our clients' behalf we must plan for the consequences of entering into a total return swap.

From a regulatory perspective we are advising clients to speak to counsel and develop policies and procedures to meet the regulators requirements.

HFM: How do you think this trend will affect the industry in the long term?

NT: In the long term hedge funds will begin to move away from certain large prime brokers, such as Goldman Sachs or Morgan Stanley. As a result we will see funds moving to smaller prime brokers. These prime brokers are more inclined to buy securities directly, rather than through total return swaps.

If hedge funds continue to use total return swaps, having a clearing platform that creates more transparency and gives investors the option to see what is happening in the market in real time. Some prime brokers are already using this kind of platform. This is poised to become a much larger trend. It has the potential to change where instruments are being traded. ■