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The mystery trader who roiled Wall Street

Former Blackstone executive used complex credit derivatives to become a feared hedge fund manager but left behind a trail of recriminations

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For [hedge funds](#) that make their money gambling on whether companies will go bust, it was an opportunity too tempting to ignore. In 2015, brokers working on behalf of a mystery client in London, offered these funds the chance to make a trade they thought was impossible to lose: betting that a teetering Norwegian paper company would imminently default on its debt. The hedge funds snapped up hundreds of millions of dollars of the derivatives contracts that would pay out in the event of a default.

By the time the buyers realised who was on the other side of the trade it was too late: they had been trapped. One hedge fund manager recalls receiving a call from a sympathetic contact pleading with him to exit a trade. “It was an off-the-record warning in order to protect me,” he says. “He basically told me who was on the other side. It was him.”

The “him” was Akshay Shah, at the time a managing director at the Blackstone Group’s GSO hedge fund unit, who for nearly a decade spearheaded a series of [unconventional trades](#) that made him the most feared operator in European credit markets, terrorising a string of rival hedge funds and costing them millions in trading losses.

The aftermath of the complex trades Mr Shah helped pioneer have shaken the \$10tn market for [credit default swaps](#) to its core, leaving a trail of at least three lawsuits and recriminations between the [world's largest private equity group](#) and some of the most powerful names in finance.

The trades have also highlighted a shift in the balance of power on Wall Street since the financial crisis, where the so-called non-bank lenders such as GSO have leveraged the infrastructure and reach of parent [private equity](#) groups to become more feared than the once dominant proprietary trading desks of Goldman Sachs and the other leading investment banks.

“This is symbolic of a shift in power away from banks like Goldman to non-bank institutions like Blackstone,” says a former Goldman Sachs partner.

The credit default swap, a financial instrument intimately associated with the losses incurred by the banks during the US subprime mortgage crisis, is most commonly used to either hedge against a company falling into trouble and possibly not paying off its debts, or as a tool of outright speculation over whether a default will occur.

How it worked

1. GSO buys a CDS contract on a struggling company from another hedge fund. The CDS is like an insurance contract: it pays out if the company defaults.
2. GSO then approaches the company and offers it very attractive financing (a low interest loan for example) with an unusual condition: it has to default in a way that will trigger a payout on the CDS contract.
3. The company carries out this proposal, for example by paying interest on a bond a few days late, causing little concern to bondholders but “triggering” the CDS contracts
4. The hedge fund then has to pay a lump sum to GSO given that the company has defaulted

The GSO unit at Blackstone where Mr Shah worked became the biggest predator in the global CDS market by going beyond merely trying to predict when companies would

fail. Instead it used Blackstone's substantial influence to directly intervene in struggling businesses, changing their fates in ways that maximised profits on GSO's trades.

The strategy allowed GSO, which has \$140bn of assets under management, to radically alter the odds in its favour by inventing a trade that had never been seen before: the manufactured default.

It is the debt equivalent of a controlled explosion: offering a company favourable financing, such as low interest loans, to convince it to intentionally default in a way that will trigger payouts on CDS contracts, but without bringing down the whole company. By doing this GSO pushed its trading edge on rivals to the limits of what many saw as legal.

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"I don't believe it's classified as insider trading, but it's pretty damn close," says one retired trader who came up against GSO and Mr Shah. "It's quite frankly shocking that they were able to get away with doing that for so long and that no one was prepared to stand up to it."

"I compare it to sports gambling," says Aitan Goelman, former head of the US Commodity Futures Trading Commission's enforcement division, about manufactured defaults. "If gamblers went out and paid players to throw games, everyone would intuitively know that was fraudulent. Highly sophisticated and not particularly upstanding actors are looking for any edge they can get: if they see areas of the law that are vague or poorly defined, they see this as an opportunity."

While rivals and observers are shocked at GSO's tactics, it has never been accused of breaking any regulations. GSO argues that the assistance it provides to distressed businesses in exchange for them triggering payouts on CDS contracts are welcomed by those companies as it helps them to survive, and only damages other hedge funds caught out speculating on their failure.

Hovnanian was at the centre of a controversial trade which was resolved when GSO and a rival fund reached a settlement © Bloomberg

“Our financing solutions were determined in competitive processes and provided the most favourable terms and crucial financial support to businesses with thousands of employees,” Blackstone said in a statement. “They were also wholly compliant with the market’s well-established rules and consistent with the expectations of its sophisticated market participants.”

So effective and surprising was GSO’s strategy that it ensnared some of the most revered names in trading, [including BlueCrest](#), founded by billionaire Michael Platt, and Goldman Sachs. BlueCrest declined to comment.

The controversy this year filtered up to the highest echelons of Wall Street, as a controversial trade GSO orchestrated around [struggling US homebuilder Hovnanian](#) was discussed in a meeting between Goldman Sachs chief Lloyd Blankfein and [Jon Gray, president and heir apparent](#) of Blackstone.

Goldman had earlier taken the unusual step of complaining in public about manufactured defaults, with the senior trader in charge of the trade telling the FT this year that “the Hovnanian situation could embolden investors to pursue manufactured credit events with other corporate issuers, which would undermine the true intention and spirit of the CDS market”.

The trade involving the Spanish gaming company Codere in 2013 attracted the attention of the comedian Jon Stewart, who dissected it in a segment on 'The Daily Show'

Having for years sat at the top of the trading food chain, observers said it would have been unthinkable in the past for a Goldman partner to complain in public about being bested in a trade.

“It is ironic any Goldman guy would be asking in public to be protected [from GSO] like this,” says the retired Goldman partner. “Goldman always had a phrase internally, the ‘big boy letter’, the letter clients sign to show they knew what the risks were of trading with Goldman.”

Rival hedge funds, investment bankers and consultants describe GSO’s success as being driven by both its traders’ attention to detail, as well as the unrivalled ability of Blackstone’s reputation and infrastructure to support its trades.

When Mr Shah joined GSO in 2008 from Lehman Brothers, few could fault his timing — the investment bank collapsed six months later. He had built a reputation as a sharp-minded analyst on Lehman’s fixed-income trading desk. And having arrived at GSO, which that year had been purchased by Blackstone, Mr Shah began working on finding ways to make money for its investment funds in the European debt market.

People familiar with his trading style say he pores over hundreds of pages of bond or loan documents, trying to find tiny details that others in the market might miss. Once he identifies chinks in the wording of particular clauses he plots a way to construct trades using derivatives on whether a company will default on its debts, which would lure rivals to take the other side.

Lloyd Blankfein of Goldman Sachs and Jon Gray of Blackstone discussed the unusual trades after Goldman Sachs complained publicly about the complex financial arrangements surrounding Hovnanian © FT montage; Bloomberg

“He’s a sniper,” says one hedge fund manager. “He would call you up and say ‘Hey, what are you doing, what are you thinking on this?’ and he knows all the information already, he’s just fishing for what you know and what you think so he can work around it.”

GSO would then directly approach company managements with proposals that guaranteed it would profit on the CDS. Ahead of the approach, Mr Shah would often hire external consultants for role-playing purposes, shadowboxing with them in a specific country’s law or corporate culture until the pitch was finely tuned. “You need to have a management team willing to screw people,” says one distressed debt investor.

In the case of [Codere](#), a cash-strapped Spanish gaming company, Mr Shah first used the manufactured default. GSO offered the struggling company a liquidity lifeline in 2013 with an unusual condition: Codere had to pay interest on its publicly traded bonds just a few days late, causing little concern to its bondholders but triggering CDS payouts.

Despite the unwanted publicity the Codere trade attracted for Blackstone — it was dissected by comedian Jon Stewart on primetime US television in 2013 — Mr Shah grew to become one of GSO’s most senior managing directors, and sat on its European investment committee. “Akshay wasn’t some cowboy,” says a former trader. “He was reporting into the most senior people at GSO.”

Rivals argue that GSO was uniquely placed to not only gain access to greater information than many rivals, but could also use Blackstone's reputation to open doors to corporate management teams.

“To do these sorts of trades you need the size and the money. Only GSO had the money, the influence to pull this off,” says one person active in the European debt markets. “Blackstone is a great brand to have behind you.”

A complex deal involving the paper manufacturer Norske Skog led to a court case in New York as a rival hedge fund tried to prevent GSO's plans from going ahead

Mr Shah used all the levers at Blackstone's disposal to push through one of GSO's most controversial trades in 2015-16. The tussle over the CDS of heavily indebted Norwegian paper company Norske Skog resulted in a bitterly fought court battle in New York, as rival hedge fund BlueCrest tried in vain to block GSO's gambit.

The trade was essentially the opposite of Codere: charging other hedge funds large premiums to bet on a company's rapid demise before doing everything possible to keep it alive for long enough to avoid having to pay anything out.

For Norske Skog, GSO pooled its firepower with rival hedge fund Cyrus to buy a substantial equity stake and then lobby for changes to its board, before getting management to formally adopt a proposal tailored to maximise the profits on the funds' CDS positions.

“We believe the company will once again run into trouble after GSO and Cyrus have cleared their CDS positions and no longer have the incentive to support the company with as much determination and creativity,” Rahul Gandhi, an analyst at research firm CreditSights, said in March 2016.

His prediction proved prescient. The CDS contracts were settled in June 2016 and 18 months later, in December 2017, Norske Skog filed for bankruptcy.

By that point, Mr Shah's career at GSO had also met a seemingly [untimely end](#). In the spring of 2017 the scourge of London's traders suddenly parted ways with the firm, which liquidated a more than \$3bn distressed debt fund he managed.

One former employee of the division says the headlines such controversial CDS trades generate are no longer compensated for by the gains, as Blackstone's in-house credit unit shifts its focus to the less acrimonious practice of making direct loans to private companies. "It's not a place that loves this publicity and in 2018 it has to look like a friendly provider of capital," he says.

This more conciliatory approach was clearly seen in the surprising resolution to the Hovnanian trade last month.

The homebuilder announced at the last minute that it was not going through with the manufactured default, as GSO and rival hedge fund Solus [reached a settlement](#) over the trade. The Blackstone unit has also in recent months struck a deal with Goldman where GSO bought back some of the contracts the bank lost money on. Goldman Sachs declined to comment.

The Hovnanian trade was devised and executed after Mr Shah left GSO, but the senior GSO executive who made use of his former colleague's manufactured default template has now also left the firm, joining a rival distressed debt fund at the start of the year.

Mr Shah says he left to set up his own hedge fund in London to focus on smaller distressed debt opportunities. His new fund, Kyma Capital, is in the early stages of fundraising.

"The reason for leaving was simple: the European stressed and distressed opportunity set is a middle-market opportunity set," he says. "These sized companies don't lend themselves to megafunds." Kyma Capital said it would "welcome any regulatory changes that would improve the stability, durability and liquidity of the CDS markets".

But experts believe the damage to the market is already done, as the run of trades from GSO have exposed how easy it is for big players to alter outcomes in the very markets they are betting on.

"This kind of 'gaming' behaviour undermines the viability of the CDS market," says Henry Hu, a professor and expert in derivatives at the University of Texas Law School. "The CDS market has shrunk terribly since the crisis. If this kind of behaviour continues, the market will shrink even further."

“We have heard with concern reports about recent ‘manufactured’ credit events,” says a spokesperson for the Financial Conduct Authority. “Such behaviour could also amount to market manipulation.”

Mr Goelman, formerly of the CFTC, says he did look at manufactured defaults before stepping down last year, but could not say who was involved. “For a number of different reasons, we decided to not act on the case.”

One of the hedge fund managers who came up against Mr Shah says he expects GSO to now shy away from such trades, given the potential regulatory scrutiny. “There are still going to be other guys out there who will be more aggressive and willing to put on these trades,” he says, adding that it would be hard for others to replicate the intricacy of the trades pioneered by GSO. “Being outside the behemoth of Blackstone, I don’t see how that’s going to work.”

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