FOCUS ON

DODD-FRANK ACT

With the July 2011 deadline for registration with the SEC looming, *HFMWeek* talks to representatives from Dechert, the IMS Group, McGladrey & Pullen and Pillsbury Law about who the Dodd-Frank Act will affect in the short-term, and the potentially long-lasting effects it could have on the US alternative funds space

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Q HFMWEEK (HFM): WHAT WILL BE THE DODD-FRANK ACT'S MOST SIGNIFICANT EFFECT ON:
i) HEDGE FUND MANAGERS (SMALLER HEDGE FUND MANAGERS IN PARTICULAR)?

A KEVIN SCALAN (KS): The elimination of the current private fund adviser exemption will make it more difficult for smaller managers. Instead of being able to defer registration as an investment adviser until their operations achieve a certain scale, they will generally need to either register as an investment adviser with the SEC or with the manager's home state. Such registration would impose, among other things, an obligation to establish various compliance policies and procedures and monitor on an ongoing basis compliance with various advertising rules and other rules set forth under the Investment Advisers Act of 1940.

A JONATHAN WILSON (JW): The legislation in the US looks to increase the amount of information available to the SEC, therefore the new regulations expose managers to new regulatory risks that they had not previously considered. Although many non-US managers may be able to take advantage of some of the exemptions, others will not and will have to make changes quickly. The issue is that there is still a lot of uncertainty surrounding implementation; for example, systemic risk reporting proposals, which require highly detailed fund-level reporting, came out very recently.

A JEFFREY YAGER (JY): Most large hedge funds are already registered, but as far as small funds are concerned, the cost of compliance and the ongoing costs of managing the funds could be quite significant. Examinations will be a distraction and a resource drain for small companies who simply do not have the existing staff to dedicate to these processes.

A JAY GOULD (JG): For large fund managers, the derivatives reporting, disclosure and definitions of who is a major swap participant will have a significant impact. The recently proposed Form PF, which divides funds into two categories – under $1bn and over $1bn – means that managers have to report a plethora of new things, such as information on holdings, positions, and leverage. The industry is trying to ensure that this information is not subject to Freedom of Information Act disclosure for a significant amount of time, and the regulators seem to be amenable to this. For small fund managers, the new asset test of $100m under management in order to be eligible to register with the SEC will be significant, as will the uncertainty around which funds will be regulated by their state, and which by the SEC. The SEC has also proposed new reporting requirements for fund managers and revised the Form ADV Part 2, which requires significant new disclosures that will raise the cost of compliance for all investment advisers. There are also new rules for non-US advisers, which will need to be aware of how much money from US sources they have under management and how many 'US persons' they provide investment advice to.

Q ii) SERVICE PROVIDERS?

A KS: The Act amends the standard applicable to aiding and abetting claims brought by the SEC. Previously, a person had to 'knowingly' provide assistance to the person who committed a fraud. The standard is now met if you provide such assistance 'knowingly or recklessly.' This change reflects the SEC's increased scrutiny in this area and will likely cause service providers to hedge funds to increase their due diligence and oversight of hedge fund managers.

A JW: The Act presents a great opportunity for service providers across the board due to the high volume of documentation and reporting that it will require. Custodians, auditors and compliance consultants will likely benefit from increased business.

A JY: Those auditors of funds managed by SEC Registered Investment Advisors (RIA) will need to be registered with the Public Company Accounting Oversight Board (PCAOB) and must also be subject to regular inspection. Furthermore, administrators and

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other service providers might consider funds registered under Dodd-Frank to be higher risk, and therefore may spend additional time on such funds; a factor which will translate into higher fees. The smaller funds will bear a disproportionate amount of those costs in relation to larger funds, as they have much smaller capital bases.

A JG: Administrators are not yet regulated in the US, but administrators, accountants and custodians will have to be disclosed by fund managers on their regulatory reports and so those service providers can expect to hear from the regulators on a more frequent basis. We expect to see consolidation among administrators in much the same way mutual fund administrators consolidated 20 years ago.

Q iii) PRIME BROKERS?

A KS: To the extent that a prime broker is a swap dealer operating in the over the counter (OTC) derivatives market, the Act will remove a substantial degree of leverage (due to new capital and margin requirements), and reduce returns from this market. In addition, these firms will be subject to new reporting and record-keeping obligations.

A JW: The Act, as we understand it, creates new short-sale reporting obligations which will fall within the realm of prime brokers, who stand to gain from this increased business.

A JY: These will be impacted based upon the type of information that has to be provided to the SEC, the detail of which has not yet been established. I suspect that the prime brokers and administrators will have the additional responsibility of assisting funds in assembling the necessary information, in conjunction with the fund.

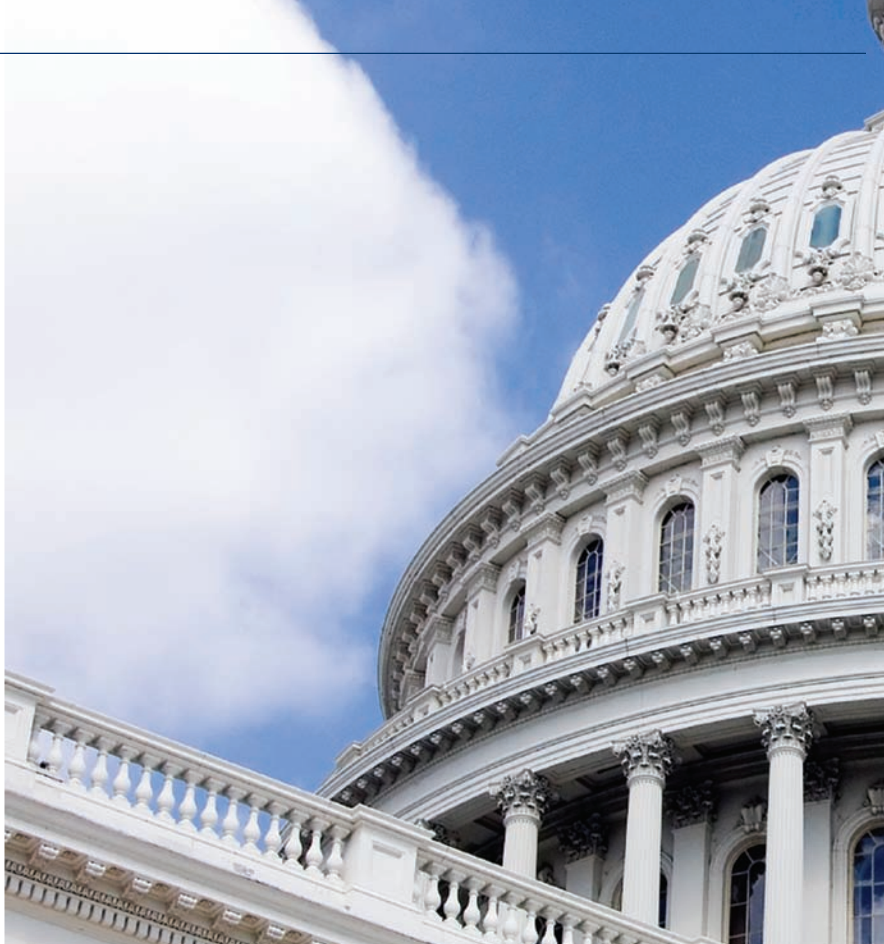
A JG: There is a lot of uncertainty regarding the reporting of short sales and leverage requirements among other things, and these details could potentially impact prime brokers' revenue.

Q HFM: IN THE SHORT TERM, WHO IS THE IMPLEMENTATION OF THE DODD-FRANK ACT LIKELY TO IMPACT THE MOST AND WHY?

A KS: Bank-sponsored hedge funds could be the most impacted. The Volcker rule severely restricts the capital these hedge funds can accept from the bank and the fund cannot share a name with the bank, thus impeding any marketing benefit associated with the bank's name. These disadvantages, when coupled with the potential for regulatory oversight and/or limitations on the compensation they can receive from the bank, may lead to an exodus of a substantial number of managers from bank-sponsored hedge funds.

A JW: We predict that the majority of UK-based hedge fund managers operating within the US space will have to register with the SEC, but will be able to take advantage of 'exempt reporting advisor' status, and be subject to a subset of rules and disclosures yet to be defined. One of the ironies surrounding the Act, however, is that managers of private funds who have one segregated account which happens to be a US client will have to register fully with the SEC as things currently stand. This means that they have an effective deadline of 4 June 2011, and so will have to react quickly.

A JY: The unregistered small hedge fund managers who have been operating without any form of oversight for several years will bear the brunt of the change, bearing additional costs and hiring additional people, such as chief compliance officers. The question is going to be whether they go out and hire a dedicated person or attempt to save costs by calling upon someone within the organisation to wear a couple of different hats. The public perception will also be impacted by this Act, as they are likely to believe that if a manager is registered with the SEC they must have strong controls in place, but this is not necessarily true. Registration involves merely filing certain forms with the SEC, and potentially being subject to reporting and an examination at an unknown future date.



A JG: In the short term, major investment banks will need to spin out or significantly restructure their proprietary trading desks in order to comply with the Volcker Rule. We expect to see the exodus of traders from major investment banks continue as these traders leave to set up their own fund organisations. The derivatives trading process will also be significantly impacted, and the effects will be felt in clearing houses, exchanges and among buyers and sellers of derivatives, as they attempt to account for the new CFTC and SEC rules.

Q HFM: WHAT PROVISIONS WILL MANAGERS HAVE TO TAKE IN THE RUN-UP TO THE ACT'S IMPLEMENTATION?

A KS: Managers will need to accept registration of some sort with the SEC under the Advisers Act and fulfill the various filing and record-keeping obligations and compliance requirements associated with such registration. Although it is not yet clear whether this will happen, the CFTC recently proposed removing two key provisions hedge funds often rely upon for their exemptions from registration as a commodity pool operator and commodity trading advisor (for example CFTC Rules 4.13 and 4.14). If these exemptions were removed, hedge fund managers trading in commodities, futures or commodity-based swaps would likely need to register with the CFTC and comply with the applicable CFTC rules. This will place additional regulatory burdens on managers and will likely force them to comply with rules imposed by each regulator that may be inconsistent with one another.

A JW: The first thing they will have to do is determine whether or not they qualify for an exemption. The main foreign private advisor exemption is a test based broadly on whether or not you have a place of business in the US, fewer than 15 US clients or investors in private funds, less than $25m in AuM attributable to US persons, and whether or not you market yourself for business in the US. To qualify for the exempt report advisor status you must deal only with private funds with less than $150m AuM managed from the US. Managed accounts currently fall outside this exemption. Once they have identified their status they must then register – this will involve a process of completing the ADV I for either category, and the ADV II for those who must be fully registered. The processing period for full registration is 45 days, so effectively these applications must be submitted by early June. A lot of paperwork will be involved in full registration, including: code of ethics, procedures, referencing US statue, proxy voting, and pay-to-play rules, among others. We hope that the exemption statuses will be a little lighter.

A JY: The biggest factor will be increasing internal controls, and looking at the things that the SEC would focus on if they were conducting an examination. Irrespective of the Dodd Frank Act, funds should be thinking about implementing 'best in class' practices which will position them better to attract institutional clients. Fund managers must begin to put additional or enhanced controls in place today, rather than waiting until 20 July 2011 to register. Staying ahead of the curve will avoid a rush later in the year.

A JG: Fund managers must be aware of all the new rules and forms for which they will have compliance and reporting responsibility. Chief among these are the new disclosure rules and the new Form ADV Part II and Form PF requirements.

Q HFM: TO WHAT EXTENT ARE YOU CONCERNED THAT THE HEDGE FUND INDUSTRY IS UNPREPARED FOR THE ACT'S IMPLEMENTATION?

A KS: As a result of the Act, the financial crisis and recent scandals, the various industry regulators have become much more aggressive in their oversight of the industry. The political rhetoric has not helped either, often portraying hedge funds in an unfair light. As a result, managers need to focus on building out and upgrading their compliance infrastructure as much as possible.

A JW: Any lack of preparation is a product of the lack of clarity around the rules, which are still in consultation, and the compressed timeframe. We saw a similar situation occur with European regulation too, such as when the remuneration code rules for hedge fund managers were introduced at the last minute. Here at the IMS group, we have had a lot of interest from clients in our seminars and literature – a result of the lack of information and a fear of the unknown. This is too important for hedge fund managers to get wrong. They need to begin the registration process, and find someone to help them do so, as soon as possible.

A JY: My sense is that many managers are leaving registration for the last possible moment or are hoping that there will be some type of reprieve or change in the law. This will lead to a rush later in the year.

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A JG: There has been a fair amount of denial surrounding the Act's implementation, but the reality is slowly starting to sink in. Law firms such as Pillsbury Winthrop Shaw Pittman are sending out client alerts with details on when managers need to comply and what steps they will need to take. Bigger funds are fortunate enough to already have the necessary infrastructure in place to get up to speed on this quickly: compliance staff, attorneys, accounting personnel and good service providers. Smaller fund managers, however, are still waiting for further information regarding Federal and State regulation, for example, before taking action, and a lot of managers are simply not prepared to make the necessary changes in time.

Q HFM: WHAT DO YOU EXPECT THE ACT'S LASTING EFFECT ON THE HEDGE FUND INDUSTRY WILL BE?

A KS: The hedge fund industry has been experiencing a great deal of consolidation over the past few years. In many ways, the Act will accelerate that consolidation due to the increased regulatory burdens that will be placed on start-up managers coupled with some aspects of the Act (such as those in the OTC derivatives market which require higher capital and margin requirements) which will likely extract available investment capital from the economy.

A JW: The proposals have not yet been finalised; there are still issues to be resolved around compensation, short-selling, and the collection and maintenance of data on systemic risk for example, and so the long-term impact of the Act is still unknown. If you compare the Dodd-Frank Act to the European Commission's AIFM Directive, there are similarities in terms of: requiring more registration of funds; more registration of managers; enhanced disclosure; and the regulators taking more direct responsibility for the protection of investors within their jurisdiction. So the way that Dodd-Frank plays out now may give us some insight into how things will look in Europe in two years' time.

A JY: Registration, oversight and the costs of these two will impact greatly on the decision of whether or not people start their own firm. This is a shame, as in the past many small, start-up funds had highly talented managers who grew them into some of the most well-known and successful funds in the world. Many people will prefer to simply join an existing firm so that they do not have to directly deal with some of the aforementioned issues, and this will degrade investor choice. However, in the aftermath of some of the insider-trading cases involving hedge funds, the industry is willing to take whatever steps it can to improve investor confidence. I also predict that the SEC will eventually raise the thresholds for registration when they realise that they cannot possibility monitor all the funds that will fall under their purview given their current budgetary constraints.

A JG: The lasting effect of the Act depends upon a number of factors, one of which is the political climate. The Dodd-Frank Act was passed on 19 July 2010 under a House and Senate controlled by the Democrats, but later that year Congress twice refused to fund the SEC sufficiently for it to implement all its mandates under Dodd-Frank. Hearings are now being held to discuss whether the CFTC is moving too quickly on derivatives regulation and disclosure.

The lasting effect will clearly be a function of the political processes going forward, but what is clear is that the heightened periodic reporting and a constant flow of information to the regulators will involve substantial additional costs. This could lead to a greater divide among managers, a bifurcated alternative funds space in which, on the one hand, the larger fund managers are able to fully comply with all of the regulatory and legal requirements without a significant disruption to their businesses; and on the other, smaller fund managers that struggle to get into the business, have difficulty scaling their businesses, and find regulatory compliance consuming a disproportionate share of their resources and infrastructure. If this Congress is successful in stalling or stopping the implementation of Dodd-Frank through the budget process, there may be significant and negative repercussions in the years ahead. ■