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DODD-FRANK'S IMPACT ON ALTERNATIVE INVESTMENTS: A BRIEF REVIEW

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Executive Summary

- Signed into law on July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank" or the "Act") attempts to address the perceived causes of the 2007–08 financial market crash in a single, gigantic—2,300 pages—piece of legislation. Unlike the regulatory framework established in the 1930s, which emphasized disclosure as a critical factor in state and federal oversight, Dodd-Frank empowers federal regulators to impose additional burdens on firms not because of their individual riskiness, but because of their contribution to overall risk in the U.S. financial system.

- For purposes of this paper, we highlight some key Dodd-Frank provisions and discuss issues that relate primarily to alternative investments. There are, admittedly, many other aspects of Dodd-Frank that will have an impact on the economy and investment advisers in the years to come. With more than 60 mandated federal studies due over the next several years, and at least 200 new regulations that have yet to be written, the final regulatory landscape is very uncertain and regulators' implementation decisions will have a significant impact on how Dodd-Frank plays out in the years ahead.

- A key element of Dodd-Frank's focus on systemic risk is the establishment of a Financial Stability Oversight Council (FSOC) as a means of coordinating federal oversight of perceived systemic risk. One significant role of the FSOC is to determine which companies should be designated as "systemically important." Companies that are systemically important are put under Federal Reserve supervision and are subject to additional risk-based capital, liquidity, and leverage standards; concentration limits; and potentially enhanced reporting requirements.

- Dodd-Frank also establishes an "orderly liquidation" process—its attempt to eliminate the "too big to fail" doctrine. As written, the Act permits the Secretary of the Treasury to appoint the FDIC as receiver of a financial company even if that company has not yet defaulted on its obligations or filed for bankruptcy.

- With some exceptions, hedge fund and private equity managers will be required to register as investment advisers with the Securities and Exchange Commission (SEC). Notable among the exceptions to adviser registration requirements are "venture capital funds," a major victory after intensive lobbying by the industry. However, Dodd-Frank does not define what constitutes a "venture capital firm"; instead, the Act requires the SEC to create the definition by regulation. Non-U.S.-based managers will also be required to register unless they have a small amount of U.S. investor dollars ($25 million) under management or fewer than 15 U.S. investors.

- Registered advisers will be subject to SEC inspections, record retention and marketing standards requirements, and a requirement to employ a chief compliance officer. Additional compliance costs for managers could be significant. While some firms are already registered or have moved toward the equivalent of a registered adviser compliance standard in advance of Dodd-Frank, many will need to build out additional compliance infrastructure as the Act increases the level of required reporting. Clearly, the costs of operating

a private fund of any scale have now risen, creating a higher economic hurdle for new entrants in what is already a difficult fund-raising environment for new firms. These increased infrastructure costs, along with fallout from the Volcker Rule (see below), may push further consolidation in the hedge fund industry.

- The "Volcker Rule" bans proprietary trading by banks. However, Volcker Rule restrictions on proprietary trading are not absolute. Proprietary trading activities excluded from the ban include trading in local, federal, and government-sponsored enterprise obligations, certain market-making activities, transactions on behalf of customers, hedging activity, investments in small businesses and SBICs, proprietary trading conducted outside of the United States by non-U.S. entities, and trading for an insurer's account.

- Proprietary trading desks, often employing high degrees of leverage, have had a significant influence on the competitive landscape for arbitrage strategies. Interestingly, the Volcker Rule's exclusion of certain classes of government bonds could enable bank's proprietary desks to continue to trade in these securities, which historically have required significant leverage to push strategy returns to attractive levels. Banks' ultimate response to the Volcker Rule prohibitions on proprietary trading is far from certain. However, there is already anecdotal evidence that some banks are winding down proprietary trading desks, while in other cases teams are spinning out into independent operations or being re-routed into banks' asset management divisions.

- Another significant element of the Volcker Rule is its restriction on bank investments in, and sponsorship of, hedge funds and private equity funds. Banks are permitted to continue to organize and offer hedge funds or private equity funds under limited circumstances. Under the Volcker Rule, seed capital plus a bank's interest in a fund may not exceed 3% of fund assets. In addition, a bank's aggregate private fund ownership must be less than 3% of its Tier 1 capital. One open question in private equity is the impact of the Volcker Rule on the secondaries market. We expect that the Volcker Rule's divestment requirements will increase secondary deal flow, but this is far from clear. While private equity funds are long-lived, the transition rules could give banks a healthy multiyear divestment period. We suspect that banks may use this as an opportunity to weed their portfolios, while those with large and promising books are likely to take advantage of extensions. As a result, we would caution secondary investors to be vigilant about the quality of assets sold by banks.

- Consistent with Dodd-Frank's theme of expanding the regulatory mandate to monitor systemic risk, the over-the-counter (OTC) derivatives market is getting a makeover. Dodd-Frank attempts to address derivatives market risks in the following three ways: (1) pushing standardized OTC derivatives to centralized clearing and exchange trading in regulated trading systems; (2) designating certain financial entities "swaps dealers" and "major swap participants," subject to additional reporting and regulation; and (3) effectively requiring that banks that qualify as swap dealers move all derivatives activities into separately capitalized and nonbank affiliates, unless transactions are *de minimis*.

- Banks will still be active participants in the swaps market. Under the so-called swaps pushout rule, depository institutions can still receive federal assistance if they only engage in swaps transactions for the purposes of

hedging the bank's own risk, or deal in swaps on interest rates, foreign exchange, or certain other permitted investments. Industry sources estimate that over 80% of the derivatives market falls within the exemption from the new swaps pushout provision.

- The use of OTC derivatives and, in particular, credit default swaps has gone from obscure to ubiquitous over the past ten years, particularly among hedge fund managers. While some managers took advantage of the less transparent nature of the swaps market to capitalize on arbitrage opportunities, many of those opportunities had passed before Dodd-Frank became law and were unlikely to resurface. The move toward the standardization of swaps and the pushout provisions of Dodd-Frank appear to reduce the breadth and liquidity of the market while also curtailing the creation of customized hedges. For now, there is uncertainty about when or whether market participants will be named major swap participants and therefore subject to heightened regulation.

- Dodd-Frank's reach is long and the final verdict on its effectiveness may not be discernable for a decade or more. While consumer protections may be greater, it is unclear if institutional investors' benefits will be limited to those afforded by increased transparency due to mandated registration and reporting. The financial markets rarely struggle with ways to "innovate" in the face of new rules and regulations. It is usually only after the fact that investors discover innovation often leads to higher fees, greater volatility, and a bewildering proliferation of new products. We suspect the pattern will be familiar this time. ■

Dodd-Frank's Impact on Alternative Investments: A Brief Review

The crash of 1929 and the Great Depression spawned a complex financial and securities regulatory infrastructure in the United States. The Securities Act of 1933, the Banking Act of 1933 (creating the FDIC and, until the provisions were repealed in 1999, preventing banks from owning other financial companies), the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 all provided a framework for addressing some of the market abuses and bank runs that destroyed Americans' wealth. Signed into law on July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank" or the "Act") attempts to address the perceived causes of the 2007–08 financial market crash in a single, gigantic—2,300 pages—piece of legislation. Dodd-Frank establishes more than a dozen new federal agencies, mandates dozens of studies by regulators, requires existing agencies to issue hundreds of new regulations, and has left open many issues that could have a significant impact on which companies and investment strategies become winners and losers in the decades ahead.

Unlike the regulatory framework established in the 1930s, Dodd-Frank puts the burden on regulators to monitor both individual companies and overall systemic risks in the U.S. financial system. A vast amount of regulatory structure has since built up around Great Depression–era financial regulation, but the overarching theme was that "sunlight is … the best of disinfectants,"[1] such that disclosure became a critical factor in state and federal oversight. For example, firms were required to provide sufficient information to enable investors to judge the risks associated with investments.

[1] Louis D. Brandeis, *Other People's Money and How the Bankers Use It*, 1914.

Welcome to a whole new world. While disclosure is still important, Dodd-Frank empowers federal regulators to impose additional burdens on firms not because of their individual riskiness, but because of their contribution to overall risk in the U.S. financial system. Dodd-Frank requires federal regulators to determine which companies are "systemically important," whether a financial company should be subject to "enhanced prudential regulation," or whether a financial company that has not yet defaulted on its obligations should nevertheless be unwound by the FDIC.

Another key feature of the old U.S. regulatory regime was that investments targeting sophisticated investors did not require the same level of governmental oversight as those serving retail customers. As a result, hedge funds and private equity firms have relied on exemptions from the requirements of investment adviser and investment company registration because their sophisticated investors fell within the definition of "accredited investors" or "qualified purchasers." Dodd-Frank now requires these private funds to register with the Securities and Exchange Commission (SEC). Pensions, endowments, retirement plans, and government entities—many of which were treated as sophisticated investors—are now instead the beneficiaries of additional protections in the form of Dodd-Frank's imposition of special business conduct requirements on swap market dealers and major swap market participants that transact with them.

As reflected in its sheer size, Dodd-Frank seeks to address simultaneously many of the issues that were perceived to have contributed to the 2008 market crash and the seizing up of U.S. credit markets. Dodd-Frank also reflects legislators'

attempts to placate outrage at the public money spent on shoring up the U.S. financial system in the aftermath. A point-by-point review of Dodd-Frank is beyond the scope of this paper, given its comprehensive coverage of consumer financial protection, executive compensation, corporate governance, securitizations, bank trading activities, and the over-the-counter (OTC) derivatives market. Instead, this paper will review specific provisions of the Act that will clearly impact managers and investment strategies, and share some thoughts on how these changes could affect financial markets. Congress has put investors on notice that there has been a sea change in the U.S. approach to regulating financial markets, and this approach will have a significant impact in the years ahead even though many of the rules have yet to be written.

Overview

There are many excellent published discussions of Dodd-Frank. For purposes of this paper, we will highlight some key Dodd-Frank provisions and discuss issues that relate primarily to alternative investments. There are, admittedly, many other aspects of Dodd-Frank that will have an impact on the economy and investment advisers in the years to come. With more than 60 mandated federal studies due over the next several years, and at least 200 new regulations that have yet to be written, the outcomes of Dodd-Frank are far from certain. (See Appendix A for a calendar of studies and rulemakings that are of particular interest.) There will be multiple agencies involved in writing the new rules of the road and a lot of anticipated lobbying as those regulations and reports are written. The final regulatory landscape is very uncertain and regulators' implementation decisions will have a significant impact on how Dodd-Frank plays out in the years ahead.

Without question, compliance and regulatory infrastructure costs are going up in a highly uncertain economic environment. As reflected by the scale of the legislation and the breadth of the regulatory action required by Dodd-Frank, there will be significant changes ahead for banks and nonbank financial companies and their regulators. According to *The Wall Street Journal*, before Dodd-Frank was even signed into law, the Commodity Futures Trading Commission (CFTC) asked for $45 million for new staff, and J.P. Morgan had assigned more than 100 teams to examine the legislation. More recently, SEC Chairman Mary L. Schapiro estimated that the agency will need to add 800 new positions to "carry out the new or expanded responsibilities given to the agency by the legislation."[2] Investors should consider the impact of these additional costs on the viability of smaller investment management firms.

There are many questions that will only be answered with the passage of time. Dodd-Frank is larded with "anti-evasion" provisions, but many commentators still raise the question of whether, with so much uncertainty on the horizon, funds and managers will choose to move an increasing proportion of their operations offshore. Similar questions have been raised about the proliferation of offshore OTC trading platforms. Will smaller bank balance sheets reduce lending and give rise to an expanded shadow banking system in which financing gaps are filled by hedge funds and other nonbank entities? Studies have been commissioned to determine how these new requirements will impact U.S. economic competitiveness. However, the overall tenor of the legislation seems to put investment managers and other financial companies in the midst of some significant crosscurrents. On the one hand, this move toward more intensive regulation and heavier reporting burdens would seem to push investment managers

[2] Testimony of SEC Chairman Mary L. Schapiro to the U.S. Senate Committee on Banking, Housing, and Urban Affairs, September 30, 2010.

in the direction of developing organizations with scale and significant operational infrastructure. On the other hand, Dodd-Frank's focus on systemic risk and the yet-to-be-created rules for companies that are deemed "systemically important" may push some firms in the direction of staying smaller and more focused in the hope of keeping off of that esteemed "systemically important" list.

Overview of Selected General Provisions

A key element of Dodd-Frank's focus on systemic risk is the establishment of a Financial Stability Oversight Council (FSOC) as a means of coordinating federal oversight of perceived systemic risk. The FSOC's voting membership is taken mostly from other federal financial regulatory authorities, including the Federal Reserve, the Comptroller of the Currency, the SEC, the CFTC, and the FDIC. A key role of the FSOC is to determine which companies should be designated as "systemically important." Companies that are systemically important—and this may not just be a size test[3]—are put under Federal Reserve supervision and are subject to additional risk-based capital, liquidity, and leverage standards; concentration limits; and potentially enhanced reporting requirements. Systemically important companies also get to foot the bill for at least part of this enhanced government supervision through provisions that require the companies to pay assessments to the Federal Reserve and the Treasury Department's new Office of Financial Research (for additional detail on some of the new regulatory bodies, see Appendix B).

While much of this paper is focused on Dodd-Frank's impact on alternative investments, long-only firms will likely also feel its effects. Upon enactment of Dodd-Frank, the mutual fund industry was quick to note that the Act left "intact a regulatory structure for mutual funds and other investment companies that has proved highly successful for many decades. This reflects Congress' judgment that mutual fund regulation served Main Street investors well during the financial crisis."[4] While mutual fund family complexes and their supporters might have argued that they were unlikely to be deemed "systemically important," the joint CFTC and SEC report pinning the origins of the "flash crash" on a mutual fund complex probably put that idea to rest.[5]

Dodd-Frank also establishes an "orderly liquidation" process—its attempt to eliminate the "too big to fail" doctrine. Already, commentators are questioning whether this new process increases the likelihood of runs on banks and other financial companies. As written, the Act permits the Secretary of the Treasury to appoint the FDIC as receiver of a financial company even if that company has not yet defaulted on its obligations or filed for bankruptcy. This raises the question of whether creditors will be less likely to extend life support in the form of credit to troubled businesses. Creditors will now have to monitor the solvency of a troubled borrower, as well as assess the likelihood of the government taking preemptive action. It is important to note that the orderly liquidation authority process also may be applied to nonbank financial companies. This

[3] The Act provides that bank holding companies with $50 billion or more in assets are automatically subject to enhanced prudential standards. According to the National Information Center, as of September 30, 2010, there were 36 domestic bank holding companies with assets in excess of $50 billion.

[4] Investment Company Institute Statement on Enactment of Financial Regulatory Reform Bill, July 21, 2010.

[5] "Findings Regarding the Market Events of May 6, 2010," report of the staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, dated September 30, 2010. In the report, the staffs noted that the crash was precipitated by a mutual fund complex issuing an order to sell approximately $4.1 billion in exposure to S&P 500 futures contracts.

raises the question of whether a troubled hedge fund could be wound down under this process.

Selected Provisions Most Relevant to Investment Strategies and Advisers

Registration Requirements for Private Fund Advisers

With some exceptions, hedge fund and private equity managers will be required to register as investment advisers with the SEC. Registered advisers will be subject to SEC inspections, record retention and marketing standards requirements, and a requirement to employ a chief compliance officer. These provisions go into effect as of July 21, 2011.

Consistent with Dodd-Frank's focus on managing and monitoring systemic risk, the Act requires that private fund advisers maintain the following records and reports about funds under their advisement:

- Assets under management
- Use of leverage (including off balance sheet)
- Counterparty credit risk exposure
- Trading and investment positions
- Valuation policies and practices
- Types of assets held
- Side arrangements/letters
- Trading practices

In addition, Dodd-Frank gives the SEC authority to establish additional systemic risk–related record-keeping and reporting requirements for private fund advisers. The SEC is required to share reports and other information it receives with the FSOC as part of its mandate to assess systemic risk. Dodd-Frank also permits the SEC to require advisers to disclose information about their clients. This eliminates a past Advisers Act exemption in the interest of assessing systemic risk. Recognizing that private fund advisers may be required to provide sensitive competitive information to the SEC, Dodd-Frank specifically excludes information provided to the SEC and FSOC from public disclosure under the Freedom of Information Act.[6]

Investment Adviser Registration Exemptions. Notable among the exceptions to adviser registration requirements are "venture capital funds," a major victory after intensive lobbying by the industry. However, Dodd-Frank does not define what constitutes a "venture capital firm"; instead, the Act requires the SEC to create the definition by regulation. This past November, the SEC proposed rules that created exemptions for venture capital firms, as well as small private fund advisers, and non-U.S.-based private fund advisers. (Public comments are due within 45 days of the SEC's published proposal.)

The SEC seeks to define venture capital investment based on several criteria, including a lack of leverage and the nonpublic start-up nature of "qualifying portfolio companies," as opposed to using a size-based criteria. The proposal includes a broad grandfathering provision for funds raised before the registration effective date of July 20, 2011, meaning that the funds do not have to satisfy the proposed definition. The SEC proposal also implies that funds-of-funds or special purpose vehicles, even if focused on venture capital, do not qualify for the exemption.

Small Advisers. Defined as private fund advisers with less than $150 million in assets under management, small advisers are exempt from SEC registration and instead must register with state securities regulators, subject to some exceptions.

[6] On September 23, 2010, Congress voted to repeal a portion of Dodd-Frank that critics said granted the SEC overly broad authority to exclude information gathered for surveillance, risk assessments, or other regulatory or oversight activities from Freedom of Information Act requests.

The SEC proposal includes parameters to define assets under management. Specifically, advisers must include uncalled capital commitments, and assets must be valued at their fair value. Non-U.S. advisers with principal offices and places of business outside the United States do not have to include in their count assets that are invested in a U.S. or non-U.S. private fund and that are managed from outside the United States.

Non-U.S.-Based Private Fund Advisers. The SEC proposal by and large provides an exemption for non-U.S.-based managers with principal offices and places of business outside the United States, provided that they have a small amount of U.S. investor dollars ($25 million) under management or fewer than 15 U.S. investors. Fund managers will not be able to sidestep SEC registration requirements by establishing or accepting capital from funds-of-funds or special purpose vehicles with U.S. investors. Each U.S. investor in a fund-of-funds will be counted toward the 15 investor registration floor.

The SEC proposal indicates that private fund advisers that qualify as venture capital firms and small fund advisers, while exempt from registration, will still be subject to some reporting requirements and SEC examinations. Non-U.S.-based private fund advisers exempt from registration will also be exempt from SEC examinations and reporting requirements.

Accredited Investor Standards. Effective immediately, Dodd-Frank increased the net worth thresholds for "accredited investors" to include a $1 million net worth threshold for individual's assets, *excluding* one's residence. While large institutional investors will not be affected by the new standards, smaller funds and start-ups relying on high-net-worth individuals or a network of friends and family may lose a portion of their client base. Dodd-Frank requires the SEC to revisit the net worth threshold at least every four years.

Impact. Additional compliance costs for managers could be significant. While some firms are already registered or have moved toward the equivalent of a registered adviser compliance standard in advance of Dodd-Frank, many will need to build out additional compliance infrastructure as the Act increases the level of required reporting. This includes establishing personal trading policies, new record retention policies and systems (e.g., a five-year electronic trail), and ensuring that marketing materials comply with detailed SEC requirements. Some managers are considering hiring firms that offer an outsourced compliance function rather than building in-house expertise. All private fund advisers will also be subject to periodic SEC audits. Some firms appear to be well prepared for this transition, with some having undergone "mock" SEC audits. Others undoubtedly do not yet have sufficient infrastructure in place.

As alternative investments have moved to the mainstream of many institutional portfolios, the investment adviser registration requirement of Dodd-Frank levels the regulatory playing field by requiring private fund advisers to be registered with the SEC. This shift should mitigate lingering post-Madoff investor concerns about hiring unregistered private fund advisers. Conversely, traditional long-only managers that have been registered investment advisers have lost another point of differentiation relative to their hedge fund brethren.

As U.S. investors look increasingly toward non-U.S. investments, and as alternative assets become mainstream investments for institutional capital pools outside of the United States, we question whether high-quality non-U.S.-based private fund advisers will begin to eschew U.S.-based investors. This could be a more immediate concern for larger investors seeking to develop an overseas "emerging managers" roster or those that have

the scale to invest in smaller, locally focused teams outside of the United States.

Importantly, the costs of operating a private fund of any scale have now risen, creating a higher economic hurdle for new entrants in what is already a difficult fund-raising environment for new firms. Industry sources estimate ongoing compliance costs of anywhere from $300,000 to $1 million a year or higher, depending upon the complexity and scale of the firm. First-year costs will undoubtedly be higher as firms go through the registration process, create compliance procedures, upgrade IT systems to comply with new record retention requirements, and hire or train staff. Who will ultimately bear the cost? Will this "investor protection" issue become an incremental expense borne by the investors? Some of the recordkeeping could be considered fund reporting expenses, and some industry sources expect that managers could try to pass this cost on to the investors, whereas other expenses will be put toward firm/partnership expenses.

These increased infrastructure costs, along with fallout from the Volcker Rule (see below), may push further consolidation in the hedge fund industry. Rather than operating independently, new fund managers may instead work with private equity seed/incubator funds.[7] Firms that use a "siloed" approach—employing autonomous teams within a single fund—may also be at an advantage as this structure may more readily lend itself to adding new teams to a pre-existing fund. Or Dodd-Frank may provide attractive product expansion opportunities for larger investment firms with a well-established, scalable compliance infrastructure that can integrate new teams onto their platform.

The "Volcker Rule": Limitations on Banks

Under Dodd-Frank, banks face significant restrictions on their ability to engage in higher-risk, nonlending activities. In addition, banks' investment in, and sponsorship of, hedge funds and private equity funds is limited by statute.

Proprietary Trading. The "Volcker Rule" bans proprietary trading by banks. However, Volcker Rule restrictions on proprietary trading are not absolute. Proprietary trading activities excluded from the ban include trading in local, federal, and government-sponsored enterprise obligations, certain market-making activities, transactions on behalf of customers, hedging activity, investments in small businesses and SBICs, proprietary trading conducted outside of the United States by non-U.S. entities, and trading for an insurer's account. Dodd-Frank requires even these permitted activities to be prohibited if they result in banks having a material conflict of interest with their customers or counterparties, increase material exposure to high-risk assets or trading strategies, threaten banks' soundness, or pose systemic risks. Regulators are expected to issue regulations better defining permitted and prohibited proprietary trading activities.

Proprietary trading desks, often employing high degrees of leverage, have had a significant influence on the competitive landscape for arbitrage strategies. On the face of it, Volcker Rule restrictions will narrow the focus of prop desk trading. Interestingly, the Volcker Rule's exclusion of certain classes of government bonds could enable bank's proprietary desks to continue to trade in these securities, which historically have required significant leverage to push strategy returns to attractive levels. What is uncertain is whether federal regulators will in turn narrow the scope of the current proprietary trading exemptions to address these risks.

[7] These are private equity funds that provide start-up funding and, in some cases, infrastructure support to new investment teams.

Sponsorship of Hedge Funds and Private Equity Funds. Another significant element of the Volcker Rule is its restriction on bank investments in, and sponsorship of, hedge funds and private equity funds. Sponsorship includes acting as a general partner of a fund, selecting/controlling a majority of the directors of a fund, or having employees serve as the majority of directors of a fund or sharing a name with a fund for marketing purposes.

Banks are permitted to continue to organize and offer hedge funds or private equity funds under limited circumstances.[8] However, banks are now subject to a cap on their exposure to individual funds and to all private funds in the aggregate. Under the Volcker Rule, a bank can provide seed capital to funds, and if the bank actively seeks other investors, it may make a *de minimis* investment in a fund. The Volcker Rule applies two size restrictions on these investments. First, seed capital plus a bank's interest in a fund may not exceed 3% of fund assets. Banks have one year after a fund's establishment (plus the possibility of some extensions) to reduce their investment to this 3% level. In addition, a bank's aggregate private fund ownership must be less than 3% of its Tier 1 capital.

Additional Capital Requirements. Dodd-Frank also allows regulators to impose additional capital requirements, quantitative limits, and/or diversification requirements on banks *and* on systemically important nonbank financial companies that are engaged in permitted proprietary trading or that have investments or ownership stakes in private funds. Under the Volcker Rule, investments in private funds would be deducted from the bank's assets and equity for determining additional capital requirements. Regulators could also effectively impose higher limits for higher leverage investments.

Non-U.S. Banks. The Volcker Rule specifically exempts proprietary trading activities by banks solely outside of the United States, unless the banking entity is directly or indirectly controlled by a bank in the United States. Similarly, its restrictions on sponsorship of, or investing in, private funds do not apply to banks outside of the United States, as long as the bank is not directly or indirectly controlled by a U.S. bank and the private funds are not sold to U.S. investors.

For non-U.S. banks or non-U.S.-based nonbank financial companies that are designated "systemically important," additional capital requirements and other quantitative limits apply.

The Volcker Rule does not go into effect until two years after enactment of Dodd-Frank or a year after issuance of final implementation rules. Banks have two years after the Volcker Rule becomes effective to get into compliance with its requirements. In addition, the Federal Reserve can grant up to three one-year extensions of the transition period. Banks may also apply for up to a five-year (maximum) extension if they had a commitment to an illiquid fund prior to May 1, 2010. This means that banks may have up to 12 years to fully comply with all of the Volcker Rule provisions.

Impact. Banks' ultimate response to the Volcker Rule is far from certain. However, there is already anecdotal evidence that some banks are winding down proprietary trading desks. We also expect to see teams spin out of banks into independent

[8] Banks may sponsor funds if: the banking entity provides trust, fiduciary, or investment advisory services to the fund; the fund is only offered to persons who are customers of those services; the banking entity complies with certain transaction restrictions with the fund; the bank complies with anti-bailout provisions; the banking entity and fund do not share a name for marketing purposes; no employee or director of the banking entity retains an equity interest in the fund; the bank discloses to investors that losses will not be borne by the fund; and the bank's stake does not exceed the *de minimis* thresholds outlined above.

operations. Some Wall Street banks have already reorganized their proprietary trading operations by reducing staff and reassigning others to the banks' asset management division, where talented traders can serve client interests. The ban on proprietary trading could certainly lead to an exodus of experienced executives who join established hedge funds or set up *de novo* investment management firms. At least one bank has announced plans to move its proprietary teams into its asset management division, another way of capturing economic value from former in-house traders.

As we noted in the wake of the market meltdown in 2008,[9] the shuttering of bank proprietary trading desks and reduction in highly leveraged capital chasing arbitrage strategies should be beneficial to hedge funds. On the other hand, the absence of banks from the market is also likely to reduce the breadth and liquidity of markets, resulting in more short-term volatility. There is also some question of whether the operation of the Volcker Rule will enable hedge funds to step more aggressively into other areas that had been the province of banks, such as middle-market lending and other direct origination activity.

While the 3% ownership restrictions set forth in the Volcker Rule will act as a disincentive for banks to expand their footprint aggressively in the private funds investment world, banks are still selectively engaging in the space. In a recent example, a non-U.S. bank spent $425 million to purchase a minority interest in a hedge fund to be housed in its asset management division.

One open question in private equity is the impact of the Volcker Rule on the secondaries market. We expect the Volcker Rule's divestment requirements will increase secondary deal flow, but this is far from clear. While private equity funds are long-lived, the transition rules could give banks a healthy multiyear divestment period. Other secondary market participants believe that Volcker Rule–motivated divestitures could push a lot of supply onto the secondary market.

Secondary sales by financial institutions, including banks and insurers, dominated transaction volume in the first half of 2010, and this trend is expected to continue for the next 12 to 24 months. However, transaction volume in the first half of 2010 was also driven by strategic sellers looking to shift the long-term nature of their illiquid portfolios.

While the Volcker Rule requires that aggregate private fund ownership by banks be less than 3% of their Tier 1 capital, banks still have significant dollars to invest. For example, as of September 30, 2010, Bank of America Merrill Lynch had $165 billion of Tier 1 capital, and so can hold on to nearly $5 billion in private fund investments. We suspect that banks may use this as an opportunity to weed their portfolios, while those with large and promising books are likely to take advantage of extensions to the private fund divestiture rules. As a result, we would caution secondary investors to be vigilant about the quality of assets being sold by banks.

Derivatives Regulation

Consistent with Dodd-Frank's theme of expanding the regulatory mandate to monitor systemic risk, the OTC derivatives market is getting a makeover. Dodd-Frank attempts to address derivatives market risks in the following three ways: (1) pushing standardized OTC derivatives to centralized clearing and exchange trading in regulated trading systems; (2) designating certain financial entities "swaps dealers" and "major swap participants," subject to additional reporting and regulation; and (3) effectively requiring that banks that qualify as swap dealers move all derivatives

[9] See our January 2009 report *Is the "Hedge Fund Business Model" Broken?*

activities into separately capitalized and nonbank affiliates, unless transactions are *de minimis*.[10] Financial companies will be required to centrally clear swaps, while nonfinancial companies are able, under some circumstances, to opt out of central clearing.

Going forward, most derivatives will be regulated by the CFTC or, in the case of security-based swaps, by the SEC. Both the CFTC and SEC are required to create rules designed to enable real-time price and volume reporting of swaps, including swaps that are not required to be centrally cleared.

Regulators are charged with defining the term major swap participant (MSP), but the Act contemplates regulating nondealers that maintain a substantial position in swaps, have outstanding positions creating counterparty exposure that could have an impact on U.S. financial stability, and are highly leveraged and not subject to capital requirements imposed by a federal banking agency. Importantly, a financial company can be designated as an MSP with respect to a single type of swap and not for others. MSPs will be subject to a higher level of regulatory oversight and will be subject to yet to be determined position limits, enhanced recordkeeping, business conduct standards, and margin and capital requirements.

The CFTC is empowered and directed to establish position limits on the aggregate number or amount of positions that can be held by any one person or group or class of persons in contracts based on the same underlying commodity. For security-based swaps, the SEC is required by the Act to establish limits, including related hedge exemption provisions, on position sizes held by a person or in aggregate.

[10] Item 3 is known as the "swaps pushout rule." Under the rule, an insured depository institution may not receive "federal assistance" if it is a swaps dealer or major swap participant.

Banks will still be active participants in the swaps market. Under the so-called swaps pushout rule, depository institutions can still receive federal assistance if they only engage in swaps transactions for the purposes of hedging the bank's own risk, or deal in swaps on interest rates, foreign exchange, or certain other permitted investments. Industry sources estimate that over 80% of the derivatives market falls within the exemption from the new swaps pushout provision.

Impact. The use of OTC derivatives and, in particular, credit default swaps has gone from obscure to ubiquitous over the past ten years, particularly among hedge fund managers. While some managers took advantage of the less transparent nature of the swaps market to capitalize on arbitrage opportunities, many of those opportunities had passed before Dodd-Frank became law and were unlikely to resurface.

The move toward the standardization of swaps and the pushout provisions of Dodd-Frank appear to reduce the breadth and liquidity of the market while also curtailing the creation of customized hedges. For now, there is uncertainty about when or whether market participants will be named MSPs and therefore subject to heightened regulation.

While hedge funds' participation in the swaps market have certainly made the headlines, there are long-only managers that are also significant players in the market. For them, it is unclear how the MSP designation might affect their ability to do business. For investors employing managers that have swaps exposure, this will be an issue to monitor.

Conclusion

Dodd-Frank's reach is long and the final verdict on its effectiveness may not be discernable for a decade or more. In the meantime, industry participants and their lobbyists will wage furious battles to secure the most lenient interpretation of congressional intent as lawmakers punted the detail work to a diverse set of regulators. While consumer protections may be greater, it is unclear if institutional investors' benefits will be limited to those afforded by increased transparency due to mandated registration and reporting. The financial markets rarely struggle with ways to "innovate" in the face of new rules and regulations. It is usually only after the fact that investors discover that innovation often leads to higher fees, greater volatility, and a bewildering proliferation of new products. We suspect the pattern will be familiar this time, thus requiring our periodic review of the changing landscape as legislative details emerge and investment manager behavior evolves in response. ■

Appendix A: Calendar of Studies and Rulemakings of Interest

Derivatives

July 2011 Effective date of various provisions pertaining to derivatives, although dates are different for different provisions.
July 2013 Swap pushout rule becomes effective two years after derivative requirements are effective, subject to up to three-year transition period for insured depositories.

Foreign Bank Intermediate Holding Company Capital Requirements

January 2012 Within 18 months of enactment, GAO and federal banking agencies will investigate the capital requirements applicable to U.S. holding companies of foreign banks that are bank or thrift holding companies and submit the results to Congress.

Hedge Funds and Private Equity Funds

July 2011 Registration provisions become effective one year after date of enactment.
July 2011 Within one year of enactment, GAO to submit a report to Congress on the feasibility of forming a self-regulatory organization to oversee private funds.

Leverage and Capital Requirements

January 2013 The Federal Reserve must impose leverage and capital requirements within 18 months of the "transfer date," which will be 12 months from the date of enactment (possible extension for up to six additional months).
January 2013 In general, the Trust preferred phase-out will be phased in from January 1, 2013, to January 1, 2016.

Permitted Banking Activities

January 2012 Federal banking agencies to issue a report on activities that banks are permitted to engage in and their impact on the safety and soundness of the banks and the U.S. financial system within 18 months of the date of enactment.

Rating Agency Independence

July 2013 Within three years of the date of enactment, the Securities and Exchange Commission (SEC) must complete a study on the independence of rating agencies and its effect on ratings and submit to the Senate Banking Committee and House Financial Services Committee.

Short Selling

July 2012 Within two years of the date of enactment, the SEC must submit a report to Congress on short selling, examining, among other things, the impact of recent rule changes, failures to deliver shares sold short, and the delivery of shares on the fourth day following a short sale transaction.

Systemic Risk

January 2011 Within 180 days of enactment, the FSOC must issue a study on the economic impact of financial regulation designed to limit systemic risk. The study will include an examination of the costs and benefits of imposing limits on the size, complexity, and interconnectedness of financial institutions.

Venture Capital

July 2011 SEC to issue final rules regarding the definition of "venture capital" within one year of the date of enactment.

Volcker Rule

January 2011 FSOC study on effective implementation of Volcker Rule within six months of the date of enactment.
January 2011 Federal Reserve to issue rules to implement the two-year transition period and the

extended transition period for illiquid funds within six months of enactment date.

September 2011 Regulators to issue rules on implementation within nine months of study's completion.

October 2011 GAO study on proprietary trading to be produced within 15 months of date of enactment.

January 2012 Within 18 months of enactment, banking agencies must jointly review banking activities permitted under federal and state law and consider whether additional restrictions, including those related to concentration limits, are needed.

July 2012 Effective date of the rule will be the earlier of (a) 12 months after the issuance of rules on implementation (September 2012) or (b) two years after the date of enactment (July 2012).

July 2012 Beginning of transition period for investments in funds. For large banks, two-year phase-in period from the effective date; up to three one-year extensions granted by the Federal Reserve for liquid funds. The Federal Reserve may extend the transition for up to five years for illiquid funds. ■

Appendix B: Meet Your Regulators—Descriptions of Selected New Regulatory Bodies Established by Dodd-Frank

Financial Stability Oversight Council (FSOC)

The FSOC is a new standalone entity charged with monitoring systemic risk. FSOC membership is taken primarily from federal regulatory agencies.

The FSOC has a major role in driving the systemic risk provisions of Dodd-Frank. For example:

- With a two-thirds vote, the FSOC can designate a nonbank financial company as "systemically important" and therefore put it under the Federal Reserve's enhanced oversight.

- The FSOC has the authority to recommend to the Federal Reserve specific enhanced capital, oversight, and risk standards for companies that are systemically important.

- The FSOC can approve (with a two-thirds vote) the Federal Reserve's finding that a firm represents a "grave threat" to financial stability; giving the Federal Reserve the right to take actions up to and including requiring a firm to sell or transfer assets to an unaffiliated company.

Office of Financial Research (OFR)

Part of the U.S. Treasury Department, the OFR is empowered to collect data from all financial companies. It shares information with the FSOC, any FSOC member agencies, and the Bureau of Economic Analysis. The head of the OFR is appointed to a six-year term by the president.

OFR's mandate includes development of tools for risk management and monitoring and collaboration with federal agencies to standardize financial data collection.

OFR is to establish a data center to collect and publish financial data. This will include financial transaction data and position data from reporting companies. While OFR is required to maintain the confidentiality of data it collects, there are open questions about the types of data that will be treated as confidential by the OFR.

The FSOC can request data from nonbank financial companies or bank holding companies through the OFR in order to assess systemic risk either at the company level or more broadly.

Office of Credit Ratings

Created within the Securities and Exchange Commission, the Office of Credit Ratings is to review rating agencies and reduce the impact of conflicts of interest on the rating process.

Credit Rating Agency Board

The Credit Rating Agency Board is a self-regulatory organization charged with qualifying credit rating agencies to provide initial ratings for structured financial products.

Federal Insurance Office

The Federal Insurance Office will be part of the U.S. Treasury Department. This new office does not have enforcement powers, but is charged with gathering information and monitoring the insurance industry as part of Dodd-Frank's focus on systemic risk, as well as recommending to the FSOC that certain insurers be designated as "systemically important." ■