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The Devil in Dodd-Frank

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Will regulators be looking into hedge fund pay packages? Leading hedge fund attorney Paul Roth addresses the many ways that the recently-passed financial reform legislation could affect oversight of hedge funds.

By Paul Roth

The Dodd-Frank Wall Street Reform and Consumer Protection Act will require hedge fund managers to register under the Investment Advisers Act, but that could only be its most obvious impact. The outcome on a significant number of issues—including compensation of managers, short sales, and the way advisers need to collect and maintain systemic risk data—are all subject to rulemaking by the Securities and Exchange Commission. Not until the SEC completes its rulemaking will we be able to assess the full impact of this legislation on private fund managers.



One of the most potentially troublesome arenas is in hedge fund compensation arrangements. Compensation programs that fund managers arrange with their investors are an essential element of the private fund industry and the incentive fee arrangements are transparent.



Yet the Act requires the SEC (together with applicable regulators) to jointly prescribe regulations for so-called “covered financial institutions,” including registered investment advisers, to disclose the structure of their incentive-based compensation arrangements. This rule is intended to help regulators determine whether the compensation structures are excessive, encourage inappropriate risk taking or could lead to material financial loss.

Until the Financial Services Authority’s July 29 release for comment of its consultation paper, “Revising the Remuneration Code,” which may require deferral of 40-60% of variable compensation for many employees of private fund managers, I thought these compensation disclosure requirements weren’t likely to have an impact on pay packages. Now, one cannot be too certain!

While I doubt the SEC will follow the FSA’s lead (and remember, we do not yet have new FSA rules, only an exposure draft out for comment), any such changes would have an enormous impact on today’s compensation structures. In order to work fairly, these changes would have to be reconciled by a modification in the tax rules. Ironically, deferrals of incentive fees were common in the industry until Congress only a few years ago changed the tax code to eliminate the ability to do such deferrals. Developments will have to be monitored, both in terms of the FSA (which, at a minimum, will be regulating UK affiliates of US managers) and the SEC. The saving grace here is that the Act appears to exempt advisers that have assets on their balance sheet (not client assets under management) of less than \$1 billion from SEC rule-making regarding compensation, and that should significantly limit the number of advisers covered.

The Act contains many other provisions whose potential effects are unclear. For one, it mandates that the SEC adopt rules for the monthly reporting of short sales. It isn’t certain who will be required to report. Will it be limited to institutional investors, such as Form 13F filers? Nor is it clear what information will be required to be filed, other than the name of the issuer and CUSIP number of the security. What is known is that two studies are mandated to review the practice of short sales, including one that will examine the feasibility of indicating on the Consolidated Tape whether trades are short, market maker short, buys, buys for cover or long. If implemented, such a proposal could mean the market will be on notice of the accumulation and liquidation of short sale positions on a real-time basis, and the implications of such disclosure will clearly need to be examined. The question is whether such a reporting

regime would make short selling more difficult and expensive, and whether it would convey an accurate picture because much shorting is done through derivatives.

The Act also requires that the SEC's Divisions of Investment Management and Trading and Markets develop their own examination and inspection staffs reporting to their directors. In part, this is a return to the days prior to the formation of the Office of Compliance Inspections and Examinations, when examiners reported to the directors of these divisions. How the mandates of these division examination staffs will differ from the examination and inspection staff of the separate OCIE is certainly an open question. One can hope the new inspection staffs will be more substantively oriented to develop best practices in their respective areas, rather than work as task forces in coordination with the Division of Enforcement, but at this point that's just a hope!

As expected, the new legislation amends the Investment Advisers Act to eliminate the exemption that permitted private advisers that managed billions of dollars to avoid registration if they had fewer than 15 clients. The new registration test is triggered simply by assets under management and generally will require registration with the SEC as an investment adviser at a threshold of \$100 million in assets (\$150 million if the adviser's only clients are private funds).

Given Congress's determination to impose a regime of systemic risk regulation, being registered as an investment adviser will now require more recordkeeping and reporting of data that must be maintained for monitoring systemic risk. Some of the recordkeeping and data is mandated by the Act. These include assets, leverage, counterparty risk exposure, trading and investment positions, valuation policies and practices, types of assets held, side arrangements or side letters and trading practices.

However, the required list is expandable to include anything else the SEC "determines is necessary and appropriate in the public interest or for the assessment of systemic risk." Just defining what is required (such as how leverage is measured and how to determine counterparty risk exposure or define trading practices) could make the task easier or more complicated and expensive because systems will have to be designed to capture the required information. Moreover, while the Act provides confidentiality for the systemic risk



information given to the SEC, already there are calls in Congress to narrow the scope of those confidentiality provisions.

There is much, much more in the way in which the Act will affect hedge fund managers, including the provisions of the Volcker Rule and the resolution authority given to the Federal Deposit Insurance Corporation to liquidate non-depository financial entities. Also to be closely watched is the impact of the authority given to the Fed to determine whether certain hedge funds are systemically relevant and therefore may be subject to new requirements to set aside additional capital cushions or reduce leverage and increase liquidity. In addition, the regulation and manner of trading derivatives has been significantly changed.

The full impact of this new regulation of hedge fund managers will not be known until the implementing rules and regulations are adopted. As noted, they could be far reaching. This is truly a case where the devil will be in the details.

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