Issue 77, December 2010

The CutterAdvantEdge
Commentary on Investment Systems and Operations

Back to School: The Dodd-Frank Act

The *Wall Street Reform and Consumer Protection Act*, also known as Dodd-Frank, calls for the most dramatic change in US financial regulation since the 1930s. The act specifically targets the causes of the 2008–2009 financial meltdown and represents a seismic regulatory shift for the financial world's most volatile products—derivatives. It is certain to impact all players in the financial industry, including hedge funds and registered investment advisors.

The legislation is long and complex at 2,307 pages, 15 titles, and 540 sections. To back the provisions of the act, dozens of new boards, bureaus, and offices must be created. Hundreds of new regulations must be made available for comment and then implemented. The law requires more than 65 studies, most of which must be completed within 18 months. Some of the most important studies must be conducted over the next six months, including studies on prohibiting banks from proprietary trading and studies on instituting fiduciary duty for brokers.

> *"Dodd-Frank presents a seismic regulatory shift for the financial world's most volatile products."*
>
> James Hollis, CFA
> Managing Director, Cutter Associates

In the coming 6–12 months, these regulations will affect many investment managers including registered investment advisors and hedge funds, as well as other private funds such as family offices, financial planners, banks, and insurance companies. Operations and IT groups at the investment managers have many concerns about accommodating Dodd-Frank, including new requirements pertaining to derivatives trading and accounting, and examination requirements for members of the participating organizations. They are also concerned about potential regulations for short selling and high frequency trading, and about the possibility that they will need to maintain an audit trail of data on trading and on monitoring the buildup of systemic risk. The strengthened rewards and protections proposed for whistleblowers (vendor, outsourcer, and internal) could complicate the management of service providers as well as internal employees.

Over 200 participants signed on to a recent CutterCast to learn about the impact of Dodd-Frank impact derivatives central clearing. Detailed discussions included the law's requirements for closing regulatory gaps, implementing financial safeguards, increasing transparency and accountability, mandating higher standards of conduct for all participants, and perhaps most significantly, requiring derivatives to be traded on open exchanges and processed through central clearinghouses. Greater market transparency certainly means the asset managers' IT departments will need to figure out the best way to collect, store, and document market data, and how to efficiently publicize the data through clearinghouses or swap repositories. The consolidation of derivative and security exchanges would be a story on its own.

Even before Dodd-Frank takes effect, the marketplace is changing and becoming more complex. While some Central Counterparty (CCP) clearinghouses have been around for years, new ones are cropping up frequently now, and all are aggressively pursuing what they see as market opportunities created by the legislation. Turf wars appear to be shaping up as CCPs try to dominate clearing volume for specific types of derivatives. But some market participants have yet to enter the fray at all, and clear standards for CCPs are still lacking, which could cause significant operational risk and inefficiencies. Before these issues are fully resolved, asset management firms must choose the exchanges and clearinghouses they want to do business with. They will have to invest in building the secure electronic connectivity required for exchange trading, put up margin at the exchange, and comply with exchange and clearinghouse rules. They probably will also have to execute trade reporting, which includes registering all swap interests with regulatory agencies. With all these factors to consider, asset managers might first ask themselves if their derivatives volume in specific types of issues is big enough and important enough to be worth the effort required for compliance.

Another critical battleground in implementing Dodd-Frank is determining which of the existing or new governmental agencies will oversee each type of financial service company. Studies are now underway to determine the optimum regulation environments for investment management firms, hedge funds, insurance companies, banks, and financial planners. The SEC has hired an independent consultant to study the agency's own internal operations, structure, funding, and need for comprehensive reform. The study includes examining ways to improve the SEC's ability to monitor high frequency trading and other technological advances in the market.

Dodd-Frank will require that larger hedge funds and private equity advisors register with the SEC as Investment Advisors and provide information about their trades and portfolios. Although it is the subject of another study and has yet to be decided, it would seem that brokers will be held to some form of the Fiduciary Duty that applies to all registered Investment Advisors. At the same time, all investment advisors with AUM under $100 million will have their regulation transferred from the SEC to the states. These developments are likely to require significant change for many investment managers and their employees.

Meanwhile FINRA, the self-regulating organization (SRO) for brokers, appears to be aggressively seeking control of qualification and testing for all professionals in registered investment managers. In a recent letter to SEC staff, FINRA submitted its "thoughts on how an investment adviser personnel qualification program might be developed and implemented." The letter follows meetings between SEC and FINRA staff during which SEC staff "inquired about the sufficiency of current qualification requirements for investment adviser personnel." The letter emphasizes FINRA's experience in developing, maintaining, and administering various examinations and continuing education programs. With respect to the potential structure for an investment adviser qualifications program, the letter states the following:

> "In creating a qualifications program for investment advisers (IAs), the Commission should consider a program that is tailored to the law, regulations, services, and products offered by investment advisers. This structure would provide for the qualification and registration of investment adviser representatives (IARs) and supervisory personnel.
>
> "These persons should be required to complete an appropriate qualification examination and CE program to ensure that they are proficient in their field and in the rules and regulations that apply to them. While this structure would resemble FINRA's model for broker-dealers, there would be major differences in the content of the qualifications examinations and CE programs to reflect the differences between broker-dealers and investment advisers."

The FINRA letter contains a footnote stating that the SRO does not take a position on whether individuals who already hold designations should be exempted from any qualification examinations for investment advisers. These individuals would include CFAs, CFPs, and those who have completed the Series 65 examination for investment adviser representatives. It also does not spell out which specific job functions of the advisers would be required to take the exams.

Dodd-Frank will also create the Office of Financial Research (OFR) with the goal of improving the quality and utility of financial data that firms report. Firms will be required to provide data and analysis to the Financial Stability Oversight Council, a group responsible for the stability and integrity of the US economy and made up of the senior members of the President's economic team. The OFR is also charged with standardizing financial reporting requirements, which includes standardizing data associated with financial instruments, entities, and trading. Couple this with another OFR charge to ensure that the government has the timely data it needs to identify risks to financial stability, and it's possible to foresee some standardization of security master data and trading data that could significantly improve the efficiency of many investment management operations. Meanwhile there is an SEC study due next summer on the costs, benefits, and feasibility of providing short-sale positions in real time to the public or to either the SEC or FINRA. By having the government enforce industry standardization of data and data communication in the interest of risk mitigation, Dodd-Frank could increase technology costs but could also lead to important advances.

Dodd-Frank also attempts to decrease the monopolistic profitability of derivatives trading among the major controlling banks. Much of their profit is likely connected to the secrecy the banks maintain over costs and prices, and the Act may require that derivative costs and prices are revealed to all participants. The Act also calls for a body (OFR) mandated to watch cross-border financial flows and shadow banks.

The Dodd-Frank Act is a massive piece of legislative with many moving parts. Congress, especially the Republican controlled House, will continue to monitor heavily the regulator's rule making implementation of the Act. Firms must closely monitor the emerging picture of Dodd-Frank implementation as studies are completed and as rules are proposed, amended, and adopted. Financial service organizations will need to review and adjust their business strategies and assess the costs and opportunities associated with the emerging regulatory reform. Cutter Associates will keep you abreast of new and interesting developments concerning the impact on your business and responsibilities in the operations and technology areas. You should also periodically visit the treasury FSOC website or the SEC website for updates and significant events concerning the Dodd-Frank implementation.