DODD-FRANK BILL

A YEAR AND A HALF LATER

VIEWS FROM THE HEDGE FUND INDUSTRY

EISNERAMPER
ACCOUNTANTS & ADVISORS

THOUGHT LEADERSHIP PAPER
In Conjunction
with the

HOFSTRA UNIVERSITY®
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School of Business

March 2012

LISBON
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INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection Act passed on July 21, 2010 has resulted in sweeping changes to the financial industry not seen since the financial reforms enacted after the Great Depression. It is estimated that the bill will result in nearly 400 rules and 87 studies before it is fully implemented.[1] Although the bill will affect all financial institutions, its impact on hedge funds is notable because these private funds have generally been able to claim exemptions to the four major regulations imposed in the 1930s.

- Hedge funds are not subject to the Securities Act of 1933 because they do not engage in public offerings.
- Furthermore, these funds do not fall under the perview of the Securities and Exchange Act of 1934 because they are not publicly traded companies.
- Because hedge funds are not mutual funds that solicit funds from the public, they are not subject to the Investment Company Act of 1940.
- Finally, because they offer investment advice only to private clients, they are not subject to the Investment Advisers Act of 1940.

The sizable growth of hedge funds over the last two decades has regulators wary of their potential to create systemic shocks to the whole financial system. Although the financial crisis in 2008 was not the result of hedge fund activity, their potential to contribute to a similar crisis prompted the new legislation. Hedge funds recognize the dilemma – without regulation a few risky funds could jeopardize the whole financial industry. Yet, heavy-handed regulation can also stifle the innovative and entrepreneurial spirit that characterizes hedge funds. Their investors, including pension and endowments funds, have become considerably more cautious prompting increased demands for greater information and transparency.

1 Dodd-Frank progress report, Davis Polk, 2011.

Unquestionably, hedge fund activity is beneficial to the strength and stability of global financial markets. These institutions provide deep market liquidity and, by taking on risks that are shunned by traditional funds, are instrumental in pioneering new financial instruments and strategies. However, their contribution could be jeopardized if regulation is not well crafted or investor demands become too burdensome. This thought paper seeks the opinions of hedge fund managers on The Dodd-Frank Wall Street Reform and Consumer Protection Act, its impact on their organization and the future of the hedge fund industry.

EXECUTIVE SUMMARY

The key findings include:

1. The registration requirements contained in the Dodd-Frank Bill are not considered onerous, especially because larger funds have independently elected to become registered.

2. The increased threshold for accredited investors to invest in hedge funds was viewed favorably by most respondents.

3. Hedge fund managers surveyed are not particularly concerned about the creation of the Federal Stability Oversight Committee to monitor their industry, but they were not convinced that providing trading and other information to regulators would necessarily help them detect future systemic risks.

4. The Volcker Rule, which prohibits banks from engaging in proprietary trading, was generally viewed favorably.

5. A majority of the hedge funds surveyed agreed that the settlement of swap contracts should be conducted by a clearinghouse.

6. Hedge funds are concerned about European legislation such as a regulation being considered to limit financial remuneration. However, they favored the single passport provision that would allow hedge funds to operate throughout the European Union with one license.

7. Investor demands for information have increased considerably especially with regards to the due diligence process, risk management procedures and reporting requirements.

8. Hedge funds expect their operational costs to rise as a result of these new regulations and greater investor demands.

9. Future changes to the organizational structure of hedge funds will focus on the ability to more accurately monitor investment, liquidity and counterparty risks and provide greater transparency for investors.

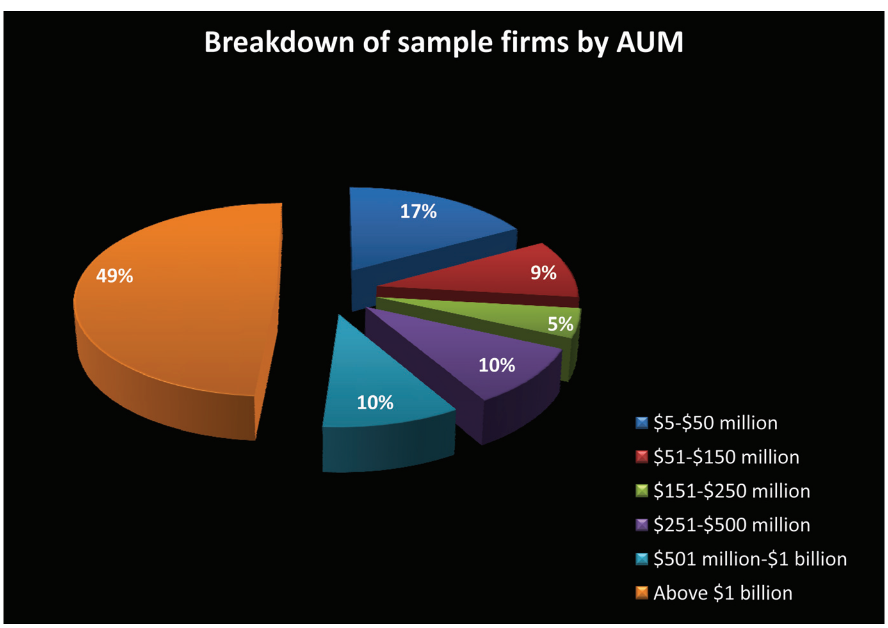
ABOUT THE RESEARCH

The survey was conducted by in-depth phone interviews of 12 senior managers of hedge funds and asset management firms plus 29 detailed email surveys also completed by senior hedge fund executives. Those at the asset management firms had either direct or indirect experience with hedge funds. The in-depth interviews provided the opportunity to ask follow-up questions and gain clarity, considerably strengthening the conclusions of this study. The graphs presented in this paper are based on all 41 responses. For the most part, the results of the interviews and mail-in surveys are consistent.

We begin with a breakdown of the sample which shows a heterogeneous group of firms, ranging from small to large funds engaged in both single and multiple strategies.

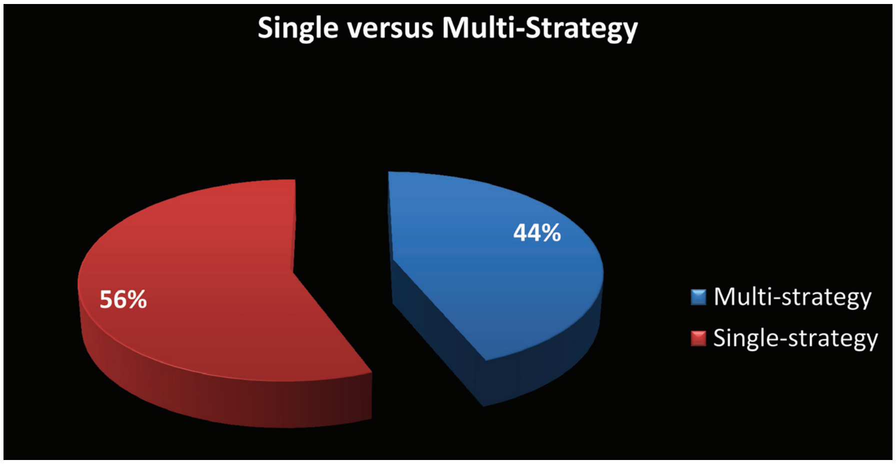
Size: Twenty of the respondent firms (49%) had assets under management (AUM) that exceeded $1 billion while the remaining 21 firms (51%) had assets under management of less than $1 billion. Of the latter group, ten firms reported assets in the $5-50 million category and eight reported assets above $250 million, providing a well-distributed range of firms by size. Figure 1 shows the breakdown of sample firms by AUM.

Figure 1



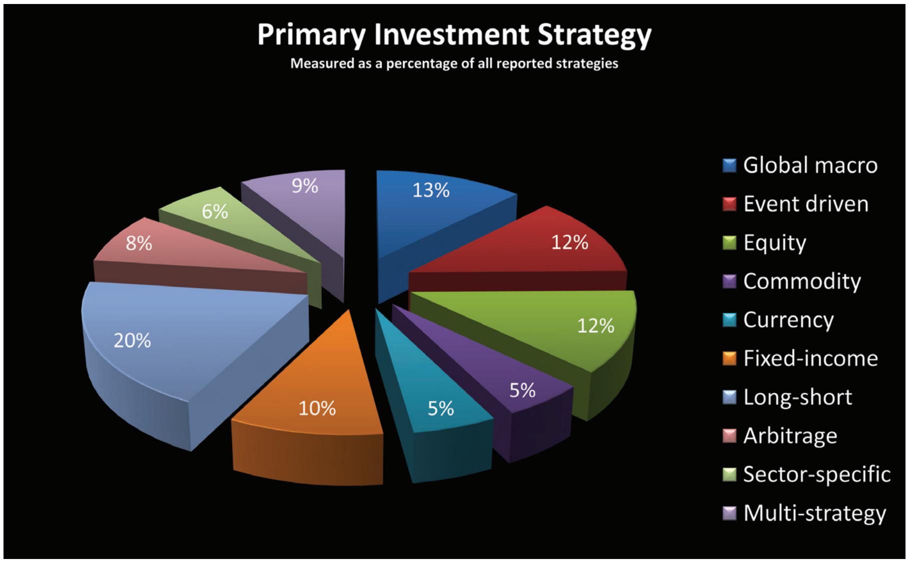
Strategy: Twenty-three of the firms specialized in a single asset class, nine of which were firms with assets greater than $1 billion. The remaining firms were engaged in multiple strategies. Figure 2 shows the breakdown of respondents by their utilization of single versus multiple strategies.

Figure 2



The investment strategies of the firms covered a wide range of activities and included long-short funds, global-macro, fixed-income, commodity, arbitrage, event-driven and sector- specific strategies.

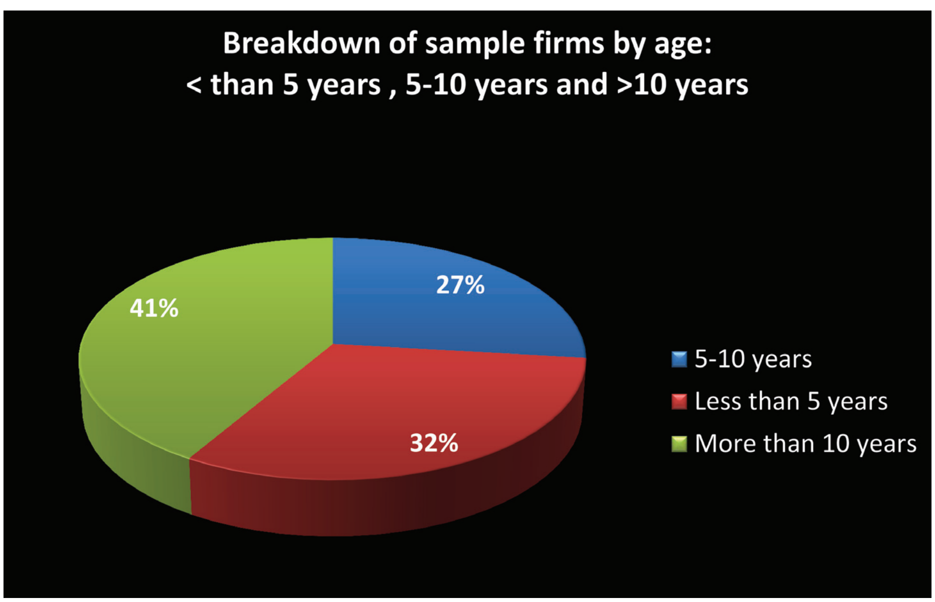
Figure 3



As indicated in Figure 3, the largest group identified long-short as one of their strategies (22 firms) followed by global-macro, event and equity strategies (14 firms for each category).

Hedge funds accounted for the bulk of the firms (31 firms) while the rest were asset management firms (7), two large banks and one commodity trading advisor with assets under management. Of the total sample, four firms were located outside the United States (Bahamas, Switzerland, Canada and the United Kingdom) although all had offices in the United States. Twenty-seven of the funds were located within the New York/ New Jersey/Connecticut region and the rest were from California, Texas and Massachusetts. All the respondents were senior managers and their designations ranged from CEO, CFO, General Partner, Chief Risk Officer, Controller, Portfolio Manager, Chief Compliance Officer and Director. More than two-thirds of the firms have been in existence for over five years with 41% over ten years. Figure 4 shows the breakdown of sample firms by age.

Figure 4



For both the in-depth interviews and email survey, the questions were divided into two sections. The first section focused on the impact of the Dodd-Frank Bill that was implemented as a response to the crisis by lawmakers and regulators. The second section examined the impact on the industry as a result of heightened investor concerns following the financial crisis of 2008 and amid reports of large risk-taking by financial institutions.

This report is authored by Anoop Rai, Professor, and Gioia P. Bales, Associate Dean of the Frank G. Zarb School of Business at Hofstra University. The survey, analysis and project was underwritten by EisnerAmper LLP. Christian Bekmessian, Tax Partner and Co-Head, Financial Services Group and Nicholas Tsafos, Audit Partner, Financial Services Group, assisted in this project.

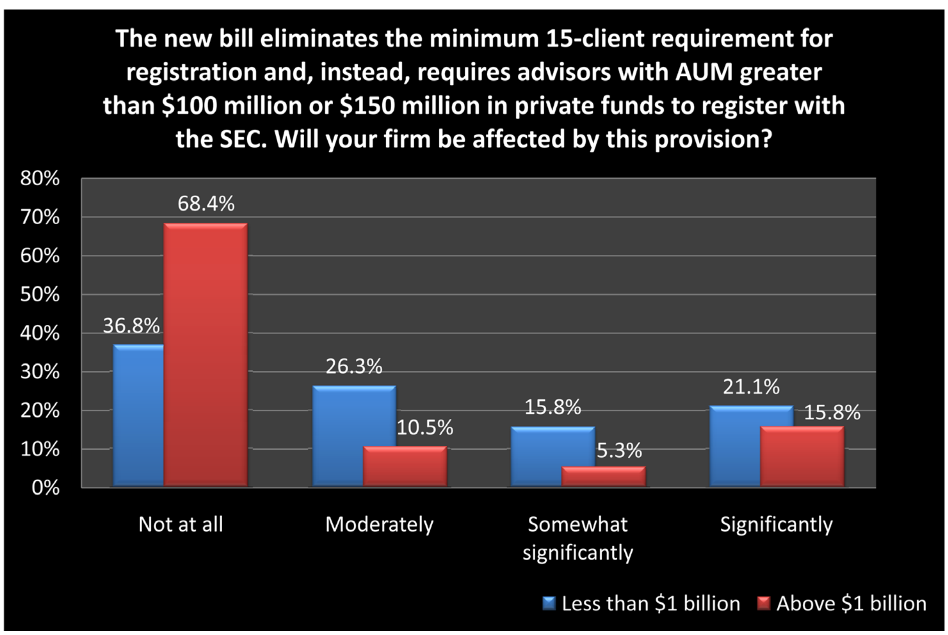
RESULTS

The first set of questions relate to the implementation of the Dodd-Frank Bill and focuses specifically on the provisions affecting the hedge fund industry. Our report will use the term "large funds" to denote firms with AUM of greater than $1 billion and "small funds" for firms with AUM less than $1 billion. The respondents' data displayed in the following graphs are categorized by size of AUM as indicated previously.

Registration requirements

The new provision requires funds with assets greater than $150 million to register with the Securities and Exchange Commission (SEC). Figure 5 displays the reaction of respondents to the following question: Will your firm be affected by this provision?

Figure 5



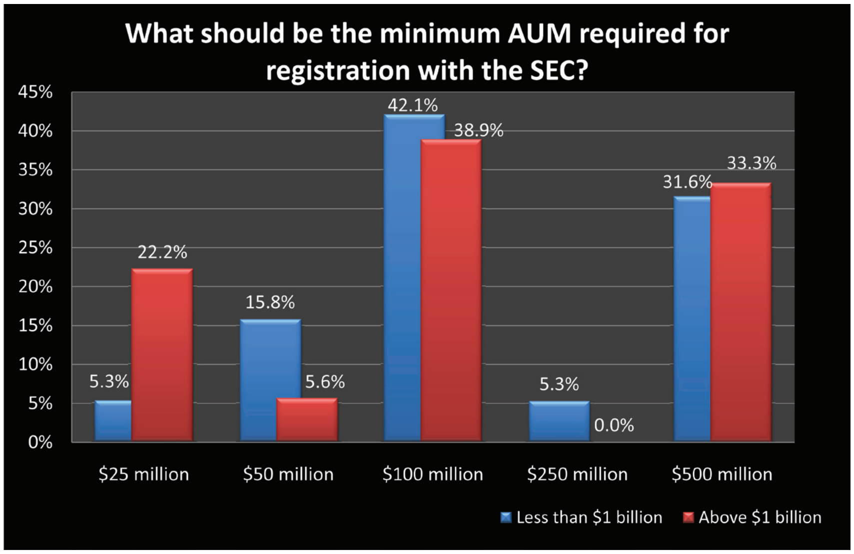
Over 68% of the large firms surveyed reported that this provision would not impact their firm. This result is expected as most of these large firms are already registered with the SEC. In contrast, only 37% of the small firms reported no impact.

Over 63% of the small firms state that the provision would moderately to significantly impact their operations.

> *Start up firms will need significantly more capital to launch. Smaller hedge funds will be at a competitive disadvantage.*
>
> FROM THE RESPONDENTS: CFO, LARGE NEW YORK-BASED HEDGE FUND

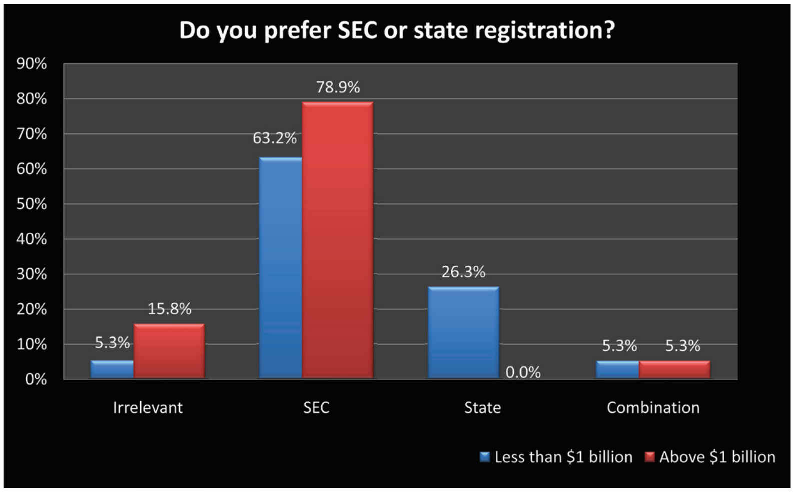
Over 75% of all respondents indicated that firms with $100 million or greater in assets should be subject to registration, with one-third reporting a minimum of $500 million. Approximately 22% of the large firms also recommended that firms with $25 million should register with the SEC while only 5% of the small firms recommended registration for these institutions (see Figure 6).

Figure 6



As shown in Figure 7, the majority of survey respondents preferred SEC over state registration. The larger firms were particularly adamant with close to 80% favoring SEC registration compared to 63% of the small firms. Just over one-quarter of the smaller firms indicated a preference for state registration while none of the larger firms preferred registration at the state level.

Figure 7



Observation: Hedge funds do not appear to be concerned about the registration provisions in the Dodd-Frank Bill except to indicate a preference for registration with the SEC rather than the individual states.

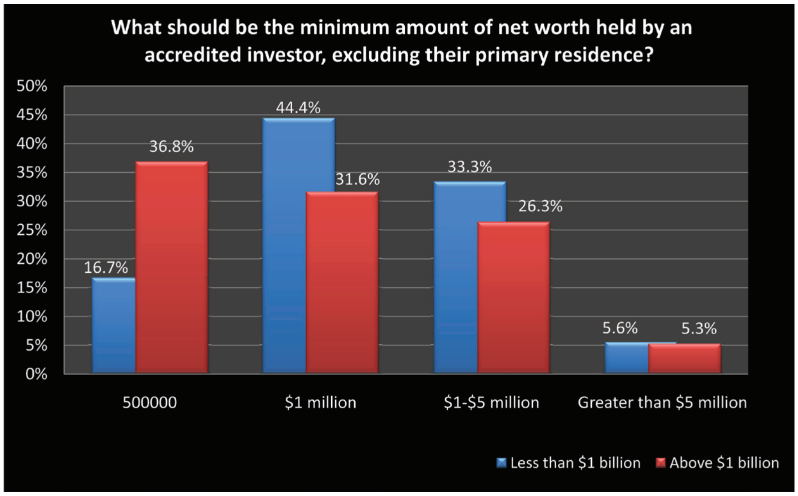
However, with the exception of a few smaller institutions, respondents indicated that the difference between SEC and state registration was not expected to impact their firms.

> *The registration process is a big yawn. Our fund has been registered since its inception. Registration with the Securities and Exchange Commission makes investors more comfortable with hedge fund investing. Registration with the SEC is actually helpful and we see it as a cost of doing business.*
>
> From the respondents: Senior Vice President, large New York-based hedge fund

Restrictions on Investors

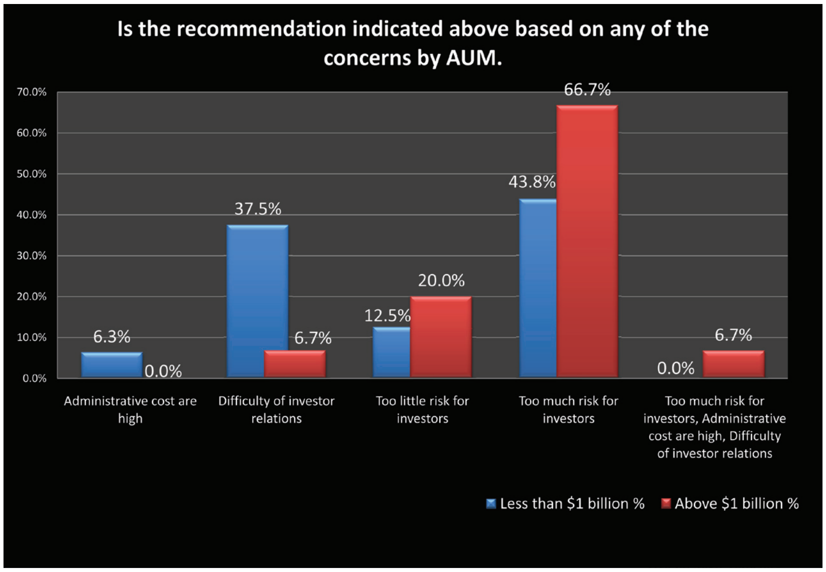
The next set of questions focused on the impact of the bill on hedge fund clients. The Dodd-Frank Bill requires accredited investors to own assets of $1 million, *excluding their primary residence.* When asked what should be the minimum amount required of investors, the responses ranged from $500,000 to greater than $5 million, with the average around $1 million. Figure 8 displays the reaction of respondents to the following question: What should be the minimum amount of net worth held by an accredited investor, excluding their primary residence?

Figure 8



Smaller funds were more consistent with over 77% recommending that accredited investors hold at least $1-5 million in net worth. In contrast, there was greater variation among the larger firms with the greatest percentage of these respondents recommending a minimum of just $500,000 in net worth. As Figure 9 indicates, most respondents felt that the chief justification for raising this minimum threshold was the risk posed to small investors. This was especially evident with larger firms with 67% reporting this as the primary concern compared with just 44% of the smaller firms. Smaller firms also cited the difficulties in investor relations when servicing small clients.

Figure 9



The majority of firms reported that this provision would have little impact on their businesses, with the majority responding that less than 10% of their current clientele would be affected. The response was consistent for firms of all sizes with 83% of small firms and 87% of large firms reporting little to no effect on their client base.

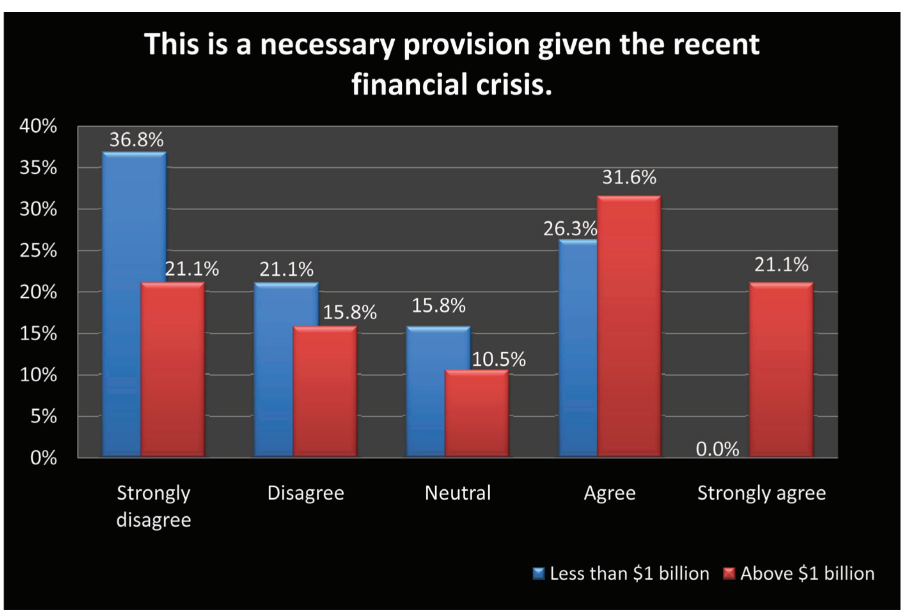
Supervision

A major change in the Dodd-Frank Bill is the authority granted to the Secretary of the Treasury and the Federal Reserve Bank to supervise hedge funds, a significant change as these investment vehicles are privately-held funds. The rationale for this provision was the tremendous growth in assets held by hedge funds over the last two decades. As a result, unidirectional trades by large hedge funds have the potential to create systemic shocks to the overall financial markets.

Figure 10 displays the reaction of respondents to this provision. Clearly, there is a dichotomy of opinion between large and small firms. Surprisingly, larger firms generally agreed that these provisions were necessary in the current financial environment. Of these larger firms, close to 53% agreed or strongly agreed while 11% remained neutral. In contrast, nearly 58% of the smaller firms disagreed or strongly disagreed with the necessity for this new provision.

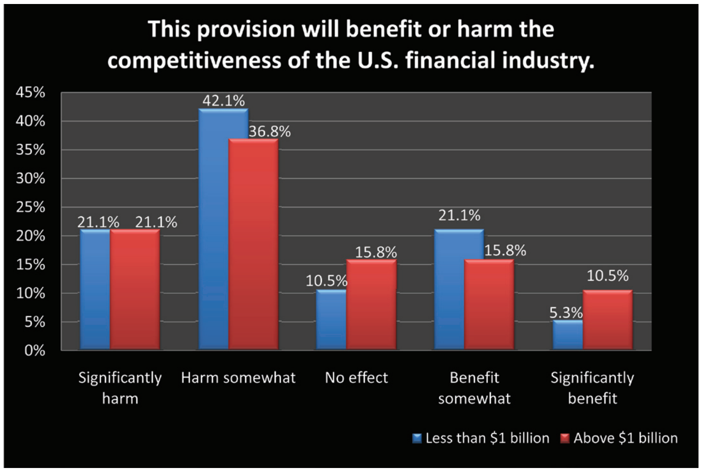
Observation: The increased threshold for investments in hedge funds by the Dodd-Frank Bill was considered favorably by the respondents with risk for the investors considered a primary reason for their approval.

Figure 10



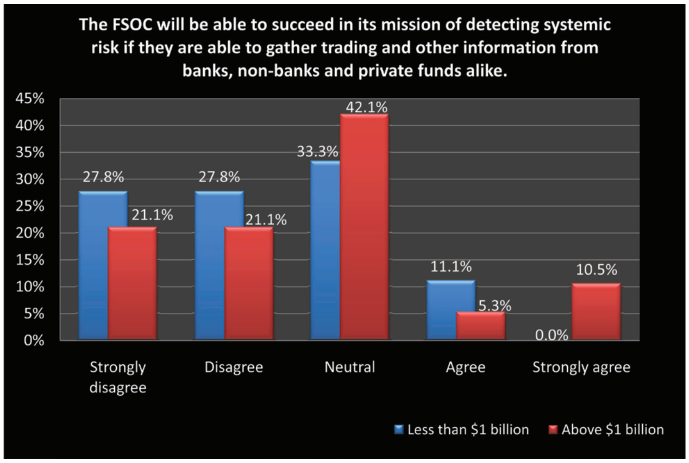
In contrast, there was more uniformity of opinion on the question of whether this new supervisory provision will harm the competitiveness of the U.S. financial industry. As Figure 11 shows, most respondents, including both large and small funds, were in agreement with approximately 63% of small firms and 58% of large firms stating that the new provision would somewhat or significantly harm U.S. competitiveness.

Figure 11



The respondents were skeptical whether efforts to prevent systemic risk by the creation of the Federal Stability Oversight Committee (FSOC) to collect trading data from a range of financial institutions, including hedge funds, would prevent systemic risk. Figure 12 displays the reaction of respondents to the question of whether the FSOC will be able to succeed in its mission of detecting systemic risk.

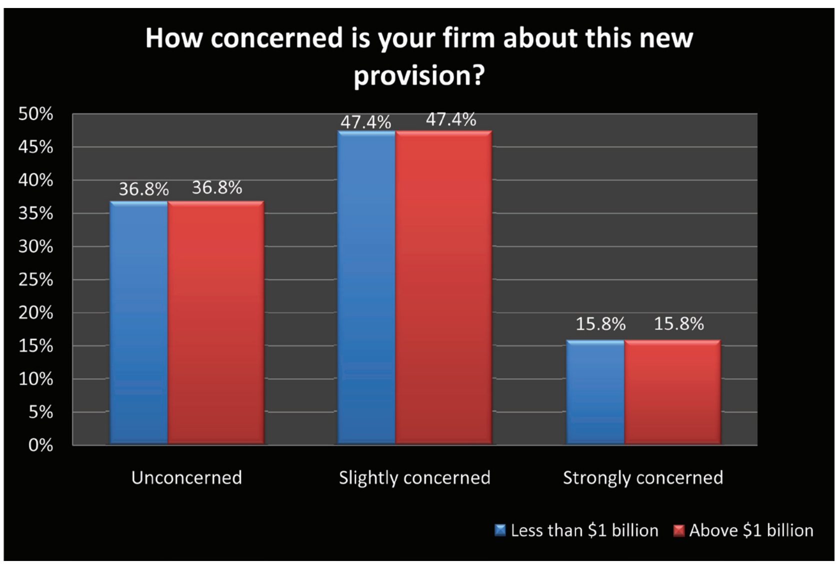
Figure 12



Similarly, opinions on the likelihood of the FSOC to achieve its goals were generally consistent. Over 55% of small firms and 42% of large firms disagreed or strongly disagreed on the ability of the FSOC to succeed in detecting systemic risk in the future. An additional 42.1% of large firms and 33.3% of small firms were neutral on this issue.

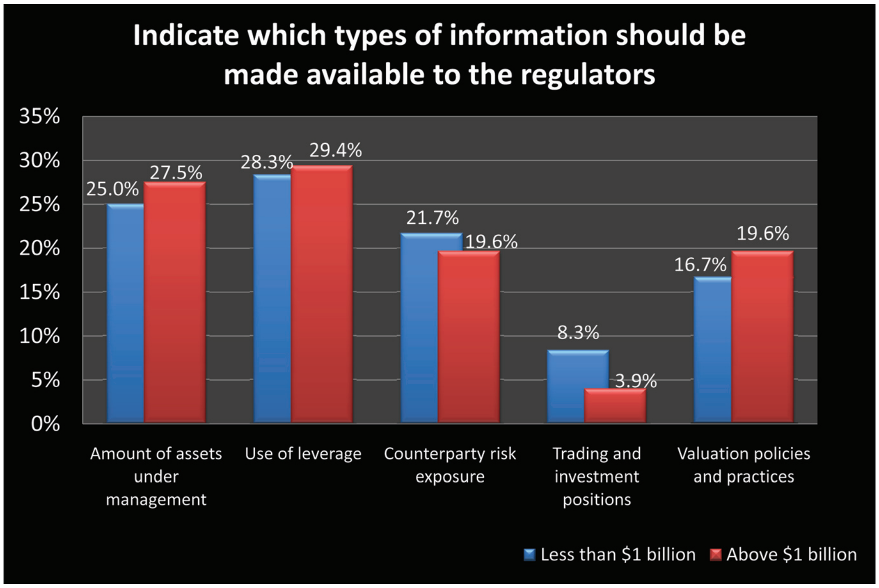
Likewise, both large and small firms appear unconcerned with the new supervisory landscape imposed by the Dodd-Frank Bill, with the majority responding that they were either unconcerned or partially concerned. Only 16% of all respondents were strongly concerned. This data is presented in Figure 13.

Figure 13



The type of data that should be made available to the regulators varied as indicated in Figure 14. However, there appeared to be a consistency of opinion between larger and smaller institutions. The greatest percentage of respondents, 28% of small firms and 29% of large firms, indicated that firms' use of leverage should be reported to regulators. Reporting the amount of AUM was the second most cited type of information that should be made available to the regulators, with approximately one-quarter of large and small funds. Likewise, 20% of large and small firms cited counterparty risk as important information to disclose to regulators.

Figure 14



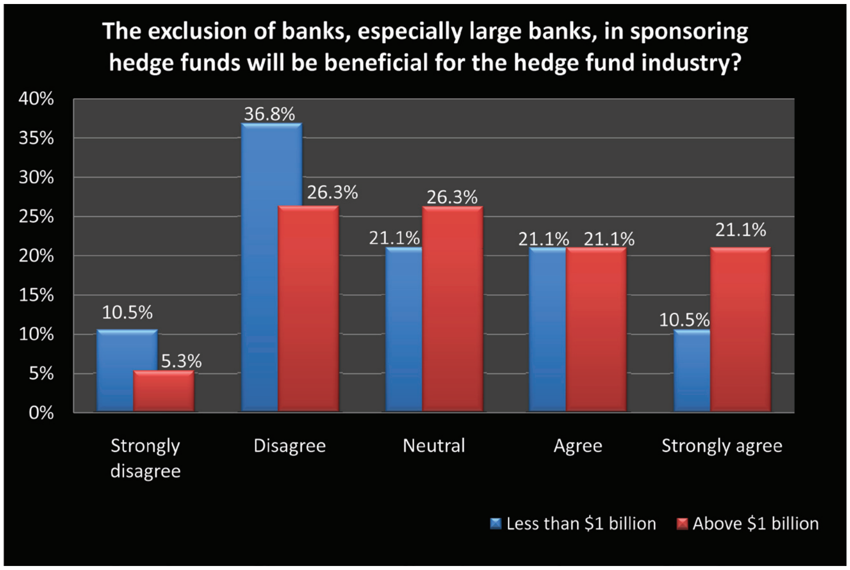
Note: Respondents could select more than one type of information. The percentages reported are the number of responses per choice divided by the total responses in the category.

> *We believe transparency is very important. However, we do not feel that the regulators will be able to detect systemic risk just through the collection of information. Our firm understands what the regulators are trying to do but questions if they are as knowledgeable as they should be.*
>
> From the respondents:
> CFO, small New York-based hedge fund

Provisions affecting trading strategies

The survey addressed other provisions in the bill that were enacted to prevent future systemic risks. This included the Volcker Rule which prohibits banks from engaging in proprietary trading and limits their investments in hedge funds and private equity funds to 3% de minimis investment.

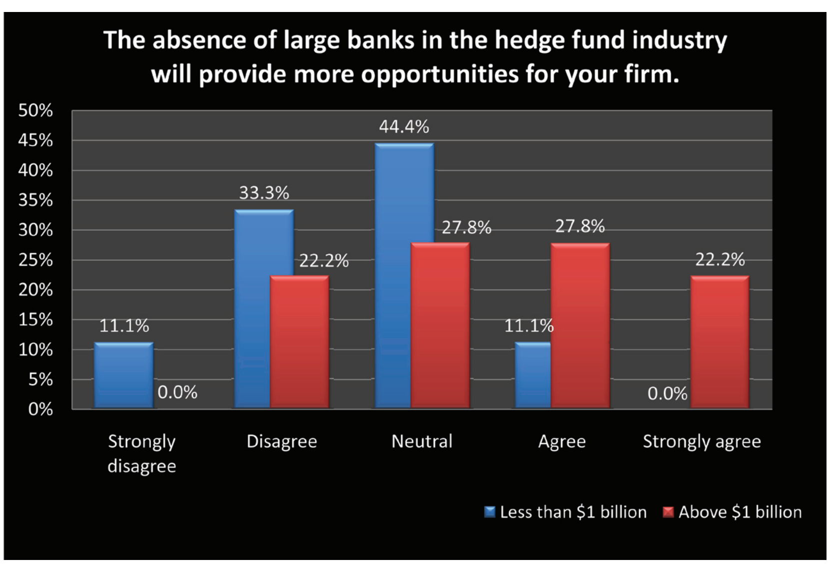
Figure 15



Figures 15 and 16 display respondents' reactions to the Volcker Rule. More large firms than small firms indicated that it was likely that the exclusion of banks would be beneficial to the hedge fund industry (42% versus 32%, respectively). Over 47% of smaller firms disagreed with this statement while a quarter of the respondents were neutral. "Interestingly, only 22% of the large firms and 44% of small firms disagreed that the Volcker rule would provide opportunities to them".

Observation: The results of the survey imply that both large and small firms expected to either be neutral or benefit from the Volcker Rule.

Figure 16



Banks were getting carried away. The Volcker Rule will definitely create more opportunities for hedge funds.

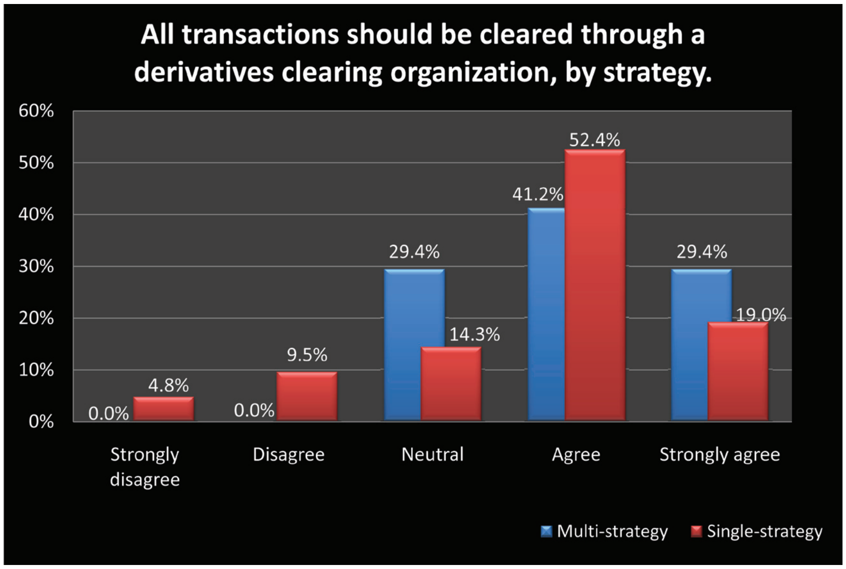
FROM THE RESPONDENTS:
CFO, LARGE NEW YORK-BASED HEDGE FUND

Observation:
The concern with counterparty risk may be the result of the recent financial crisis including the bankruptcy of Lehman Brothers and near default of Merrill Lynch, all once regarded as AAA-counterparty firms. Although willing to share counterparty risk information, respondents were less enthusiastic about reporting their valuation policies and practices. Additionally, very few were willing to provide information on their trading and investment positions.

Creation of derivatives clearinghouse

The Dodd-Frank Bill also calls for the movement of trading and settlement of many derivative contracts such as swaps, foreign exchange forwards and futures from over-the-counter to clearinghouses. Over 70% of the respondents agreed that this would be beneficial to the financial markets. It is important to note, however, that not all the respondents were involved in derivative transactions, with roughly 30% of the large firms and 47% of the small firms relying on derivatives as part of their trading strategies. Figure 17 displays the reaction of respondents to the question: All transactions should be cleared through a derivatives clearing organization.

Figure 17



Opinions were mixed regarding whether this provision will reduce the number of strategies involving swaps. In general, those firms not utilizing swaps did not believe that the creation of a clearinghouse would reduce derivative transactions. Opinions of hedge funds involved in derivatives were evenly split.

Most of the respondents agreed that it was appropriate to exclude foreign exchange swaps and foreign exchange forwards used for hedging purposes from the general definition of swaps, with only a few small funds, not utilizing foreign exchange, indicating disagreement. A majority of the firms used foreign exchange, at least occasionally, as part of their trading strategies.

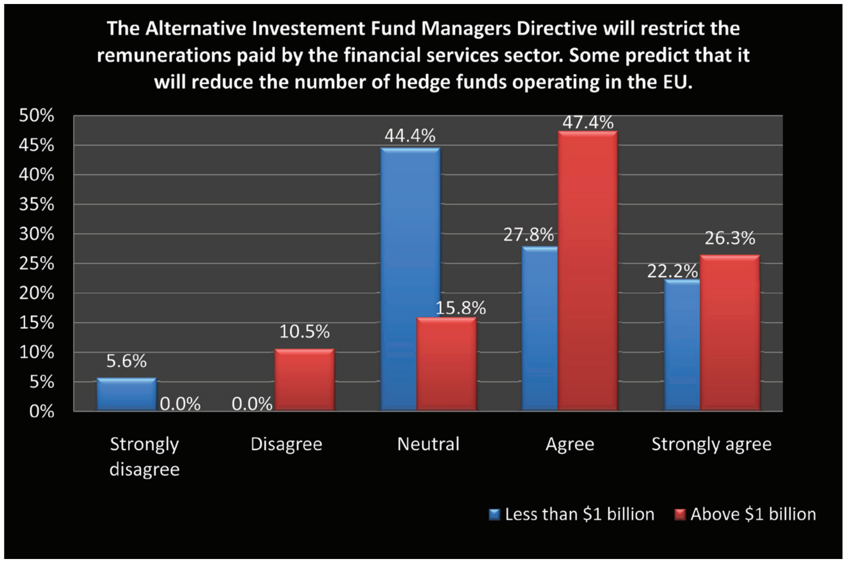
> *The creation of a central clearinghouse will impact price and push market participants away from using derivatives. The structure that the regulators are proposing does not fit the product. Futures are inherently different than credit default swaps.*
>
> From the respondents:
> Director, large New York-based hedge fund

Impact of European legislation

Because most hedge funds attract foreign capital and also engage in transactions with other countries, foreign regulations will affect their trading strategies. The survey addressed a few major proposals being considered by EU regulators. For example, the Alternative Investment Fund Managers Directive approved in October 2010 will restrict the remunerations paid by the financial services sector.

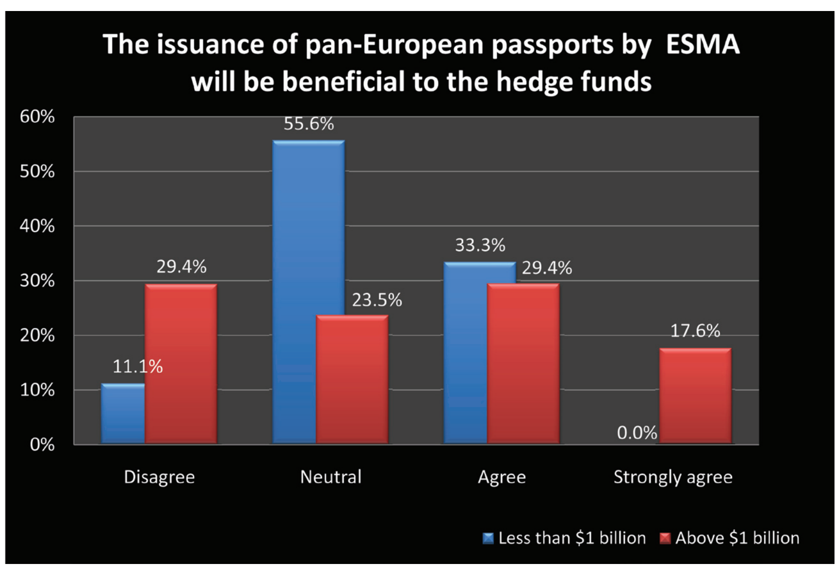
As indicated in Figure 18, most of the respondents agreed that this directive will ultimately reduce the number of hedge funds operating in the EU (50% of small firms and 73.7% of large firms). Figure 18 displays the reaction of respondents to the question: The Alternative Investment Fund Managers Directive will restrict the remunerations paid by the financial services sector. Some predict that it will reduce the number of hedge funds operating in the EU.

Figure 18



However, the responses were mixed on the new regulation by the ESMA that would issue pan-European passports for hedge funds to market throughout the EU under one license. Figure 19 shows that just under 50% of the larger firms agreed or strongly agreed that this passport will be beneficial compared to just one-third of the smaller firms. The greatest proportions of respondents were neutral.

Figure 19



The Dodd-Frank Bill and new European regulation is positive for the industry under the assumption that implementation is flawless.

FROM THE RESPONDENTS:
CEO, LARGE ZURICH-BASED ASSET MANAGEMENT COMPANY

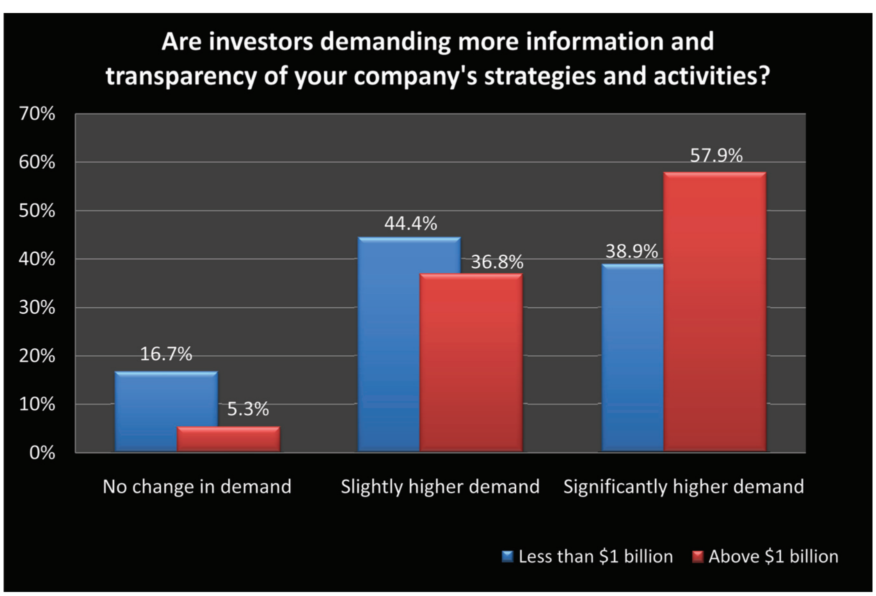
Heightened investor demands

The second part of the survey examines the impact on hedge funds of heightened investor awareness as a result of the recent financial crisis which exposed the lack of transparency of several major financial institutions.

Figure 20 displays the reaction of respondents to the question: Are investors demanding more information and transparency of your company's strategies and activities? Clearly, a majority of respondents indicated that investors were demanding more information on their company's strategies and activities. This was especially the case with larger funds. Nearly 58% of large firms and 39% of small firms reported that investors were demanding significantly more information. Only 17% of small firms and 5% of large firms found no change in the demand for information.

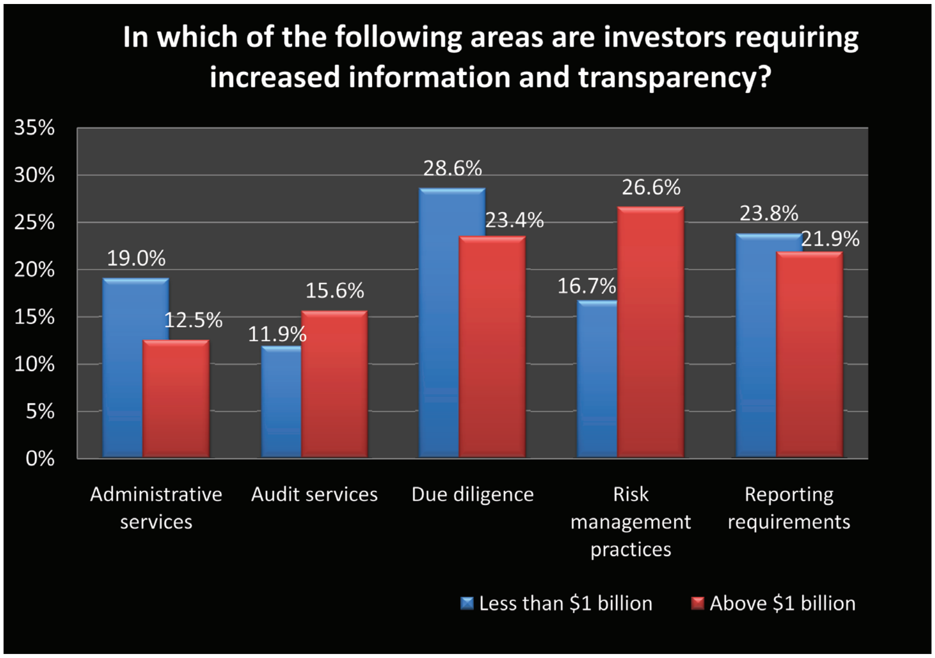
Observation: Most respondents agreed that the new regulations proposed by the EU will be burdensome and may reduce the number of hedge funds operating in Europe but the prospect of a single passport has appeal, especially among larger hedge funds.

Figure 20



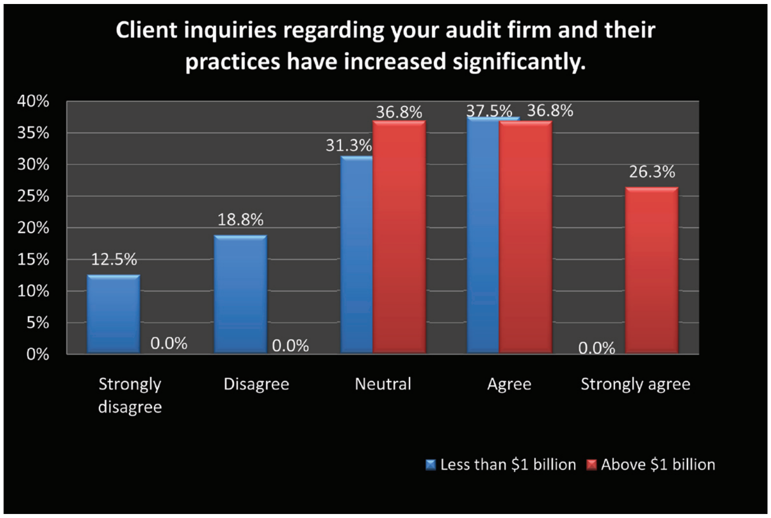
Large firms reported an increase in inquiries regarding their risk management practices, reporting and due diligence procedures while smaller firms reported due diligence and reporting as the most sought-after information by their clients (see Figure 21). Clients of larger firms appear less interested in obtaining information on administrative and audit services (13% and 16%) while information on audit services and risk management were the least demanded from smaller firms' clients (12% and 17%).

Figure 21



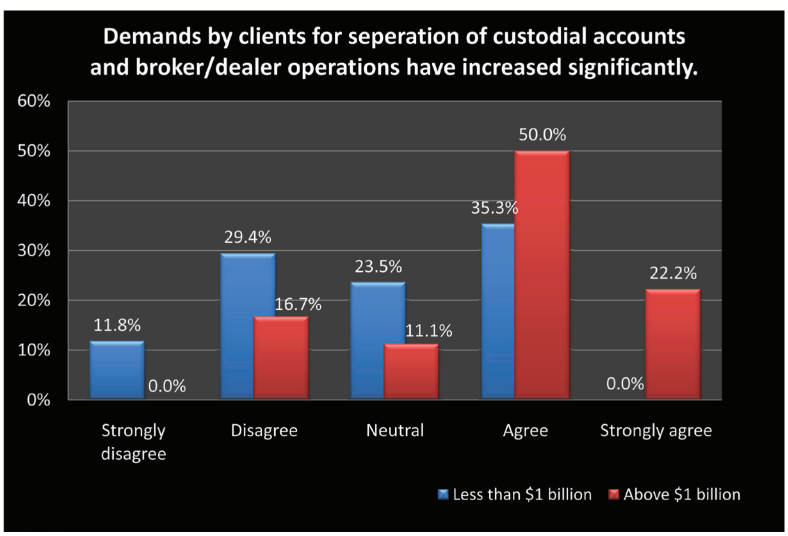
Investors, especially those in larger funds, are increasingly interested in information regarding the audit firm employed by their hedge funds. Over 60% of the larger firms reported an increase in demand for information about their audit firms compared to 38% by the smaller firms. Figure 22 displays the reaction of respondents to the statement: Client inquiries regarding your audit firm and their practices have increased significantly.

Figure 22



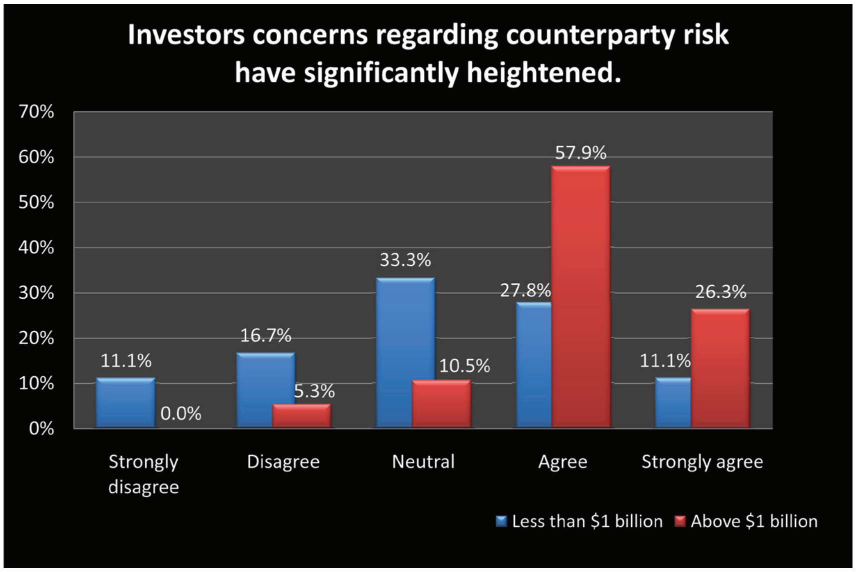
As demonstrated in Figure 23, demands by clients for separation of custodial accounts and broker/dealer operations have also increased more for larger rather than smaller firms (72.2% compared to 22.2%). This is a significant development and concern will probably increase further as a result of the MF Global crisis.

Figure 23



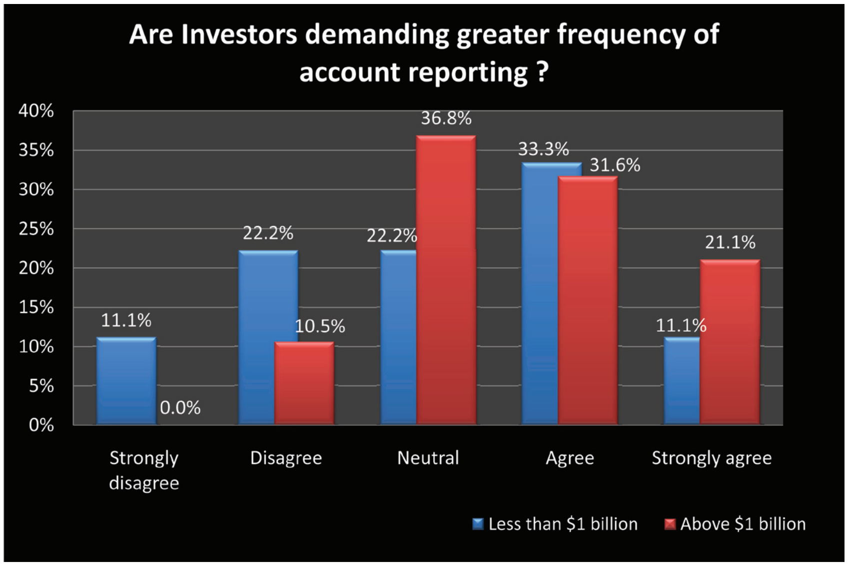
Likewise, larger hedge funds reported increased investor concerns regarding counterparty risks. Over 84% of the large funds acknowledged heightened concern compared to only 39% of the small firms (see Figure 24).

Figure 24



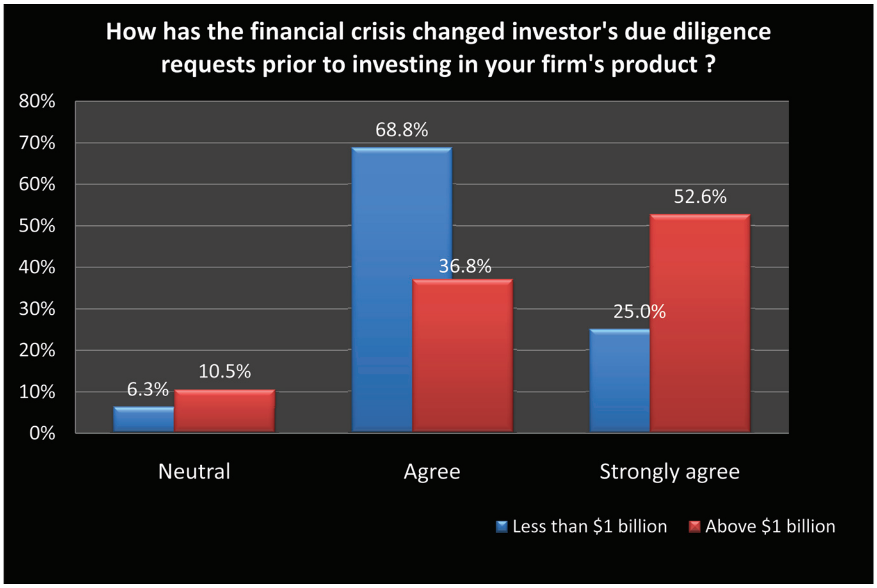
Just over half of the larger firms claimed that their clients are demanding more frequent account reporting compared to 44% of the smaller firms (see Figure 25).

Figure 25



In addition, the majority of the respondents agreed that the financial crisis has changed investor's due diligence requests prior to investing in the firm. Figure 26 displays the reaction of respondents to the question: How has the financial crisis changed investor's due diligence requests prior to investing in your firm's product?

Figure 26



When everyone was making money, due diligence was non-existent. Today, investors are less willing to give away a dollar. We have one client that asked for weekly performance numbers.

From the respondents:
CFO, small New York-based hedge fund

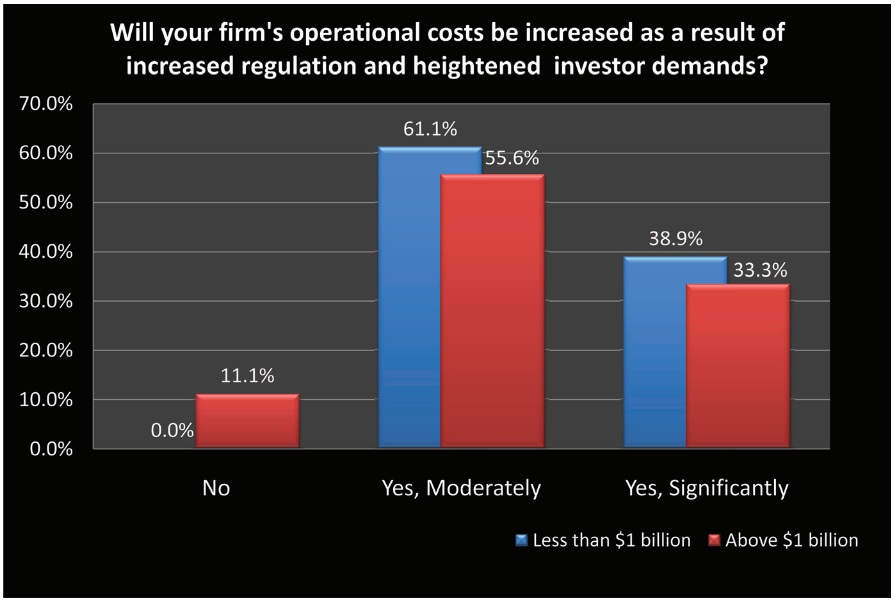
Observation: Investors are demanding more information from their fund managers, especially on the hedge funds' due diligence procedures, risk management practices, counterparty risks and account reporting. This heightened investor scrutiny can be attributed to the recent financial crisis.

Changes in organizational management

In the final section of the survey, hedge fund managers were queried about changes in operational strategies, including the outsourcing, of some or all of their back office operations, necessitated by the increase in regulatory oversight mandated by the Dodd-Frank Bill and the substantial rise in client inquiries.

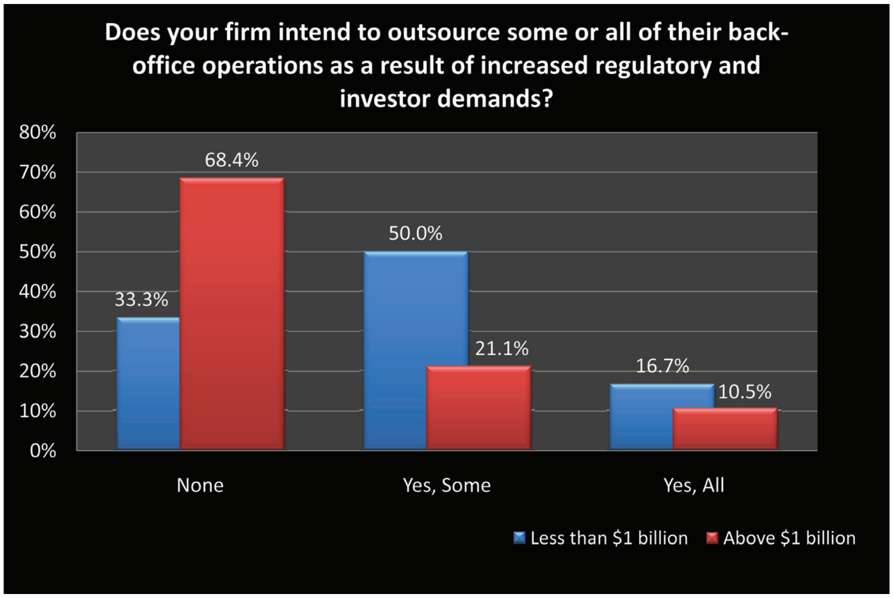
As illustrated in Figure 27, the costs associated with regulatory compliance, and the consequent impact on profitability, is a major concern of hedge fund managers. Without exception, all of the large firms surveyed expect costs to increase, either moderately or significantly, as a result of heightened regulation and investor demands. A majority of smaller firms also reported the same, with the exception of 11% of these firms expecting no increase in costs.

Figure 27



Opinions regarding the outsourcing of back office operations are mixed, with half the respondents stating an outsourcing of some, if not all, of their back-office operations is expected. Smaller firms were more likely to outsource some of their back office functions than larger companies. Figure 28 displays the reaction of respondents to the question: Does your firm intend to outsource some or all of their back-office operations as a result of increased regulatory and investor demands?

Figure 28

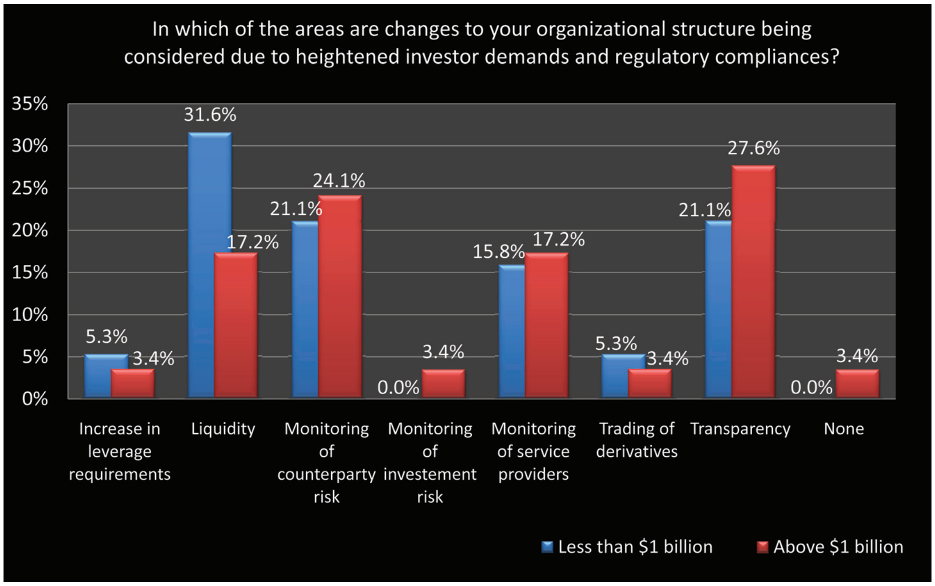


Our firm outsources the compliance function. We find this very beneficial.

FROM THE RESPONDENTS:
CFO, LARGE NEW YORK-BASED HEDGE FUND

Clearly, as shown in Figure 29, hedge fund managers anticipate changes in the organizational structure of their firms in this new regulatory era. Respondents cited changes in liquidity and transparency as the key focus areas within their organizations. Procedures involving the monitoring of counterparty risk were also indicated as a potential area for change in their organizations. Monitoring of investments received the lowest response rate. Interestingly, none of the smaller firms and only 3% of the larger firms indicated that no changes in their organizational structure were anticipated.

Figure 29



CONCLUSION

The ramifications of the sweeping reforms called for in the Dodd-Frank Wall Street Reform and Consumer Protection Act are not yet clear one and a half years since its approval. The complexity of the act combined with the diversity of impacted financial institutions present staggering challenging for regulators. In addition, political factors exacerbated by the 2012 election will undoubtedly complicate implementation further. As the United States struggles with a historic deficit, budgetary constraints may also hamper regulators. "As of December 2011, only 74 of the expected 400 rules have been finalized. This is reassuring, however, as these are important rulings and should be made only after thorough discussions and vetting with all the affected parties, "according to Anoop Rai, professor of Finance at the Zarb School of Business at Hofstra University.

The survey conducted by the Center for International Financial Services and Markets of the Zarb School of Business in conjunction with EisnerAmper LLP highlights the importance of this historic legislation on hedge funds, an industry once spared from significant regulatory oversight. As most hedge funds, especially larger institutions, are already registered, this aspect of the bill is not expected to present difficulties. However, most institutions expect operating costs to rise as structural changes are implemented to effectively deal with increased reporting requirements and client inquiries. "The results of the survey are consistent with our observations. As more final rulings are announced, hedge funds are beginning to recognize the value of reorganization and outsourcing," comments Nicholas Tsafos, Audit Partner, Financial Services, EisnerAmper LLP.

Indeed, 2012 will be an important year for hedge funds as these institutions adapt to a new regulatory landscape. Although smaller funds may be at a disadvantage as start-up costs increase, hedge funds are expected to remain resilient and continue to innovate – the hallmark of this industry.

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