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Regulation

Assessing the impact of Dodd-Frank 5 years later

Industry still feels fallout from sweeping reform law

It's been five years since President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act, a far-reaching law enacted after the 2008 financial crisis that aimed to stave off future economic meltdowns.

The act launched a sweeping overhaul of the U.S. financial regulatory system, and, among other things, created an oversight committee to evaluate systemic risk, bolstered oversight on executive compensation, and added the Volcker rule, a part of which, effective July 21, restricts U.S. banks from making certain kinds of investments. Among the many changes in the investing world, the act required centralized clearing of standard over-the-counter interest-rate and credit-default swaps. It spurred the rise of alternatives managers. And it prohibited banks from engaging in short-term proprietary trading.

Suffice to say, rule-making continues in an effort to implement its many provisions.

To gauge the impact of the law, *Pensions & Investments* reporters reached out to regulators, architects of the bill, money managers, plan executives and others about its effect on institutional investing, banking and markets. Their comments, provided in e-mails and in interviews, have been edited for space and clarity.

AP Photo/Charles Dharapak

HISTORY: Sen. Christopher Dodd and Rep. Barney Frank witnessed adoption of the law.

Are we better off?

At a recent talk, former Sen. Christopher J. Dodd summed up the impact as such: "Today, the economy is doing well. Leverage is better. Transparency in the derivatives market is much better."

Because of the Financial Stability Oversight Council, Mr. Dodd said, "we now have the ability to kind of spot the kind of activity (that puts the system at risk). Clearly we are in far better shape than we were, around the world."

Is the council working the way former Rep. Barney Frank of Massachusetts envisioned? "I think they should look at the (big financial institutions)," Mr. Frank said. "There might be the need to break some of them up."

Kurt Schacht, New York-based managing director of the CFA Institute's standards and financial market integrity division, noted: "For an industry that was not really the major culprit in the financial crisis, Dodd-Frank came down like a ton of bricks on investment management.

"There has been an inordinate amount of the regulatory fallout, but (the industry) has weathered it and has emerged stronger.

"As far as a safer system, I am convinced the too-big-to-fail banks pose as great a risk today as they ever have. Becoming bigger and even more complex is hardly a solution."

In a release, SEC Chairwoman Mary Jo White said that within a year of the legislation taking effect, the Securities and Exchange Commission began bringing greater transparency and oversight to hedge fund and other private fund advisers.

"The commission also established stronger standards for the clearinghouses that stand at the center of the global financial system and built an enhanced program for their supervision," Ms. White said.

"Dodd-Frank has done what it initially intended, which was to address issues that arose in the financial crisis, but it is not perfect," said Stacey Slaughter, partner in the New York office of law firm Robins Kaplan LLP.

Another plus, she said: "One of the biggest items for institutional investors is corporate governance … alignment of executive pay with performance and clawbacks."

Large money managers see Dodd-Frank differently, because the rules and exemptions are complicated, she said.

"My colleague says it's like the 'freshman 15.' You gain 'the Dodd-Frank 50' in terms of learning all the rules and exemptions, many of which have not been implemented yet," Ms. Slaughter said. "It's taken so much time and it's so cumbersome, many asset managers have found Dodd-Frank debilitating."

Bruce I. Jacobs, principal, Jacobs Levy Equity Management Inc., Florham Park, N.J., noted, "Financial regulators, like generals, are always fighting the last war. After the market crash of 1987, circuit breakers were introduced in the hope of restraining volatility in the U.S stock market. These did not prevent market breaks in 1989, 1991 or 1997."

After the collapse of Long-Term Capital Management LP in 1998, "international regulators … publicized numerous guidelines designed to improve bank lending standards and rein in hedge fund leverage," Mr. Jacobs said. "These did not help us avoid the credit crisis of 2007-'08. The next financial crisis is just as likely to arise outside the banking sector as inside it."

Anne Simpson, director of global governance for the California Public Employees' Retirement System, Sacramento, said the $302.2 billion fund is a strong supporter of Dodd-Frank.

"Effective regulation is essential to address systemic risk," Ms. Simpson said.

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"CalPERS considers that smart regulation needs to be comprehensive, to ensure all market actors are covered, to be proportionate so that it allows market participants to play their proper role, and it needs to be coordinated, within and across borders."

Upping focus on risk

William R. Atwood, executive director of the Chicago-based Illinois State Board of Investments, which oversees $15.7 billion in defined benefit assets for three state retirement systems and $4.1 billion in defined contribution assets for the 457 Illinois State Employees' Deferred Compensation Plan, said the law has put more attention on risk.

"The good news about institutional investors around Dodd-Frank shows the system is much more attuned to risk than it used to be," Mr. Atwood said. "Regulators are paying more attention, investment managers are paying more attention to risk and we are more attentive to risk."

But "as the economy recovers and (the 2008 financial crisis) gets further in the rearview mirror, the question is how vigilant will we remain."

"While most of the Dodd-Frank Act is directed at specific problems exposed by the crisis, the act does attempt to deal with systemic risk," noted Mr. Jacobs of Jacobs Levy Equity Management.

"In particular, tougher capital requirements (in some cases, beyond the mandates of Basel III standards) could reduce the potential for leverage-induced instability," he said. "The Financial Stability Oversight Council, with the support of the Office of Financial Research, has the ability to take a 'macroprudential' approach to the financial markets.

"Its purview spans banks, non-bank financial companies and any other entities, including insurance companies and hedge funds, that it deems to have the potential to pose systemic risks to the U.S. economy, as well as the various financial regulatory agencies of the government.

"Certain aspects of the law may benefit institutional investors," he continued. "Moving trading of over-the-counter derivatives, including credit default swaps, to clearinghouses has the potential not only to reduce counterparty credit risk, but to increase the availability of information about the type and volume of trading."

Taking stock

"While the additional regulation for banks (i.e. Volcker rule) did not change the fundraising environment or competition over deals for the private markets industry, it did lead to a significant increase in activity in the private equity secondaries market," said Kevin Lu, Singapore office head for Zug, Switzerland-based private markets investment firm Partners Group.

"This was a direct result of banks looking to shed assets in view of the additional capital requirements for 'risk-taking' activities. Partners Group has worked with a number of financial institutions globally on transactions related to such activities."

Those U.S.-led regulatory changes quite clearly had an impact on general lending activities among banks, leading to a decline in their lending activities for buyouts, he said. "As a result, the participation of institutional investors in the lending market via private markets funds is at record highs today globally."

Jon Dorfman, chief investment officer in the New York office of credit manager Napier Park Global, noted that it is hard to distinguish the market impact of Dodd-Frank from regulations like Basel III.

"Put together, they've resulted in a meaningful decline in trading volume, wider spreads … and it requires managers to be more thoughtful about liquidity provision to their investors," Mr. Dorfman said.

Napier Park executives expect the new regulations on the capital markets will inhibit larger financial crises, but they won't prevent more, smaller blips.

"Volatility will be increasing and we will be having more frequent instances of significant credit market movements (formerly two or three standard deviation events) but dramatic capital market sell-offs (formerly six or seven standard deviation events) will occur less frequently, due to regulation," Mr. Dorfman noted.

"Qualitatively speaking, credit markets are now like a safer car on a bumpier road," he added.

Jon Mansfield, partner at private equity firm Praesidian Capital in New York, is not pleased with Dodd-Frank.

"I think overall Dodd-Frank has been negative for the industry, specifically when it comes to fundraising," he said. "A meaningful amount of capital can no longer be deployed by investors in the asset class which historically came from banks."

Dodd-Frank and the regulations that come with it are having consequences in perhaps unexpected places, some noted.

For example, rules regulating money market accounts are affecting mergers and acquisitions of private equity portfolio companies, said Mark Vogel, co-CEO of San Francisco-based SRS Acquiom LLC, a firm that provides post-mergers and acquisitions services to alternatives investment firms.

Parties to a merger or acquisition typically deposit up to about 20% of the sales price in an escrow account during the transaction to cover unexpected costs or breaches. Many times this cash is invested in money market accounts, Mr. Vogel said. Banks don't want the cash in the form of a commercial deposit because under the Dodd-Frank regulations it is very expensive for banks to hold company cash, he said.

Under floating net asset value rules that take effect in October, parties in a money market fund will be taking on market risk they won't want to take. According to SRS Acquiom's data and model, the typical escrow lasts about 18 months.

"The money could go into a money market fund at $1 but 180 days later could come out at 98 cents (even though) escrow's role is to preserve and protect cash," said Mr. Vogel, whose firm has created a product for escrow investment that has an insurance wrapper provided by insurance company AXA. "The escrow contract typically says the money has to be available at a moment's notice. Money funds will become a non-viable product next year."

Debating Volcker rule

Some alternative investment managers say the Volcker rule is more of a benefit than a detriment to the capital markets.

"I think overall it (the Volcker rule) has been good. The idea that these banks can use proprietary capital and take outlandishly risky bets; that's how the economy was brought down," said Brendon Tyne, managing director who runs the North and South American business in the New York office of private equity and real estate fund administrator Augentius (US) Inc. "Being prudent with capital is mostly positive."

Still, "regulations can have unintended consequences," noted Mr. Jacobs of Jacobs Levy Equity Management. "New capital and leverage requirements under Dodd-Frank, as well as the Volcker rule, can have the unfortunate effect of moving risks from more regulated and transparent sectors, such as banking and insurance, to the so-called shadow banking system, where these risks may be more difficult to discern and control."

Yet, he noted, "there are also limits to the ability of markets to regulate themselves, which leaves a role for judicious regulation."

Shadow banking is not necessarily a bad thing, said Ms. Slaughter of Robins Kaplan.

"The official position by regulators is that shadow banking causes systemic risk to the global financial system," she said. "That is mostly because shadow banking is not transparent and not regulated, but I think there's some tension with that.

"Yes, we may need regulation on some of these activities. But shadow banking is supplying much-needed money to people in places and areas that are not getting what they need," Ms. Slaughter said. "And banks are not foolproof."

Dodd, Frank reflect

Reflecting on the law at a Better Markets event to mark the anniversary, Mr. Dodd noted: "$30 trillion of national wealth evaporated, and we are still seeing the effects of that today."

Added Mr. Frank, at the same event: "It has not kept America from having the best economy in the Western world. We did not ban anything except lending money to people for their homes that they couldn't pay back."

And what are the two former lawmakers' disappointments with their namesake law?

"To get the bill through we had to add risk retention in securitization in mortgages, we had to create what I thought was going to be small category for a small number of mortgage lenders. But that loophole — now there is no risk retention for residential mortgages," Mr. Frank said.

Added Mr. Dodd: "I regret not self-funding for SEC. That is the one thing that I do worry about to some extent."

P&I staffers **Arleen Jacobius**, **Douglas Appell**, **Hazel Bradford**, **Barry B. Burr** and **Randy Diamond** contributed.