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Dodd-Frank May Impose New Obligations on Managers of Large Hedge Funds and Plan Asset Hedge Funds that Enter into Swaps

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Placement agents, in-house marketers, data providers and others interviewed by the Hedge Fund Law Report have identified two salient trends in the current hedge fund capital raising environment: the "race to the top" and the growing importance of ERISA money. As discussed below, both trends highlight the importance to the hedge fund industry of a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act), enacted on July 21, 2010, relating to swaps with "special entities."

On the first trend: The race to the top refers to the fact – good for larger managers, not so good for smaller and start-up managers – that the lion's share of recent inflows have gone to the largest hedge funds. According to data provider Hedge Fund Research, Inc., 93 percent of the $9.5 billion of net inflows into hedge funds in the second quarter of 2010 went to funds managed by managers with more than $5 billion in assets under management (AUM). And that capital raising advantage is only enhancing the current distribution of assets in favor of larger managers. According to HFR, as of June 30, 2010, managers with $5 billion or more in AUM managed approximately 60 percent of total industry assets of $1.6 trillion. Moreover, HFR data as of June 30 showed that while 342 hedge funds with $1 billion or more in AUM comprised just 4.9 percent of the total number of hedge funds globally, they accounted for 76.1 percent of total industry AUM. While a full analysis of the reasons for this race to the top is beyond the scope of this article, a few of the reasons, in summary form, include the following: the renewed, post-crisis emphasis on hedge fund infrastructure, operations and compliance coupled with the ability of larger managers to invest more resources in those areas; the frequency with which larger managers are registered with or otherwise subject to regulation by government agencies, and the perception that regulation diminishes the likelihood of fraud (though Madoff is often cited to rebut this thesis); longer track records; more funds, and thus less reliance on a single fund or strategy; more personnel, and thus (presumably) less reliance on any one key person; risk aversion among decision-makers at institutional investors (for whom the personal downside of a bad investment decision is considerable while the personal upside of a good investment decision is often negligible); better-developed marketing and distribution systems; and survivorship bias (i.e., larger managers that had significant investment losses or redemptions are no longer larger managers). However, investors racing to the top may miss many of the more interesting hedge fund investment opportunities. According to research published by PerTrac Financial Solutions in February 2007 and updated to incorporate 2009 data, smaller, younger hedge funds appear to perform better, over longer periods, than larger, older funds.

And on the second trend: the Hedge Fund Law Report has and continues to analyze the growing importance of ERISA investors in hedge funds. See, for example, the Hedge Fund Law Report's three-part series on ERISA considerations for hedge fund managers and investors. The story here is essentially as follows: private sector pension funds are the most important category of ERISA investor. According to data provider Preqin, as of late 2009, private sector pension funds represented 14 percent of institutional investors in hedge funds and constituted the largest group of investors actively considering their first investment in hedge funds in 2010. Moreover, survey data released by Preqin on August 10, 2010 indicates that 29 percent of institutional investors plan to allocate more capital to hedge funds in the next 12 months while just 15 percent are looking to redeem, meaning the balance of inflows into hedge funds over the next year is expected to be positive. Preqin also found that 37 percent of institutional investors are planning to invest in new hedge funds in the next 12 months. Many of those new investments, often with new managers, will come from private sector pension funds and other ERISA investors. Accordingly, more hedge fund managers (by number and AUM) will become subject to ERISA in the near term. In anticipation of that trend, we have provided managers with a roadmap for accepting ERISA money without materially undermining their investment and operational discretion. See "How Can Hedge Fund Managers Accept ERISA Money Above the 25 Percent Threshold While Avoiding ERISA's More Onerous Prohibited Transaction Provisions? (Part Three of Three)," Hedge Fund Law Report, Vol. 3, No. 24 (Jun. 18, 2010).

In light of the importance of the race to the top and ERISA money to hedge fund capital raising, any legal provision that directly impacts larger hedge funds and hedge funds subject to ERISA (Plan Asset Hedge Funds) is of central importance to the industry. Dodd-Frank contains precisely such a provision. Specifically, Dodd-Frank will require a "swap dealer" or "major swap participant" that enters into a swap with a "special entity" to: (1) have a reasonable basis to believe that the special entity has an independent representative that, among other things, has sufficient knowledge to evaluate the transaction and risks; and (2) comply with certain business conduct standards. As explained more fully below, the definition of "major swap participant" in Dodd-Frank may include large hedge funds, and the definition of "special entity" in Dodd-Frank may include Plan Asset Hedge Funds. See "Hedge Fund Industry Practice for Defining 'Class of Equity Interests' for Purposes of the 25 Percent Test under ERISA," Hedge Fund Law Report, Vol. 3, No. 29 (Jul. 23, 2010).

To help explain the application of this "swaps and special entities" provision of Dodd-Frank to hedge fund managers, swap dealers and others, this article: defines the relevant terms, including a discussion of the extent to which those definitions may include hedge funds and hedge fund managers; offers examples of applications of the special entities provision in the hedge fund context; explains the mechanics of the "reasonable basis test" included in the statute; describes the business conduct standards; then analyzes the elements of the statutory reasonable basis test, including a potential "de facto best execution" standard included in the test.

Definitions and Applicability to Hedge Funds and Hedge Fund Managers

Dodd-Frank introduces a new regulatory framework for derivatives that includes definitions of key terms. Some of those definitions – for example, the definition of swap dealer – reflect current market practice and understanding, while other definitions – for example, the definition of major swap participant – introduce new concepts. As discussed below, certain aspects of the definitions relevant to this article are subject to further rulemaking which will clarify the extent to which hedge fund managers are included in or excluded from the definitions.

Swap Dealer

Title VII of Dodd-Frank defines a "swap dealer" as any person who: (1) holds itself out as a dealer in swaps; (2) makes a market in swaps; (3) regularly enters into swaps with counterparties in the ordinary course of business for its own account; or (4) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. The Act does not specify the conduct that would constitute a person "hold[ing] itself out as a dealer in swaps" or entering into swaps "in the ordinary course of business." Nor, curiously, does the Act require the SEC or CFTC (Agencies) to define these phrases by rule, though the agencies may define the phrases through other activities such as enforcement actions. Consequently, under a plain language reading of the statute, a hedge fund that regularly enters into swaps in its ordinary course of business may be deemed a swap dealer. However, sources polled by the Hedge Fund Law Report suggested that regulators are likely to use a definition of swap dealer that more closely follows the current market understanding of the term (and does not include hedge fund managers).

Major Swap Participant

Title VII of Dodd-Frank defines a "major swap participant" as any person: (1) who maintains a "substantial position" in swaps, excluding positions held primarily for hedging or mitigating commercial risk and positions held by employee benefit plans; (2) whose outstanding swaps create a "substantial counterparty exposure" that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (3) that is a financial entity that (a) is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate federal banking agency, and (b) maintains a substantial position in outstanding swap transactions. The Act directs the SEC and CFTC to define "substantial position," and the Act notes that in doing so, the Agencies may consider: (1) the person's volume of cleared (as opposed to uncleared) swaps (presumably the more uncleared swaps held by a person, the more substantial that person's position); and (2) the value and quality of collateral held to secure the person's position. The Act does not define "highly leveraged relative to the amount of capital." Sources interviewed by the Hedge Fund Law Report suggested that hedge funds (as opposed to hedge fund managers) may be characterized as major swap participants.

Special Entity

Dodd-Frank defines a "special entity" as a federal agency, a state, a state agency, a political subdivision of a state, an employee benefit plan, any governmental plan or any endowment. Accordingly, the definition of "special entity" under Dodd-Frank generally is broader than the definition of "benefit plan investor" under ERISA. For more detail on the definition of "benefit plan investor" under ERISA, see "How Can Hedge Fund Managers Accept ERISA Money Above the 25 Percent Threshold While Avoiding ERISA's More Onerous Prohibited Transaction Provisions? (Part One of Three)," Hedge Fund Law Report, Vol. 3, No. 19 (May 14, 2010).

Industry participants are sensitive to the possibility that Plan Asset Hedge Funds may fall within the definition of "special entity." Steven Rabitz, a Partner at Stroock & Stroock & Lavan LLP, explained that whether the Agencies will define special entity to include Plan Asset Hedge Funds "is uncertain right now. The definition clearly picks up employee benefit plans and government plans, but until regulations come out, it is unclear whether a fund that accepts benefit plan investors will also be included in the definition." Similarly, Leigh Fraser, a Partner at Ropes & Gray LLP, noted that "there is a risk" that plan asset hedge funds will be considered "special entities." And Mary Alcock, Counsel at Cleary Gottlieb Steen & Hamilton LLP, explained that although Plan Asset Hedge Funds are not explicitly included in the definition of "special entity" in the Act, the definition does include employee benefit plans and regulations may explicitly or implicitly include Plan Asset Hedge Funds.

Rabitz concluded that the Agencies may take one of three approaches on this question. First, they may follow the literal language of the statute and explicitly exclude Plan Asset Hedge Funds from the definition of special entity. Under this approach, employee benefit plans would be special entities, but hedge funds that are considered employee benefit plans for ERISA purposes would not be special entities. Second, the Agencies may follow ERISA, such that Plan Asset Hedge Funds would be considered special entities for purposes of the new derivatives regulation. Third, the Agencies can try to craft a rule between the two poles, but as Rabitz pointed out, any such rule presumably "could raise implementation challenges."

Examples of Applications of Special Entities Provision in the Hedge Fund Context

Assuming for purposes of this analysis that large hedge funds may fall within the definition of major swap participant (or even, though it is less likely, of swap dealer) and that Plan Asset Hedge Funds may fall within the definition of special entity, the special entities provision of Dodd-Frank may apply in the hedge fund context in the following circumstances:

- A large hedge fund (major swap participant or possibly swap dealer) enters into a covered swap with a small Plan Asset Hedge Fund (special entity).
- A large hedge fund (major swap participant or possibly swap dealer) enters into a covered swap with an endowment (special entity).
- A large hedge fund (major swap participant or possibly swap dealer) enters into a covered swap with a municipality (special entity).
- A traditional swap dealer (swap dealer under the statute or future regulation) enters into a covered swap with a small Plan Asset Hedge Fund (special entity).

Reasonable Basis Test

A swap dealer or major swap participant will have to comply with rules to be promulgated by the Agencies requiring a swap dealer or major swap participant to have a reasonable basis to believe that the special entity has an independent representative (in the hedge fund context, the independent representative would be the hedge fund manager) that:

1. Has sufficient knowledge to evaluate the transaction and risks;
2. Is not subject to statutory disqualification;
3. Is independent of the swap dealer or major swap participant;
4. Undertakes a duty to act in the best interests of the counterparty it represents;

5. Makes appropriate disclosures;
6. Will provide written representations regarding fair pricing and the appropriateness of the transaction; and
7. In the case of employee benefit plans, is a fiduciary within the meaning of Section 3(21) of ERISA.

Business Conduct Standards

In addition to satisfying the reasonable basis test, a swap dealer or major swap participant entering into a swap with a special entity will be required to adhere to certain business conduct standards, including:

1. Verifying that any special entity counterparty meets the eligibility standards of an eligible contract participant;
2. Disclosing information to the special entity counterparty about the material risks and characteristics of the swap and any material incentives, conflicts of interest and, upon request, daily marks of the transaction;
3. Communicating in a fair and balanced manner based on principles of fair dealing and good faith; and
4. Following all other standards and requirements established by the SEC or CFTC.

Analysis of Reasonable Basis Test

Broadly, the reasonable basis test may hit different hedge fund managers in two different ways. To the extent large hedge fund managers fall within the definition of major swap participant or, less likely, swap dealer, those large hedge fund managers will themselves have to satisfy the reasonable basis test. On the other hand, to the extent that Plan Asset Hedge Funds fall within the definition of special entity, such Plan Asset Hedge Funds will have to provide information to their swap counterparties sufficient to enable the counterparties themselves to satisfy the reasonable basis test. In practice, either way, the bulk of the burden is likely to fall on Plan Asset Hedge Funds to the extent they are characterized the special entities for purposes of the provision. This is because major swap participant or swap dealers who may be counterparties to special entities likely will only enter into swaps with a special entity if the special entity provides all required data and information and represents and warrants with respect to the accuracy and completeness of such data and information. In other words, to the extent permissible within the scope of the Act and any regulations promulgated thereunder, major swap participants and swap dealers are likely to seek to shift the burden of any liability potentially arising out of violations of the Act or regulations thereunder to the special entity counterparty. Of course, if regulations promulgated by the Agencies explicitly prohibit such liability shifting provisions in swap documentation, the legal burden on Plan Asset Hedge Funds characterized as special entities would be relieved, but at the same time, such entities would have difficulty finding swap counterparties or would pay higher fees to those counterparties.

Written Representations Regarding Fair Pricing

The most contentious and potentially onerous aspect of the reasonable basis test is the provision requiring a swap dealer or major swap participant to have a reasonable basis for believing that the independent representative of the special entity counterparty will provide written representations to the special entity regarding fair pricing and the appropriateness of the transaction. This is the only provision of the reasonable basis test that has the potential to materially change current market practice, likely in a manner that makes it more costly and operationally cumbersome for Plan Asset Hedge Funds to enter into swaps. In effect, the "fair pricing" provision can impose on managers of Plan Asset Hedge Funds a de facto best execution obligation with respect to swaps. Arthur Kohn, a Partner with Cleary Gottlieb Steen & Hamilton LLP, explained that under current market practice, hedge funds generally enter into over-the-counter swaps with their prime brokers or affiliates of their prime brokers. In doing so, hedge fund managers do not frequently "comparison shop" among their various prime brokers and others to determine who offers the best price. Seeking multiple price quotes may slow execution, and it is unlikely that any swap dealer would be willing to represent that its prices are the best offered in the market. This provision of the Act may require hedge funds to obtain quotes from two or three swap dealers before entering into any swap, which would increase the cost and time required to enter into swaps. As Kohn said, this could "affect the way the market works."

However, query whether this provision in the Act would increase the use by Plan Asset Hedge Funds of interdealer brokers, especially inasmuch as any such interdealer brokers were willing to represent to the hedge fund (who in turn could represent to its swap counterparty) that the pricing of the relevant swap was, in context, the best available and appropriate to the hedge fund.

Clarification via Rulemaking and Market Practice

Fraser, of Ropes & Gray, and Andrew Oringer, a Partner in Ropes & Gray's Tax & Benefits Department and leader of the firm's ERISA and executive compensation practice, both noted that the Act is silent with respect to various provisions of the reasonable basis test. For example, the Act does not specify how the "independence" of a representative of a special entity should be determined. Nor does it specify how the "sufficiency" of a representative's knowledge should be ascertained. Likewise, it does not particularize what disclosures are "appropriate" in this context. Fraser suggested that more clarity on these terms is likely to come, if it comes at all, from rulemaking by the Agencies and market practice.

Oringer emphasized the importance of market practice in this context, and noted that a rule of reason may govern the level of disclosure provided by special entities and the level of due diligence conducted by swap dealers and major swap participants. That is, swap dealers and major swap participants may perform a lower level of diligence on larger, more established Plan Asset Hedge Fund managers, and only confirmatory due diligence on Plan Asset Hedge Fund managers that are existing or recent past counterparties.

Best Interests of the Special Entity and ERISA Fiduciary Status

The reasonable basis test requires a swap dealer or major swap participant to have a reasonable basis for believing that the independent representative of the special entity (1) undertakes a duty to act in the best interests of the counterparty it represents, and (2) in the case of employee benefit plans, is a fiduciary within the meaning of Section 3(21) of ERISA. To the extent that Plan Asset Hedge Funds are construed as special entities, these provisions are not likely to change market practice materially because the duties imposed by the Act are redundant of existing legal duties. The existing fiduciary duty owed by hedge fund managers to their funds likely incorporates the "best interests" concept in the Act. As Rabitz said, "embedded within the definition of a fiduciary is the concept of acting in the best interests" of a hedge fund. Moreover, if a hedge fund constitutes an "employee benefit plan" within the meaning of ERISA, the manager of that hedge fund becomes a fiduciary within the meaning of Section 3(21) of ERISA. In other words, ERISA imposes the relevant fiduciary duty, independent of Dodd-Frank. That is, where ERISA applies, this particular provision of Dodd-Frank would not add a new or different duty.

Beyond the content of the duty, Rabitz noted that under current market practice, swap dealers already ask managers of fund counterparties for representations regarding the fund counterparties' ERISA status; and where managers of swap counterparties represent to a dealer that the fund counterparties constitute plan assets, the dealer usually asks for – and the manager of the counterparties usually provides – a representation that the manager is a fiduciary within the meaning of Section 3(21) of ERISA and has complied with all relevant obligations. Similarly, Cleary's Alcock noted that under current market practice, where a hedge fund manager is subject to ERISA and causes one of its funds to enter into a swap with a dealer in reliance on the Qualified Professional Asset Manager (QPAM) exemption, the dealer generally requires a representation from the manager with respect to its eligibility to rely on the QPAM exemption. A hedge fund manager that relies on the QPAM exemption also must comply with the fiduciary duty provisions of ERISA. Accordingly, if Plan Asset Hedge Funds are characterized as special entities and thus their managers are required to represent and warrant to swap dealers and major swap participants regarding their compliance with the fiduciary duty provisions of ERISA, it would not constitute a material departure from current market practice.

Avoiding Adviser Characterization

The Senate version of the bill that became Dodd-Frank engendered some trepidation in the hedge fund and derivatives industries because it sought to impose an essentially unworkable fiduciary duty on swap dealers serving as counterparties to special entities. Dodd-Frank as passed and reconciled with the House bill removed that fiduciary duty on swap dealer counterparties to special entities, but retained it, in substance, for swap dealers serving as advisers to special entities that enter into swaps. Specifically, the Act requires a swap dealer acting as an adviser to a special entity to make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap recommended by the swap dealer is in the best interests of the special entity. Such information may include information relating to the special entity's financial and tax status, investment or financing objectives and any other information that the Agencies may prescribe.

While the industry breathed a sigh of relief when the fiduciary duty on swap dealer counterparties was dropped, Fraser introduced a cautionary note, pointing out that the term "advisor" is not defined in the Act and there is some risk that the Agencies may define the term broadly. However, the market has already addressed this issue in large part. Fraser noted that swap documentation typically includes representations from both (or all) parties to the swap that no party is serving as an adviser to any other party. Fraser predicted that such representations as currently included in form documentation may be revised and strengthened to provide additional comfort to swap dealers that they will not be construed as advisers to special entity counterparties, regardless of the breadth of the definition of "advisor" ultimately promulgated by the Agencies.

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