MARKET STREET TRUST COMPANY

Investment Viewpoint: FinReg Bill

September 24, 2010

Market Street on the Dodd-Frank Wall Street Reform and Consumer Protection Act

Robert J. White, Investment Manager

While the Act was signed into law on July 21, 2010, it will be several years before all the new rules are drawn up.

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law, initiating one of the most sweeping overhauls of the financial services industry and regulatory environment. The passing of the bill ushers in a long and uncertain period during which new rules and regulations will be crafted by a myriad of existing and new Agencies. It is expected that most rules will be drawn up over the next 6-18 months, resulting in a long period of regulatory uncertainty. Law firm Davis Polk & Wardwell estimates that as a result of the Bill, 11 Agencies have been tasked with writing 243 new rules, conducting 67 one-time studies and producing 22 new periodic reports.

Why did we need this new Act?

The financial crisis that started in 2007 promoted calls for widespread changes in financial regulations and regulatory structure. Such was the public outcry over the banking industry's behavior (irresponsible use of leverage, executive compensation, shoddy mortgage origination, rating agency's negligence, etc.) that that the Obama Administration has been able to enact the greatest transformation of financial services regulation since the Great Depression. The stated aim is:

> *to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.*

What are the major provisions of the bill?

The new law aims to both protect the country and individual consumers from the financial services industry.

The key aspects include:

- The creation of a Financial Stability Oversight Council to monitor and protect against systemic risks, and prevent "too big to fail" from happening again.
- The "Volcker" Rule, which prohibits banks from engaging in most forms of proprietary trading or investing in hedge and private equity funds.
- A new Consumer Financial Protection bureau, created to provide new protections in virtually all levels of contact one may have with the financial services industry, from investment advice to checking accounts to credit cards.
- Tighter regulation of certain derivative transactions, such as swaps, by mandating clearing through regulated exchanges or a central clearinghouse.

How is this legislation paid for?

The most explicit cost is an increase in FDIC premiums and the redeployed use of funds from the Troubled Asset Relief Program. It remains possible that a new 'Bank Tax' may be proposed and implemented. Less clear are the implicit costs. With the increase in FDIC premiums expected to have a greater impact on the larger and more complex banks (Davis Polk & Wardwell), much of this cost will likely be passed on to consumers through annual fees or higher spreads on lending.

What impact will there be on the way Market Street manages client investments? What about hedge funds in general?

Market Street does not believe that the new environment will change the way we build diversified portfolios, nor do we believe it will reduce the opportunity set. On the contrary, uncertainty usually breeds opportunities. As market changes take hold, there may be periods of dislocation or illiquidity, leading to higher short-term volatility. But the financial service industry is resilient and where certain players are forced to exit, others will step in to make a market.

Market Street Trust Company, 80 E Market Street, Suite 300, Corning, New York 14830

Many hedge funds quietly admit that the regulatory changes may actually present them with increased investment opportunities.

We believe hedge funds will be net winners from the prohibition on bank proprietary trading.

- With bank proprietary trading desks dissolved, there is reduced competition for idiosyncratic trades, increasing opportunities for hedge funds. It is felt that the arbitrage strategies, such as convertible bond and risk arbitrage strategies utilized by some of Market Street's underlying managers, could particularly benefit.
- The establishment of a regulatory structure for 'over the counter' (OTC) derivatives that requires orders to go through third-party clearing houses should both reduce counter-party risk and increase transparency. Furthermore, with banks required to sell existing derivative positions that are not used for hedging (i.e. are speculative positions), there will be potential buying opportunities for hedge funds.

- With bank investment into hedge funds and private equity vehicles limited to just 3% of fund capital, Market Street's fund of fund managers will have greater opportunity to invest in talented emerging managers who once would have relied on investment banks for seed capital.
- New registration requirements for managers with assets greater than $150 million should ease investor concerns of hedge fund fraud in this post-Madoff era.

How does this Act impact Family Offices such as Market Street Trust Company, and will there be an increase in regulation and the attendant costs?

Market Street should remain exempt from Investment Advisor regulations.

As a limited purpose trust company regulated by the New York Banking Authority, Market Street continues to have an exemption from the Investment Advisors Act. While an exception for single family offices with a limited number of clients was included in the Act, the SEC is tasked with defining 'family office' for the purposes of this exemption. Other 'family offices' might have to register as an Investment Advisor and be subject to additional regulation. This is something Market Street will be monitoring closely over the coming year.

What else is there in the Act that could impact me personally?

The Act impacts almost every aspect of financial regulation and the potential impacts of the Act in many respects are still to be determined. However, some of the areas that could affect Market Street clients are:

There are very few areas of finance that are not impacted by the Bill. It is likely that there will be many future unintended consequences for both institutions and consumers.

- There are changes in the definitions of Qualified Client and Accredited Investor, which impact ones ability to invest in hedge funds and private equity. In calculating net worth, individuals will no longer be able to include the value of their primary residence. The SEC must adjust the Qualified Client thresholds by inflation every four years. For Accredited Investor status, the SEC must review thresholds every four years and modify as appropriate for the protection of investors, in the public interest and in light of economic conditions.
- The Federal Deposit Insurance Corporation (FDIC) limit has permanently been increased to $250,000, retroactive to January 2008 – this may aid deposit holders who lost money prior to the original increase from $100,000 in October 2008. Likewise, share insurance at credit unions has been increased to $250,000.

Market Street will continue to track the new rules that are created over the next few years. Please feel free to give us a call if you have any questions about any aspects of the FinReg Bill.