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The Dodd-Frank Act: Legislative Sunshine During an Economic Hurricane?

It's been said that "*if a window of opportunity appears, don't pull down the shade*" but, as the offshore industry gazes out over yet another new statutory landscape, do we reach for the blinds or enjoy a new ray of sunshine?

On 21 July, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") with the intention of enhancing the safety and soundness of U.S. financial markets. Most of the Act will come into force on 21 July 2011 and is designed to strengthen financial market infrastructure by: restricting the ability of US banks to operate proprietary trading desks; requiring central clearing and transparency for most "*over-the-counter*" derivative transactions; mandating the registration of advisers to hedge funds and other private investment funds; and regulating credit rating industries.

Hedge Funds

Although the Act's so called "*Volker Rule*" generally prohibits any US banking entity from sponsoring or investing in hedge funds or private equity funds, the rule is never-the-less subject to a large number of complex exemptions and has a lead-time of at least three years before it comes fully into force.

From 21 July 2010 the Act amends the definition of "*accredited investor*" in regulation D of the Securities Act of 1933 by removing the net value of a primary residence from net worth calculations: the disclosures in many private placements and subscription forms will therefore have to be amended accordingly.

The Act also amends the definition of "*qualified client*" under the Investment Advisers Act of 1940, and as a consequence some advisers will be prevented from charging performance fees.

The New Swaps Market

The insolvency of Lehman Brothers in 2008, and the subsequent bailout of AIG by the US government, dramatically illustrated the potential that OTC swaps have for creating systemic risk. The answer from US legislators has been to insist upon centralised clearing, real-time public reporting and the payment of initial and variation margin for most OTC swaps. For less standard transactions there is no clearing requirement but there must still be real-time public reporting (albeit in such a manner that market participants can have confidence that their individual positions remain confidential) and significant capital, in addition to margin, must be placed with the swap dealer or major swap participant. Interestingly, from July 2012, the Act will prohibit Federal assistance to swap dealers or major swap participants (with the exception of insured depository institutions).

Inevitably swaps will become more expensive, but the removal or reduction of credit counterparty risk is expected to revive the market from its stupor.

Non-US Asset Managers

The Act will require non-US asset managers to register with the SEC if they:

- have a place of business in the US; or
- have15 or more clients and investor in the US in private funds managed by the asset manager; or
- have assets under management from investors in the US of more than $25

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million; or

- hold themselves out to the US public as an asset manager.

Any non-US manager falling into any one of the above categories must register with the SEC and:

- Comply with applicable SEC filings;
- develop a compliance manual, code of ethics, employee investment policy (personal account dealing policy) and a compliance monitoring programme that meet with SEC requirements and industry best practices
- undertake an annual review and testing of the compliance programme; and
- undertake annual compliance training.

Asset managers around the globe are questioning whether the Act applies to them and whether it represents fine providence or a further impediment to business.

US Securities

The Act requires that US listed companies that have had to re-state their financial statements must "*clawback*" incentive and bonus payments made to all executives, regardless of culpability. These arbitrary clawback provisions are expected to have a real impact on corporate America: more than 600 US public companies re-state their accounts each year. It is worth noting that re-stating accounts is much less frequent under IFRS than US GAAP, because an adjustment is usually made in the current year rather than a re-statement of previous financial periods.

Onerous disclosure requirements imposed by the Act will mean that companies engaged in extracting natural resources (such as oil, natural gas or minerals) will be less likely to wish to list on US exchanges.

Anti-manipulation provisions will protect all options and non-government securities, and not just exchange traded options and listed securities. The scope of transactions covered by these provisions is now therefore even larger than for transactions involving market abuse of EU securities.

Whistle-blowing Bounty Hunters

Under the Act, the SEC and the CFTC are to establish and operate "*bounty programs*" in which whistle-blowers may be awarded between 10 and 30 percent of fines received by the US Government (regardless of the citizenship of either the whistle-blower or the defendant). Recent SEC fines have reached $800m for a single case, so there is little surprise that the SEC are reported as expecting a "*tremendous response*" and have systems in place to deal with thousands of tip-offs every year.

When combined with the SEC's ability to prosecute for aiding and abetting (not just under the Exchange Act but now also under the Securities Act of 1933, the Investment Adviser's Act of 1940 and the Investment Company Act of 1940) whistle-blowing may become something of a sport that has more extra-territorial influence than baseball's World Series.

EU Alternative Investment Fund Managers Directive

Similar discussions arise from the EU's proposed Alternative Investment Fund Managers Directive which will restrict trading strategies of European investment managers as well as burden custodians with increased liabilities (thereby increasing costs significantly).

Hedge Fund Review has recently compiled on-line surveys that confidently predict that not only will Cayman be able to meet the challenges of the Directive but that the island will have the most to gain of all offshore financial centres.

Industry Consolidation

Optimism in the face of adversity perhaps also helps to explain the current fashion for consolidation in the asset management industry: particularly the

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recently announced proposals such as Man's purchase of GLG, and F&C's purchase of Thames River.

Conclusion

The above discussion is intended as commentary on the legislative changes, from an offshore perspective, rather than as legal advice. Professional advice is therefore critically important, but if good fortune is the time when preparation and opportunity meet, then those with global ambition will choose to see the light of opportunity through a window of enhanced regulatory governance.

Cayman can enter the next phase of the regulatory reaction to the global credit crisis with some confidence that it has the tools to meet the challenge: banking groups with offshore operations may wish to restructure in the light of exemptions to the Volker Rule; executives of mining and other companies might be persuaded to list on the Cayman Stock Exchange in preference to the regulatory burden (and personal risk) associated with US listings; the trend for investment managers to leave London for Geneva could stimulate growth in the use of Cayman management companies; and consolidation in the asset management industry is likely to lead to fund re-structuring work.

As and when the SEC and other US agencies produce regulations under the Act there will no doubt be other opportunities for the Cayman Islands. Even in the current climate, regulatory clouds have silver linings.