# Too Big to Work?

**James Thomas** asks whether the industry is ready for a statute as huge as Dodd-Frank

The practice in the US of naming statutes after their congressional sponsors gives them a certain human quality which, depending on their contents, can either make them seem like familiar friends or dreaded enemies. For compliance professionals, that process of anthropomorphism has perhaps already lent the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") an air of monolithic, fuzzy-edged menace, as its enactment into law has been greeted by a collective intake of breath within the financial services community.

Indeed, as statutes go, Dodd-Frank is immensely wide-reaching, and as Scott Cammarn, of law firm Cadwalader, explains, it represents a sea change in the mindset of Congress. "In 1999 there was concern about ensuring US financial services companies maintained a competitive position on the international stage," he says, "and so the Gramm-Leach-Bliley Act was passed to allow banks to expand, grow in asset size, and enter into new business areas. Just the opposite is occurring now – Dodd-Frank aims to constrain the growth of banks, and constrain the businesses banks can engage in." Dodd-Frank also usurps Gramm-Leach as the largest financial services Act in US history, running six times its length at 2,300 pages. "It's not just huge; it's sweeping legislation," Mr Cammarn explains, "It impacts banks, investment banks, the securities industry, and even the governance and some of the compensation provisions of general purpose corporations." The Act will also impact advisers to private funds, such as hedge funds, and anyone entering into swap transactions.

**Big and bold**

But while Dodd-Frank spells the beginning of a new era, there is some disagreement as to whether it is a proportionate or appropriate response to the financial crisis, or whether it merely uses the political window created by the crisis to enact a range of disparate regulatory measures. According to Gordon Burnes, of OpenPages, the form and function of Dodd-Frank is a logical response to recent events. "There has been a worldwide recognition that Basel II and Basel II-like regimes, which were implemented through regulatory rule-making in the US, were really focused on institutions and not the system," he explains. "In response to that, Dodd-Frank addresses the systemic risk associated with these financial and securities activities." Hence, the Act's creation of the Financial Stability Oversight Council, aimed at providing a better early warning system in times of systemic stress.

For others, the correlation between the crisis and the Act's provisions is less straightforward. "The relationship between the causes of the crisis and Dodd-Frank is unclear," says Steve Lofchie, of Cadwalader. "The economic crisis was a credit crisis caused by an asset bubble and the relationship between those causes and the changes that Dodd-Frank requires is not obvious to me." Indeed, in Mr Lofchie's view, the political motivations of Dodd-Frank may potentially undermine its efficacy. "Even a supporter of the Act would have to ask whether it simply attempts too much," he argues. "Whereas Gramm-Leach was largely a ratification of regulations that had already taken place, this is a sudden and complete reversal of what came

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before. Moreover, Dodd-Frank is largely a framework, lacking specificity. Much of the actual architecture has been left to the regulators to fill in, but what the regulators actually do is subject to massive uncertainty, making it extremely difficult for businesses to plan major changes. I've been advising clients to really understand the way they operate now so that they are prepared to make radical changes quickly as the rules start to be published."

Gordon Burnes offers similar advice. "This is a very dynamic regulatory environment, and the rulemaking that is spawned by Dodd-Frank could last two years or more," he says. The Act's requirement for regulated financial services institutions to provide increasingly transparent information about the risk in their business will prove to be a particular challenge. "Companies will have to put in place an information architecture that can describe their risk exposure in an accurate and timely fashion to regulators, business managers and boards," he continues. "In response to Dodd-Frank, clients are currently trying to establish a flexible information architecture that can adapt as the regulatory environment changes over time."

With so much of the detail around the provisions of the Act yet to be filled in, the question is whether – or how – that detail will be influenced by the shifting economic climate in which it is set. As Scott Cammarn points out, the leadership of the various agencies that will be making the rules is largely going to be in flux over the next two years, which makes it difficult to predict the type of approach those agencies will take. "However, I certainly don't anticipate some type of regulatory nullification of the statute," he adds.

### Wide impact

The impact of Dodd-Frank will, of course, not be confined to the US. But with the US moving so boldly, the question is whether other countries will follow suit – using Dodd-Frank as a model for reform – or not (which could give rise to arbitrage opportunities). Again, the outlook is uncertain.

In Steve Lofchie's view, many provisions in Dodd-Frank have an "unclear policy rationale". "It is not evident that there is a universal policy consensus behind the Act, and so I would not assume that other jurisdictions would choose to follow it," he suggests. Gordon Burnes feels that the Act may introduce regulatory arbitrage opportunities on both sides. "While there will be opportunities for certain kinds of products or services to be more successful in one jurisdiction than the other, there won't be a wholesale flight of banks and non-bank financial companies from the US," he argues. "And efforts have actually been made to ensure that regulatory arbitrage opportunities aren't introduced. For example, Dodd-Frank was careful not to require certain prescribed levels in tier one capital, in anticipation of deliberations over Basel III."

Regardless of arbitrage opportunities, the impact on how non-US firms conduct business in the US is likely to be of more immediate international concern. In many cases, non-US firms will be required to set up new vehicles in which to book transactions with US counterparties, while non-US advisers may have to register with the SEC and comply with SEC rules. "Like all other aspects of the Bill, international firms are struggling to figure out how they will be implemented, especially given that there is uncertainty not only as to how Dodd-Frank will be implemented but also as to developments in Europe – so there are two moving targets," adds Steve Lofchie.

### Costs

All of this change – and uncertainty – will incur considerable cost. By Cadwalader's estimation, Dodd-Frank will require the federal regulators to promulgate around 250 new rules over the next three years, not including the large number of rules that will be necessary simply to fix existing regulations that become outdated due to the Act. The costs of monitoring, let alone implementing, those changes will be enormous, but firms will also have to factor in loss of business opportunity and restructuring costs. As Steve Lofchie explains: "The cost to firms of no longer being permitted to engage in certain activities will run into the billions of dollars. On top of that, firms will incur the cost of restructuring those businesses that they are still permitted to be in, for example, being required to move operations to a different legal entity with additional technology and potentially separate personnel. The third cost is the compliance cost; and there's no doubt that will be substantial.

And these costs will also be far-reaching due to the Act's widening of the regulatory perimeter. "There will be a horizontal expansion of costs as industries that formerly were not subject to heightened federal regulation will become subject to it," explains Scott Cammarn. "Those entities that may have had lower compliance costs will certainly have to ramp up their expenditures as they become federally regulated."

Gordon Burnes agrees. The Act introduces the notion of a "non-bank financial company", a term designed to capture an institution that is broadly engaged in financial services but might not fall under the regulatory scrutiny of one of the federal regulators. "As a model that will have far-reaching effects, because what we learn from the crisis is that there are entities out there that are outside the 'banking world' that can have systemically significant impacts on the financial system and they need to be, if not regulated, then at least subjected to substantial oversight," he explains.

The coming years represent an enormous challenge to anyone touched by Dodd-Frank, and while many are currently still sizing it up, time will tell whether the Act comes to be regarded as a friend or foe.

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