Caledonian Story: Offshore Banking Group Brought Down by Long Arm Reach of the SEC

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Abstract

Ian Huskisson from Travers Thorp Alberga in the Cayman Islands discusses the recent demise of the Caledonian offshore banking group as a result of "incredible government overreach" by the Securities and Exchange Commission.

> "The Cayman Islands is recognised as one of the top 10 international financial centres in the world, with over 40 of the top 50 banks holding licences here. This is a testament to the worldwide recognition of the quality of Cayman's financial industry. Over 80 percent of more than US$1.5 trillion on deposit or booked through the Cayman Islands represents inter-bank booking between onshore banks and their Cayman Islands branches or subsidiaries."

This quote is taken from the Cayman Islands Monetary Authority ("CIMA")'s website. It underscores both the size and globalisation of the financial services industry of the Cayman Islands. The Cayman Islands continue to be ranked sixth internationally based on the value of cross-border assets, highlighting the role of the Cayman Islands as a financial intermediary. The Cayman Islands Government made it clear in 2001 when signing the OECD Accord on Transparency that it intended to be a leading jurisdiction when it came to the implementation of international standards on tax transparency and anti-money laundering initiatives. Following the US/Cayman Tax information Exchange Agreement effective in 2005, the Cayman Islands Government signed a model agreement with the US Government, as well as an amended Tax Information Exchange Agreement. This was important because it paved the way for the automatic exchange of tax information between the Cayman Islands and the United States under the Foreign Account Tax Compliance Act ("FATCA"). FATCA was introduced to deter tax evasion by compelling non-US financial institutions to report to the US Internal Revenue Service certain information about US accountholders. So too for a decade CIMA has been a full member of IOSCO and provides regulator to regulator disclosure of regulated entities.

Legitimate criticism of the Cayman Islands on the basis of tax evasion or secrecy should then have become a thing of the past, although none of the evident transparency prevented then Presidential candidate Obama from seeking to give a different impression to potential voters in his last election campaign, when he famously and quite unfairly labelled the activities at Ugland House in the Cayman Islands as "the biggest tax scam on record". Now the US regulators, in the form of the Securities and Exchange Commission ("SEC"), have landed a real blow against the offshore banking industry by bringing about the collapse of Cayman Islands based Caledonian Bank ("Caledonian"), but should someone have called "foul"?

Caledonian was a very small but not insignificant Cayman Islands bank. According to recent reports, Caledonian had total assets of approximately US$585 million against depositor liabilities of the US$455 million. The bank had 1,550 customers and 1,900 active accounts in January 2015. The bank's balance sheet included cash of US$290 million, bond assets of US$92 million which can be realised on three days' notice and an office building believed to be worth some US$10 million. As an indication of the global nature of a modern offshore bank's business, Caledonian's 1,000 or so depositors came from over 90 different jurisdictions.

The SEC's interest in the bank arose from sales that had taken place through an arm of the bank on behalf of a customer of penny stocks that it is alleged were part of an illegal "pump and dump" scheme operated by the customer in question. The shares concerned were Swingplane Ventures, Goff Corp, Norstra Energy and Xumanii. The SEC filed a law suit in the Southern District of New York on February 6, 2015, naming Caledonian as one of several defendants. It was alleged the bank had sold restricted unregistered shares in breach of US securities law. The law suit was accompanied by a temporary restraining order which froze all of the bank's assets in the US.

The SEC's actions dealt a crippling blow to the bank since its assets were predominantly cash and bonds held in the US. The action was also accompanied by adverse publicity which prompted a run on the bank. The law suit was filed on a Friday and the bank was forced to suspend operations the following Tuesday. The same Tuesday, the Cayman Islands regulator CIMA appointed two Ernst and Young partners as controllers of the bank under its regulatory powers. At a court hearing the following day that is discussed in further detail below, Counsel for CIMA explained that the appointment of controllers was made by CIMA in its role as regulators out of concern about the regulatory implications of the SEC allegations and actions as well as out of CIMA's separate concern for the interests of depositors.

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The sting in the tail for the bank and its creditors is that shortly following CIMA's intervention the SEC twice lowered the value of the temporary restraining order, first to $76 million and then to only US$7 million, representing the SEC's best outcome on a successful claim. Having previously frozen *all* the bank's assets, including customer deposits held in US Dollars, this was a very surprising turnaround. It is hard to see any proper basis for freezing all of the bank's assets in the first place and hardly surprising that the combination of serious allegations and a complete freeze of the bank's US assets precipitated a fatal run on the bank.

The controllers have now been appointed as liquidators of the bank. Once the not inconsiderable costs of the liquidation have been provided for, the liquidators have advised there is a risk that depositors will not recover 100 per cent of their claims. When asked to explain why the bank was brought down, one of the liquidators explained "given the circumstances of what happened, it is not surprising to me CIMA took the action it did in appointing controllers". He did not think the bank's operations were risky and noted that a very large portion of the bank's assets was held in cash. He added that in the business of international securities trading and banking "you are at the risk of a regulator taking action".

He did not comment on the appropriateness of the SEC freezing all of the bank's US assets on the back of a US$7 million claim or why the Cayman Islands regulators CIMA had not been in a position to work with the SEC to avoid what on any view was a heavy handed and unnecessary restraining order. This last failing is particularly striking when one considers the extent to which the Cayman Islands Government is openly cooperating with the US on FATCA and similar cross border arrangements. With no sense of irony the press release issued by the SEC in relation to its law suit concludes "The SEC appreciates the assistance of Financial Industry Regulatory Authority, the Cayman Islands Monetary Authority …".

The judge presiding in the New York Court that is to hear the SEC's claim took a more robust line however. Although his intervention was too late to prevent the collapse of the bank, it provides at least some level of appreciation that regulators should not behave in this way. The following extract from the transcript of a hearing in the aftermath of the restraining order shows in no uncertain terms the judicial disapproval both of the "excessive force" used with the initial restraining order as well as some of the underlying allegations:

> "THE COURT: It's stunning. It's incredible government overreach. You wrote me this rather casual letter in which you disclose that you have made all kinds of erroneous allegations relating to Verdmont. I'm going to turn to Verdmont in a moment. Are there a lot of erroneous allegations relating to Caledonian in the complaint?
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> MR SIMPSON: I don't believe so, your Honor."

The judge then turned to the bank's counsel and was highly critical of her failure to make it clear to the SEC at an earlier stage that the effect of the restraining order was to freeze depositors' money:

> "THE COURT: You knew that every dollar over 25 million that was frozen belonged to somebody else, your depositors, right?
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> MS DALE: That was our understanding, yes. I think what we were hoping, your Honor, was that we could resolve the matter, there wouldn't be the run of the withdrawals, and that by putting $76 million aside for a few days, we could manage to a resolution. That's what we were trying to do. Once the withdrawal requests exceeded whatever we had in the United States minus $76 million, then the shareholders of the bank made the decision to go into voluntary liquidation. They didn't want to start allowing some people to get full withdrawals and others not.
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> THE COURT: It's stunning. It's really stunning. You bear as much responsibility for what happened as the SEC did in this foolhardy exercise."

There is no Cayman Islands equivalent of the special administration process that applies to distressed banks in the UK. In an effort to regain some sort of control of the process, upon suspending its operations on February 10, 2010, the bank's shareholder passed a resolution to place the bank in voluntary liquidation. This move backfired because it was plainly an attempt by the shareholder to supplant the authority of CIMA's controllers by the appointment of its own liquidator. Unsurprisingly CIMA and its controllers objected and the question of who could call the shots in the winding up of the bank's operations fell to be determined by the Grand Court of the Cayman Islands.

The Cayman Islands court agreed with CIMA and the controllers that the latter's appointment in effect had priority over any liquidator appointed by the shareholder. Whilst there was nothing to prevent the shareholder placing the bank into liquidation, this could not be used as a device to supplant the authority of the controllers and therefore defeat the regulatory purpose of their appointment. The court explained:

> "It surely cannot be right that as against the licensee on notice of their appointment, the Controllers can simply be ignored. The licensee and those hitherto in control of it, are bound to comply with the appointment of the Controllers and this must mean immediately relinquishing control of the licensee's affairs. The position therefore is that the Controllers have effectively assumed control of the licensee's affairs to the exclusion of the JVLs, the Directors and the Shareholder, and anyone else who may claim any aspect of control. That being my interpretation of the legislation, it must follow that although the Shareholder here was not shorn of his right to resolve to place the licensee into voluntary liquidation, it

> did not keep a residual power to vest control of the affairs of the licensee in its appointed JVLs once the appointment of the Controllers had been effected by CIMA”

The outcome of the hearing was that the controllers were formally appointed as liquidators of the bank themselves and have set about the task of realising the bank’s asset for the benefit of its creditors. For a bank with US$290 million cash deposits to end up in liquidation as a result of an unproven claim from the US regulator of only US$7 million remains somewhat shocking. The treatment of this bank also stands in contrast to the treatment of distressed banks in the UK and other countries following the financial crisis at the end of the last decade. It is supposedly the role of the regulators, here SEC and CIMA, to protect depositors’ interests. In the light of what occurred in relation to Caledonian at the hands of both regulatory agencies it is hard to conclude that either fulfilled its statutory function, rather the contrary.