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SEC Advocates Broad Based Reform of Equity Derivatives,
CDS and Other Synthetic Ownership Instruments and Markets

As we have pointed out for some time, non-traditional structured and derivative arrangements that create economic exposure to publicly traded securities have allowed activist and short-term investors to exert vast but hidden influence. With respect to equity securities, investors have used such instruments to secretly accumulate large equity positions with a view to exercising control over corporate decisionmaking, with little or no disclosure of the existence or nature of these positions or their plans. With respect to debt securities, such devices have often been used – frequently in conjunction with short selling – to manipulate the market in bear raids, placing companies dependent on access to the capital markets in peril. While these phenomena directly implicate the policies underlying traditional disclosure requirements and anti-manipulation rules, they have thus far largely escaped adequate regulation.

In [testimony](#) yesterday before the Senate, advancing Treasury Secretary Geithner’s regulatory reform agenda [announced](#) on May 13, SEC Chairman Schapiro has now addressed these concerns four-square, calling for long-needed fundamental reform in the regulation of derivatives by the SEC. Chairman Schapiro put the matter clearly in saying:

The current regulatory framework has permitted certain opaque securities-related OTC derivatives markets to develop outside of investor protection provisions of the securities laws. These provisions include requiring the disclosure of significant ownership provisions and ... prophylactic measures against fraud, manipulation, or insider trading Trading in securities-related OTC derivatives can directly affect trading in the securities markets. From an economic viewpoint, the interchangeability of securities and securities-related OTC derivatives means that they are driven by the same economic forces and are linked by common participants, trading strategies, and hedging activities. ... [M]anipulative activities in the markets for securities-related OTC derivatives can affect US issuers in the underlying equity market, thereby damaging the public perception of those companies and raising their cost of capital. To protect the integrity of the markets, trading in all securities-related OTC derivatives should be fully subject to the US regulatory regime designed to facilitate capital formation.

Chairman Schapiro called upon Congress to enact legislation to bring securities-related OTC derivatives clearly under the umbrella of the federal securities laws, including so that the SEC might require regulated central counterparties (CCPs) for derivatives markets, to address concerns about counterparty risk by substituting the creditworthiness and liquidity of the CCP for the creditworthiness and liquidity of counterparties. In her testimony, Chairman Schapiro also recognized that “[a]ny new regulatory framework ... should take into consideration the purposes that appropriately regulated derivatives can serve, including affording market participants the ability to hedge positions and effectively manage risk.”

Broad-based reform of the OTC derivatives market to prevent the abuses and dangers exposed by the recent financial crisis – without destroying the ability of financial institutions, corporations and investors to make appropriate use of derivatives to assist in the process of capital formation and risk management – is a complicated project that will require a great deal of judgment and compromise. Disclosure under the Securities Exchange Act of 1934 of equity derivatives so that ownership and transactions in the derivatives would be treated equally with ownership and transactions in the underlying security is but one part of this larger task. It is, however, an important part, and one that we do not believe requires legislation but only rule-making and interpretation by the SEC. For so long as the current loopholes in the 13D reporting regime are not closed, parties seeking to disguise their activities or manipulate the market will try to take advantage of those loopholes. So too with manipulative trading in credit default swaps and short selling. We encourage the SEC to close the gaps in the current disclosure regime and to actively take enforcement action against abusive transactions, even while the SEC, other regulatory bodies, the Congress and the Administration together pursue the larger project of comprehensive reform of the regulation of derivatives that is now under consideration.

Theodore N. Mirvis
Adam O. Emmerich

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