March 31, 2021

Archegos Debacle Highlights the Continuing Need for Disclosure Reform

The market dislocation triggered by the blow-up of Archegos Capital Management offers yet another example of the urgent need for the Securities and Exchange Commission (SEC) to require disclosure of derivative positions, long and short, on an equal footing with accumulations of publicly traded shares.

Archegos made huge, heavily leveraged bets on publicly traded shares, apparently using undisclosed equity swaps and bespoke derivatives, achieving exposures at times in excess of 10% of a company's shares. The secret synthetic leveraged directional bets on stock price employed by Archegos, structured to avoid an investor itself having to actually buy or sell the underlying security, represent a clear and present danger to the fair and efficient functioning of markets for public securities and the investors and companies they serve. In the case of Archegos, as is common practice for many hedge funds, the derivative positions involved high leverage, and when Archegos suffered margin calls, it was forced to liquidate its positions. As a result, in a vicious circle, the stocks on which it was gambling plummeted. ViacomCBS lost more than half its market capitalization in less than a week. Several counterparty financial institutions have also announced losses.

The Archegos fiasco demonstrates that pervasive trading in opaque, undisclosed derivatives – some of which also exacerbated the 2008 financial crisis – remains a serious threat and a potential catalyst of systemic risk. The wild swings in share prices resulting from the unwinding of Archegos (and similar situations both past and likely in the future) are untethered to corporate value, raise serious questions about market manipulation, and can only undermine stability and confidence in our public securities markets.

In the Dodd Frank Act, Congress specifically authorized the SEC to provide rules that include synthetic, derivative ownership in required beneficial ownership reporting, so that when any holder or group reaches the 5% level of beneficial ownership, including through derivatives, the markets would have the benefit of some measure of disclosure and transparency. Federal and state courts have noted for years that gaps in the securities laws render companies vulnerable to activist "lightning strikes" and leave ordinary investors in the dark about the financial gamesmanship of aggressive hedge funds. It now appears that even Wall Street, as well as Main Street, is being kept in the dark regarding major market-moving accumulations structured through derivatives. But the SEC has refrained from implementing disclosure reforms.

We have long advocated transparency in the disclosure of derivative positions. As we recently noted, our formal petition to reform and update the rules under Section 13(d) of the Securities Exchange Act was submitted to the SEC ten years ago this month. Derivatives can also be used to avoid (or deliberately evade) disclosure under even the minimal periodic reporting requirements of Section 13(f) and positions reported on Form 13F may mislead when offset or amplified by derivative positions. We urge the new leadership of the SEC to address these glaring and dangerous gaps in the securities laws, and to require disclosure not only of short positions, but also of derivative positions, long or short, whether synthetic, cash-settled or otherwise.

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