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The **Nuances** of Securities Reform

Renewed commitment to enforcement is needed.

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THE URGENT drum beat echoing through the halls of Congress, the Securities and Exchange Commission (SEC) and other agencies is leading Washington's key decisionmakers toward a major restructuring of the laws, regulations and institutions that govern our securities markets. The litany of woes on Wall Street and the state of our markets provide ample cause for this urgency.

Bernard Madoff's recent guilty plea to crimes in connection with his reportedly $65 billion Ponzi scheme was a signature moment in a signature case, but it is only the latest in a series of events that has revealed serious deficiencies in our securities regulatory system, or, at least, in the enforcement of our current regulatory regime. The collapse of Lehman, the fire sale of Bear Stearns, and the government's bailouts of AIG, Citi and other landmark financial institutions are but a few of the other notable events that have played out in the midst of the most significant fall in our securities and real estate markets since the Great Depression. It is clear that change is needed and that it is coming.

Reform efforts to date have focused on the potential (and, in our view, advisable) merger of the SEC and the Commodity Futures Trading Commission (CFTC), enhanced regulation of credit default swaps (CDS) and hedge funds, and renewed emphasis on the use of mark-to-market accounting. It is equally clear that the required change does not need to come at the end of a sledge hammer.

Effective securities reform, as we discuss in this article, can be the product of a more surgical approach to modernizing existing laws and regulations and, as important, a renewed commitment to enforcing the laws and rules already on the books.

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Regulating Credit Default Swaps

Lehman's bankruptcy last fall threw a harsh spotlight on the massive, but largely invisible, presence of CDS in the nation's securities markets and on the absence of either a centralized market to ensure their liquidity or a clear regulatory structure to police the conduct of those involved in their purchase and sale.

If the message was missed when Lehman collapsed, it was driven home by the federal government's takeover of AIG, which had sold over $440 billion worth of CDS.[1] The CDS marketplace is in desperate need of meaningful reform.

By way of background, CDS are over-the-counter (OTC) negotiated contractual agreements between two parties designed to transfer credit risk from the buyer to the seller. The buyer agrees to make a fixed payment, and the seller agrees to pay a settlement amount to the buyer if a credit event, usually a bankruptcy or payment default, occurs with respect to a specified company (the reference entity) that is unrelated to the buyer or seller. Until recently, these derivatives were hailed by many as a valuable credit enhancement, so valuable that the total dollar value of CDS bought and sold in 2007 reached $62 trillion.[2]

Despite the significant role played by CDS in our markets, they remain largely unregulated. CDS are not considered a "security" under the Securities Act of 1933 or the Securities Exchange Act of 1934 and, as a result, are not regulated by the SEC. CDS have also been excluded from regulation by the CFTC under the Commodity Futures Modernization Act of 2000, and are similarly exempt from regulation by the Federal Reserve.

The absence of a regulatory structure to police the CDS market became a serious issue in the last year, as rising rates of payment defaults and bankruptcies among reference entities triggered an increase in both the number of credit events and demands for payment from CDS sellers. Defaults by sellers soon followed. Many are now convinced that regulatory deficiencies in the oversight of the CDS market, and related fraud and manipulation, caused an escalating chain reaction of defaults and economic loss.

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Reform is underway to bring these derivatives under regulatory oversight. The SEC, for example, has asked Congress to expressly grant the agency authority to regulate the CDS market.[3] The SEC is also working with the Federal Reserve and the CFTC to establish a central, unified clearinghouse for the sale of CDS, known as a CDS central counterparty (CCP).[4]

The SEC believes that a CCP will reduce the risk of individual sellers being exposed to the credit risk of other sellers, and permit the netting of individual CDS against one another, reducing the liquidity issues posed by an increasing number of defaults and requests for settlement in the CDS market. A CCP can also facilitate greater market transparency and encourage a more competitive trading environment, says the SEC, which could decrease transaction costs, improve price transparency, and contribute to an increase in market liquidity.[5] On Jan. 14, 2009, the SEC issued a temporary rule to facilitate the clearing and settling of CDS by CCPs.[6]

Merging the SEC and CFTC

The deepening economic crisis and the role that CDS have played in the crises here and overseas have also reignited talk of merging the CFTC with the SEC (or bringing both agencies under a larger financial regulatory umbrella) to regulate complex financial products traded on the OTC market more efficiently and effectively. Former Treasury Secretary Henry M. Paulson's call for such a merger, part of his "blueprint" for reforming financial regulation in early 2008[7] was hardly the first.[8] For many good reasons, the time for this merger may have come.

First, a merger of the two agencies would facilitate more consistent and enhanced regulation of financial instruments that have developed along the interstices between the historical jurisdiction of both regulators, such as stock index futures and other equity-based derivatives.[9]

Second, a merger would allow the two agencies to answer to a single Congressional overseer rather than the current split among the House Financial Services Committee and Senate Committee on Banking, Housing and Urban Development (banking, insurance and securities products) and the House and Senate Agriculture Committees (futures). And third, for the first time, the SEC is being led by a regulator who is both a former SEC Commissioner and a former chair of the CFTC, and well qualified to serve as head of a consolidated SEC/CFTC.

Short-Selling and the Uptick Rule

Short sales serve a purpose in maintaining efficient and orderly markets, but recent events have shown that the reinstatement of prior safeguards is necessary.

Until the current downturn, short-selling was generally permitted, but with certain important restrictions, such as the need to borrow the stock prior to the sale (preventing "naked shorts") and the need to sell at a higher price than the previous trade (pursuant to the SEC's "uptick rule," Rule 10a-1 of the Exchange Act). When the uptick rule was adopted in 1938, the SEC's stated goal was a sound one: to prevent short sellers from manipulating stock prices, causing successively lower share prices, and to stop related predatory trading practices, such as "bear raids" where a particular stock is sold short in an effort to drive down the price of the security to permit raiders to acquire the stock at artificially deflated prices.

In 2005, the SEC instituted a pilot program to test the market impact of relaxing the uptick rule for a select group of 1,000 securities.[10] Based on that study, the SEC concluded at the time that there was little evidence that the removal of the short selling restrictions would have a negative impact on market volatility, price efficiency or liquidity[11] and, as a result, eliminated the uptick rule in June 2007.[12]

The 18 months that have followed, however, have seen the most volatile trading in the modern era and since the advent of leveraged trading strategies.[13] It seems clear that the SEC had it right the first time, and that the uptick rule should be reinstated.

The Call for Hedge Fund Regulation

The government has had an uneasy relationship with hedge funds for some time, wary of their perceived market influence, exclusive nature and, until the recent downturn, their extraordinary financial success.[14] And although Bernard Madoff does not appear to have ever run a hedge fund, he used the cachet of the hedge fund community to help support a front for his massive Ponzi scheme, embarrassing the SEC and institutional investors alike.

The ensuing media frenzy and market outcry have put tremendous pressure on the SEC and Congress to react in some fashion. Unfortunately, much of that attention has focused on hedge funds, rather than on the broader market misconduct that the Madoff and other recent cases have exposed.[15]

A number of legislative proposals to regulate hedge funds have been introduced and, while they vary in certain respects, the bills generally call for the registration of hedge funds with the SEC in a manner similar to that already required of mutual funds and advisers.

In the Senate, Carl Levin (D., Mich.) and Charles Grassley (R., Iowa) have proposed the Hedge Fund Transparency Act,[16] which would require hedge funds to formally register with the SEC, file annual disclosure forms with the agency, comply with its recordkeeping requirements and cooperate with agency investigations or requests for information, among other provisions. The bill would expand the definition of "investment company" under the Investment Company Act of 1940 to include funds that had previously been exempt, either because they had 100 or fewer beneficial owner ("3(c)(1) funds"), or because all of their equity securities was owned by "qualified purchasers" ("3(c)(7) funds").

Notably, the Act would cover not only hedge funds, but also venture capital funds, private equity funds, and funds-of-funds, all of which have relied on §§3(c)(1) and 3(c)(7) to avoid investment company status.

On the House side, in January 2009, Representatives Michael Castle (R., Del.) and Michael Capuano (D., Mass.) introduced three related bills. In general terms, their bills seek to compel hedge fund registration under the Investment Advisors Act of 1940 (pursuant to the proposed Hedge Fund Advisor Registration Act of 2009), require pension plans to disclose their hedge fund investments (pursuant to the proposed Pension Security Act of 2009), and direct the President's Working Group on Financial Markets to study and report to Congress on the hedge fund industry (as provided by the proposed Hedge Fund Study Act).

These proposals have a certain superficial appeal. Registration would give the SEC the authority to review applications and other periodic reports, as well as disclosures about a hedge fund's management and structure, much like that already appearing in the fund's offering materials. Registration would also allow the SEC staff to perform on-site inspections of the registered hedge fund's books and records, presumably on either a routine or "for cause" basis.

That said, reliance on registration as a safeguard against fraud, by a hedge fund or even a currently regulated entity, is only as sound as the oversight that follows it. Lest anyone forget, the Madoff firm was a registered investment advisor and subject to on-site examination. The SEC inspection staff simply never conducted one.

We believe that the emphasis on hedge fund registration in the wake of the Madoff and other scandals is wrong and misses the point. To be meaningful, and fair, reform efforts in this area should address all market participants, rather than just the asset management community, and market integrity issues in their broadest sense (financial fraud, price manipulation and insider trading), and, now more than ever, the unwavering commitment to enforcement that they demand. Fortunately, the new leadership at the SEC appears to have this in mind as well.[17]

Mark-to-Market Accounting

The current financial crisis has also intensified the spotlight on fair value or "mark-to-market" accounting—valuing marketable securities at market prices—because many financial firms have been forced to take enormous losses in connection with illiquid assets. Investments in collateralized debt obligations, for example, have been valued at zero because there is no longer a market for them.

Mark-to-market accounting requires that assets and liabilities be carried on balance sheets at their respective fair values based on market prices, and that changes in fair value be reflected in income statements. Financial Accounting Standards Board (FASB) Statement No. 157, which embodies fair market accounting, defines "fair value" as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Accordingly, the accounting rule relies on the notion that the market is an asset's best arbiter of value. Critics claim this assumption breaks down in a market crisis because, when investors are gripped by fear, panic selling can produce prices dramatically out of line with underlying asset values.

While this pricing disparity undoubtedly occurs, it does not offer a persuasive argument for changing existing mark-to-market rules. In a 211-page report, the SEC recently concluded that the accounting for complex securities did not necessarily play a part in the current credit crisis.[18] In the context of failed banks, the SEC noted that fair market value accounting was applied to only a small minority of assets, and that losses recorded as a result of applying fair market value accounting did not have a significant impact on the banks' capital.

The SEC also concluded that the abrupt elimination of mark-to-market requirements would actually harm the economy by eroding investor confidence in financial reporting. Investors generally have found existing fair market value accounting standards to have increased the quality of the information available to them, according to the SEC report, and many investors have indicated that investor confidence is reinforced by providing transparency relating to the underlying asset value of their investments.

We agree. Existing mark-to-market accounting and pricing rules must be maintained. Fair value accounting with robust disclosures provides more accurate, timely and comparable information to investors than amounts that would be reported under other alternative accounting approaches.

Conclusion

The market crisis that continues to play out on the front pages of our financial press has laid bare some obvious shortcomings in our securities regulatory and enforcement regime. Clearly, the time has come for credit default swaps to be regulated, for the uptick rule to be reinstated, for mark-to-market accounting to be fully embraced, and for Washington to seriously consider merging the SEC and the CFTC.

Equally clear is that the sound enforcement of existing laws by our regulators could have stemmed many related problems. The Madoff fiasco is but one sad example of that fact. As much as new rules should be enacted, they will prove worthless without their timely and effective enforcement.

1. See Tim Reason, "Cox: Default Swaps Are Naked Shorts," CFO.com, Sept. 23, 2008, available at http://www.cfo.com/article.cfm/12286366/c_2984351/?f=archives.

2. Nicholas Varchaver and Katoe Benner, "The $55 Trillion Question," CNNMoney.com, Sept. 30, 2008, available at http://money.cnn.com/2008/09/30/magazines/fortune/varchaver_derivatives_short.fortune/index.htm?postversion=2008093012.

3. Testimony of SEC Chairman Christopher Cox before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Sept. 23, 2008.

4. Speech by SEC Commissioner Luis A. Aguilar, Jan. 10, 2009, available at http:www.sec.gov/news/speech/2009/spch011009laa.htm. The proposed Derivatives Markets Transparency and Accountability Act of 2009 (H.R. 977) also calls for CDS to be settled and cleared through a CCP.

5. Speech by SEC Associate Director Elizabeth K. King, Jan. 23, 2009, available at http:www.sec.gov/news/speech/2009/spch012309ekk.htm.

6. Interim Final Temporary Rule, Securities and Exchange Commission, Temporary Exemptions for Eligible Credit Default Swaps to Facilitate Operation of Central Counterparties to Clear and Settle Credit Default Swaps, Jan. 14, 2009, available at http://www.sec.gov/rules/final/2009/33-8999.pdf.

7. The Department of Treasury, "The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure," March 2008, available at http://www.treas.gov/press/releases/reports/Blueprint.pdf.

8. See, e.g., Testimony of SEC Chairman Arthur Levitt before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee on Banking and Financial Services, U.S. House of Representatives, March 30, 1995, available at http://www.sec.gov.news/testimony/testarchive/1995/spch033.txt; Testimony of Richard R. Lindsey before the Committee on Banking and Financial Services, U.S. House of Representatives, July 24, 1998, available at http://www.sec.gov.news/testimony/testarchive/1998/tsty0898.htm.

9. Congressional Research Services Report RL33036, Federal Financial Services Regulatory Consolidation: An Overview, by Walter Eubanks, July 10, 2008.

10. Office of Economic Analysis, U.S. Securities and Exchange Commission, Economic Analysis of the Short Sale Price Restrictions Under Regulation SHO Pilot, Feb. 6, 2007, available at https://www.sec.gov/news/studies/2007/regshopilot020607.pdf.

11. Id.

12. Amendments to Regulation SHO and Rule 10a-1, Rule No: S7-21-06, available at http://www.sec.gov/rules/final/2007/34-55970.pdf.

13. CRS Report RL 34519, Gary Shorter, "The Uptick Rule: The SEC Removes a Limit in Short Selling," June 3, 2008.

14. See, e.g., Implications of the Growth of Hedge Funds, Staff Report to the U.S. Securities and Exchange Commission, September 2003, available at http://www.sec.gov/news/studies/hedgefunds0903.pdf (noting the SEC's concern regarding the lack of information about hedge fund advisors).

15. See, e.g., *United States v. Marc Dreier*, No. 08 MAG 2676, U.S.D.C., S.D.N.Y. (2008); *Securities and Exchange Commission v. Stanford Int'l Bank, Ltd.*, No. 3:09-cv-0298-N, U.S.D.C., N.D. Tx (2009).

16. Available at http://grassley.senate.gov/private/upload/01292009-2.pdf.

17. See Speech by SEC Chairwoman Mary L. Schapiro, Feb. 6, 2009, available at http://www.sec.gov/news/speech/2009/spch020609mls.htm; Speech by SEC Commissioner Luis A. Aguilar, Jan. 10, 2009, available at http://www.sec.gov/news/speech/2009/spch011009laa.htm; SEC Press Release, "Robert Khuzami Named SEC Director of Enforcement," Feb. 19, 2009, available at http://www.sec.gov/news/press/2009/2009-31.htm.

18. Office of the Chief Accountant Division of Corporation Finance, U.S. Securities Exchange Commission, Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting, Dec. 30, 2008, at 201-02.