Financial Crisis Alert: SEC Chairman Cox Calls for Credit Default Swaps Regulation

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On October 8, 2008, Securities and Exchange Commission (SEC) Chairman Christopher Cox provided new details regarding his call for Congress to enact legislation imposing new regulations on the credit default swaps (CDS) market.[1] Chairman Cox had previously called for regulatory scrutiny of the CDS market on at least two recent occasions: in his testimony before Congress[2] on September 23, 2008; and in his announcement ending the Consolidated Supervised Entities Program[3] on September 26, 2008. In the latter announcement, he commented that "voluntary regulation does not work," and noted that the $60 trillion CDS market is not regulated by any agency of government and no one "has authority even to require minimum disclosure."

Calling it a "regulatory black hole," Chairman Cox explained[4] his concerns with the CDS market:

- The total amount of outstanding CDS contracts far exceeds the total value of what the swaps are meant to insure. Thus, when entire asset classes fall in value, the exponentially larger losses on CDS contracts can work to amplify the risk to the financial system. Further, the $58 trillion value that CDS contracts insure is more than the gross domestic product of every country on earth, combined.
- CDS contracts trade in an over-the-counter market that is approximately 10 years old and has doubled in size during the last two years. The market grew "between the gaps and seams of the current regulatory system, where neither the Commission nor any other government agency can reach it. No one has regulatory authority over credit default swaps—not even to require basic reporting and disclosure."
- The over-the-counter CDS market is a tangled web of global interconnections where the failure of any one financial institution could jeopardize the entire financial system. The specific risk is the "complete lack of information about who is exposed to whom," thus creating a situation "that is ripe not only for rumor and misinformation, but potentially fraud."
- When prices rise or fall in the CDS market, it "has begun to serve as a signal to the markets about the pricing of the underlying debt and equity securities." Thus, manipulation in the unregulated CDS market can drive prices in the regulated market for securities.

Chairman Cox noted in his speech that "the Commission's only authority with respect to over-the-counter credit default swaps is limited to enforcing the antifraud laws, such as those against insider trading. In fact, federal securities law specifically prohibits the Commission from regulation of credit default swaps—even as a preventative measure against fraud."

As a result, Chairman Cox said he believes the CDS market needs to be transparent because "when investors have clear and accurate information, and when they can make informed decisions about where to put their resources, money and credit will begin to flow again." Further, he said the "solution is to provide in statute the authority to regulate these products to enhance investor protection and ensure the operation of fair and orderly markets." He then outlined measures that he sees as necessary to achieve transparency[5]:

- Congress needs to enact legislation that will "require trade and position reporting by dealers in over-the-counter credit default swaps. Public reports of over-the-counter transactions would provide transparency and ensure better pricing."
- Both the SEC and the Commodity Futures Trading Commission (CFTC) should be given authority to issue anti-fraud rules, which could be used to prevent fraudulent, deceptive, or manipulative acts and practices.
- Regulators should require position reporting from market participants with significant positions, which "would provide regulators with the information they need to uncover manipulation and monitor risk."
- Basic recordkeeping is necessary for over-the-counter CDS transactions and would be a valuable tool in enforcing anti-fraud requirements.
- The US needs to work closely with governments and parliaments in other major market centers "because the cross-border impacts of the current market problems are quickly becoming obvious to all."

Finally, Chairman Cox advised of current efforts by the SEC to prevent manipulation in the unregulated CDS market:

- The SEC's Division of Enforcement has undertaken a nationwide investigation of potential fraud by issuers of securities in financial institutions and manipulation of those securities through means including abusive short selling and the intentional spreading of false information.[6]
- The SEC's Office of Information Technology is working with the Division of Enforcement to create a database of trading information, audit-trail data, and CDS clearing data.
- The SEC's Office of Economic Analysis is supporting the database effort by helping to analyze the data across markets for possible manipulative patterns in both equity securities and derivatives.
- The SEC is working with the Federal Reserve, the CFTC, and industry participants to create one or more central counterparties for the CDS market, in order to prevent the failure of a single market participant from having a disproportionate effect on the overall market.
- The SEC is working toward the establishment of one or more organized markets for CDS, such as one or more electronic trading systems.

Chairman Cox's October 8, 2008 speech and September 23, 2008 testimony before Congress came on the heels of the SEC's issuance of new rules restricting short selling in financial institutions and "naked" short-selling abuses.[7] The Commission also recently approved measures to make it easier for issuers to repurchase their own shares on the open market, providing an important source of liquidity during times of market volatility[8], and measures requiring weekly reporting to the SEC by hedge funds and other large investment managers of their daily short positions.[9] *See* Mintz Levin Financial Crisis Alert, "SEC Extends Emergency Short-Sale Restrictions and Reporting Requirements" (Oct. 10, 2008).

As a result, clients need to be aware that the SEC is rigorously pursuing anti-fraud enforcement action with respect to past CDS activity while pressing equally rigorously for an entirely new joint SEC-CFTC regulatory regime to regulate swaps trading, at a minimum CDS trading, prospectively. CDS participants should also be prepared to seek advice as appropriate before disclosing positions to the SEC under oath, as contemplated in the SEC Chairman's statements. Chairman Cox explained that the SEC would use its anti-fraud authority, "even though swaps are not defined as securities, because of concerns that CDS offer outsized incentives to market participants to see an issuer referenced in a CDS default or experience another credit event."[10]

Mintz Levin will continue to monitor the SEC's efforts to enact regulatory oversight of the CDS market and concerns over alleged market manipulation relating to the financial crisis. For the latest developments, visit Financial Crisis Central at Mintz.com.

Endnotes

[1] *See* Speech by SEC Chairman Christopher Cox: Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008).

[2] *See* SEC Chairman Christopher Cox Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Sept. 23, 2008).

[3] *See* SEC Press Release, No. 2008-230 (Sept. 26, 2008).

[4] *See* Speech by SEC Chairman Christopher Cox: Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008).

[5] On September 18, 2008, the House of Representatives voted to approve a bipartisan bill (H.R. 6604) to increase the transparency, oversight, and anti-manipulation authority over commodity futures and options markets. As part of the bill, it directs the Commodity Futures Trading Commission (CFTC) to get a clearer picture of the over-the-counter markets, and it calls for new full-time CFTC staff to improve enforcement, prevent manipulation, and prosecute fraud. *See* House Agriculture Committee Press Release (Sept. 18, 2008).

[6] Previously, Chairman Cox indicated that the SEC Enforcement Division would use its anti-fraud authority to monitor activity in the CDS market by conducting a "sweeping investigation into market manipulation of financial institutions, focused on broker-dealers and institutional investors with significant trading activity in financial issuers and with positions in credit default swaps." As part of this authority, the SEC intends to require hedge fund managers, broker-dealers, and institutional investors with significant trading activity in financial issuers or positions in credit default swaps to disclose, under oath, those positions to the SEC and provide certain other information. *See* SEC Press Release, No. 2008-214 (Sept. 19, 2008)

[7] *See* Securities Exchange Act, Release No. 34-58572 (Sept. 17, 2008); Securities Exchange Act, Release No. 34-58592 (Sept. 18, 2008); Securities Exchange Act, Release No. 58611 (Sept. 21, 2008); Securities Exchange Act, Release No. 58711 (Oct. 1, 2008); Securities Exchange Act, Release No. 58723 (Oct. 2, 2008).

[8]*See* Securities Exchange Act, Release No. 58588 (Sept. 18, 2008); Securities Exchange Act, Release No. 58703 (Oct. 1, 2008).

[9] *See* Securities Exchange Act, Release No. 58591 (Sept. 18, 2008); Securities Exchange Act, Release No. 58591A (Sept. 21, 2008); Securities Exchange Act, Release No. 58724 (Oct. 2, 2008).

[10] SEC Chairman Christopher Cox Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Sept. 23, 2008).

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