Deregulating the U.S. financial markets: current issues and developments

Lecture 2: Information Asymmetries in the Capital Markets

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Today's lecture

- Overview of capital markets regulation, with focus on capital formation (IPO process)
- Mandatory disclosure: its costs and benefits
- Deregulating disclosure in equity offerings to promote capital formation: Choice Act v.2
- How Dodd-Frank addresses informational asymmetries in OTC derivatives markets
- Compare "level the playing field" concept in OTC derivatives market with that in insider trading regulation

Overview of U.S. capital markets regulation

- SEC, CFTC
- SEC's 3 "missions"
- Banking v. capital markets regulation

Overview of capital markets regulation

- Primary capital markets agencies
  - Securities and Exchange Commission (SEC)
    - Securities Act and Exchange Act disclosure and anti-fraud and anti-manipulation rules for securities; regulation of intermediaries (e.g., broker-dealers)
  - Commodity Futures Trading Commission (CFTC)
    - Commodities Exchange Act – covers futures markets, anti-fraud and anti-manipulation; regulation of futures and swaps intermediaries
- Both agencies regulate pricing and trading platforms for the respective capital markets instruments they regulate, and the market intermediaries
- SEC regulates "securities" and CFTC regulates commodities, futures, derivatives generally – but all are capital market instruments
  - Inefficiencies of overlapping and fragmented regulation

SEC role and organization

- Independent agency, created in 1934
- Five commissioners, appointed by the President
- One chairman, no more than three from any one party
- Divisions:
  - Corporation Finance
  - Trading and Markets
  - Investment Management
  - Enforcement
  - Risk, Strategy, and Financial Innovation
    - Outgrowth of financial crisis of 2007-8
    - Provides SEC with economic and financial expertise on risk and economic analysis, strategic research, and financial innovation
    - Keep up with Wall St.'s financial innovation (e.g., CDS)
    - Supposed to integrate SEC's work across all the agency
- Office of Compliance Inspections and Examinations (OCIE)

The 3 SEC missions

- Capital markets regulation under Securities Acts can be categorized roughly under the three "missions" of the SEC: https://www.sec.gov/about.shtml.
  1. Protect investors. Enforcement of anti-fraud and anti-manipulation regulation; full disclosure of material risks
     - Which investors? In SEC's public statement, the average retail investor
  2. Maintain fair, orderly, and efficient markets. Involves market structure, best execution (also investor protection), regulating HFT
  3. Facilitate capital formation. Ensure that regulations on disclosure don't hamper ability of firms to raise capital in the capital markets
     - But firms have incentive to hype their stock, make misleading statements
     - How to balance (1) and (3)? This is the central conflict of missions in JOBS Act, which is aimed at smaller issuers
- Two or all 3 of these missions are at issue in any question of policy
  - Regulatory approach then becomes a matter of balancing, prioritizing regulatory objectives

CFTC's history, oversight, structure

- History, oversight responsibilities, and structure of CFTC
  - Created as an independent agency in 1974
  - Agency structure with 5 Commissioners, enforcement powers, and examination practices closely resemble those of SEC
  - Commodities Exchange Act (CEA) is governing statute
    - Passed in 1936, regulates trading of commodity futures
- Futures markets have existed since 1860s
  - Beginning with agricultural commodities such as wheat, corn, and cotton
- Definition of a "future" contract: an agreement traded on an organized exchange to buy or sell assets, esp. commodities or shares, at a fixed price but to be delivered and paid for later
  - A "forward" contract is generally same as a futures contract but is a customized transaction, not traded on an exchange and may not have interim margin requirements

CFTC today

- Missions
  - Foster open, transparent, competitive, and financially sound markets
  - Avoid systemic risk (added by Dodd-Frank)
  - Protect the market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices related to derivatives and other products subject to CEA
- Futures market regulated by CFTC:
  - $40 trillion U.S. futures market; $300 trillion swaps market
  - Contracts on energy and metals commodities, such as crude oil, heating oil, gasoline, copper, gold, and silver
  - Contracts on financial products, such as interest rates, stock indexes, and foreign currency

Regulatory intensity a function of investor sophistication / market

- Different investors → different type and level of regulation
- Investors can be “retail” or “institutional”
- Equity markets are largely institutional (by volume), with many retail investors participating indirectly
- Debt markets are primarily institutional, with retail investors participating indirectly through, e.g., mutual funds
  - Liquid, highly creditworthy U.S. Treasury market is very lightly regulated
  - Only anti-fraud rules apply, not mandatory disclosure
- But securities regulation assumes an offering is “public” and thus subject to stringent disclosure

Banking v. capital markets regulation

- Banking regulation:
  - Address externalities created by FDIC deposit insurance
  - Ensure "safety and soundness" due to banks' enormous impact on general economy
  - Credit extension and allocation, asset/maturity transformation, payments system, transmitter of monetary policy
  - Systemic risk
- Role of disclosure
  - Banking regulation is not primarily disclosure oriented – <u>regulators</u> assess financial condition
  - Capital markets regulation – ensure sufficient information to do deals (fair and full disclosure), prohibit fraud and manipulation
  - <u>Investors</u>, not regulators, assess financial condition and do valuation
- But both frameworks are increasingly converging
  - Like banks, capital markets and intermediaries impose systemic risk (e.g., contagion effect of subprime securities throughout the markets)
  - Securitization of loans ⇨ capital markets
  - Systemic risk in capital markets – HFT and other algorithmic trading can disrupt markets
  - No longer any "pure" major U.S. investment banks

Dodd–Frank's enhancement of CEA

- Brings comprehensive regulation to swaps marketplace
  - Swap dealers subject to robust oversight
  - Standardized derivatives will be required to trade on open platforms and be submitted for clearing to central counterparties
  - We'll cover this in detail later today
- Significantly broadens antifraud authority to pursue false or misleading information
  - Greater authority than SEC against manipulation and fraud
  - CFTC Rule 180.1 prohibits any fraud by any person acting intentionally or recklessly in connection with any swap or cash or futures contract
  - Unlike SEC Rule 10b-5, Rule 180.1 is not limited to actual transactions but extends to all activities that have a relationship to the swap or futures contract
    - E.g.: "spoofing"
- Bottom line: Rule 180.1 makes it much easier for the CFTC to charge individuals with fraud

Rationales for securities regulation

- Asymmetric information
- Capital formation
- Market efficiencies
- Investors' behavioral biases

Reasons for securities regulation: asymmetry of information

- Prior to 1929 Crash, corporate and banking insiders regularly used inside information to profit at public's expense
- The average investor can't "kick the tires," leading to wide informational disparities
  - Institution investors and Wall St. analysts have special access to issuers due to their impact on the markets
  - An issue of bargaining power
    - Widely dispersed investors need information on which to make an investment decision and can't bargain separately with issuers

Reasons for securities regulation: promote capital formation

- Securities Acts were passed in the Great Depression
  - Prolonged withdrawal of investors from markets, resulting in inability of companies to raise capital, investors not to return until 1950s – need to instill confidence
- Investor protection ensures trust and thus high participation rate of investors, allowing business to raise funds for investment
  - Rational, effective balancing of mission (1) and (3)
- Today, U.S. households are highly invested in the equity markets (mostly indirectly, through, e.g., pension funds)

Reasons for securities regulation: promote market efficiency

- Efficient capital markets direct capital to their highest value uses, to all of society's benefit (capital allocation) – mission (2)
  - One of SEC's key missions is to ensure accurate information so that securities prices accurately reflect the "fundamental price" of the security
  - Through mandatory disclosure and stringent liability
- "Accuracy": securities prices conform to the "fundamental value" of the security
  - "Efficient market hypothesis" (EMH): weak, semi-strong, strong
- Capital markets allocate scarce resources (capital offered by investors) among competing users
- Securities markets are "nerve center" for a capitalist economy by determining the correct cost of capital

Irrationality of investors / intangibility of the investment "good"

- Roaring '20s – Congress in 1933 believed investors had been massively misled by stock promoters and hucksters
- Innate biases (behavioral economics):
  - Over optimistic about own investment abilities
  - Loss aversion, "fear" factor: e.g., 2008 stock crash
  - Prospect theory
- Does paternalism thus justify securities regulation?

Balancing SEC's three missions

- Efficiencies underlying informational advantage (mission (2)) v. "level playing field" (1)
- How attempting to ensure level playing field affects balancing priorities among SEC 3 missions
- Is an informational advantage inherently a sign of market failure or does it reflect an efficient capital market?
  - Specialization in asset management industry: Wall St. gets privileged access to issuers
- Capital formation: reducing regulatory burdens on issuers
  - But issuers are primary source of information and least-cost providers
- The pro-regulatory ethos and market based ethos
  - SEC's focus on investor protection (e.g., insider trading enforcement actions) driven by budgetary politics – public choice explanation
  - Market-based: that in an efficient market offers best investor protection (intrinsic price = market price)

SEC's mandatory disclosure regime

- Rationales for mandatory disclosure
- Liability drives accuracy

U.S. securities laws are predominantly focused on *disclosure*

- Federal securities regulation is highly focused on disclosure to investors where the type of investor needs this information
- SEC requires mandatory disclosure of certain items, such as audited financial statements, operations, and managerial bios
  - Assumes that voluntary disclosure involves market failure
- Full disclosure regime applies to both initial offerings ("primary market", under Securities Act of 1933) and ongoing disclosure ("secondary market", under Securities Exchange Act of 1934):
  - Unlawful to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading"

Disclosure for secondary market

- Securities Exchange Act of 1934 governs secondary market and intermediaries; requires periodic disclosure by issuers
- Public companies must file quarterly (10-Qs) and annual (10-Ks) reports with the SEC on EDGAR per mandatory disclosure regime
- Form 8-Ks: non-routine – companies must disclose important, material events (e.g., mergers and major asset sales, departures of CFO)

Mandatory disclosure applies only to “public companies”

- Vast majority of companies are not public
  - By and large, problems of agency costs and disclosure are solved by contractual means, trust-based relationships, shareholders’ control
- As a company expands this mechanism becomes increasingly challenging
- State law solutions go a certain way
  - Corporations must have a board of directors and follow certain processes; fiduciary duties
- But with larger company and more dispersed investors, collective action problem of forcing disclosure increases

Disclosure rationale: securities are complex, "delicate merchandise"

- Securities are difficult to understand and value
  - "Delicate merchandise" in words of statutes' drafters
- Intangible assets are harder to value than tangible goods and services (can kick a car's tires)
- Some markets are extremely fungible (wheat, oil, etc.), whose grade and characteristics can be easily specified
- Securities disclosure plays a different and arguably more important role than in futures markets
  - Disclose material aspects of issuer's business for analysts to adequately conduct fundamental analysis
  - Discounted future cash flow analysis plus many other factors
- But in both futures and securities markets, real-time, accurate price information is critical for efficient markets and investor protection

Rationales for mandatory disclosure: market failure

- Why mandatory disclosure? Answer: market failure
  - Peer comparison: information on an issuer is more valuable if investors can use it to compare against peers – standardization
  - Agency costs: Reduces agency costs due to managers' conflict of interest.
    - Managers shirking duties or siphoning resources may not voluntarily disclose
    - IPOs: afterwards, those in control have access to the liquid funds, pay high salaries, engage in related party transactions
    - *Such items are candidates for mandatory disclosure*
    - Investors compare performance of managers against peer issuers
    - Stock price goes down, and directors discipline managers
    - Disclosure of exorbitant bonuses, pay; SHs elect different directors
  - Collective action problem: widely dispersed investors
  - Duplicative research: Reduces social cost of duplicative research

SEC's balancing of costs and benefits of mandating disclosure

- Many items to disclose:
  - Public companies must disclose specified items such as 3 years of audited financial statements, major litigations, material financings such as a bond offering
- Has SEC and Congress gotten the balance right? Case in point – minerals conflicts disclosure
- Under §1502 of Dodd-Frank, publicly traded companies are required to report annually on the use of conflict minerals in their products
  - To provide information, companies must survey their entire supply chain and create a Conflict Minerals Report
  - Solution for corporate ills (beyond simple goal of assisting investment decisions of the "reasonable investors")
  - Why try to solve social ills? Mission creep?
  - Moot issue now: Congress passed resolution under Congressional Review Act that disapproves SEC's rule
- Broad discretion to SEC on disclosure
  - SEC has entered controversial area of executive comp; its requirements have sometimes backfired (top 5 executives)
  - E.g. – boards hire increasingly expensive CEOs

Mandatory disclosure + anti-fraud rules = accuracy

- Anti-fraud and anti-manipulation regulation is important in both markets to ensure full disclosure and accuracy
- But full disclosure must be *accurate* disclosure
- Thus, mandatory disclosure regime is backed up by stringent anti-fraud liability
  - Primary market: Securities Act Sections 11, 12(a)(1) and 12(a)(2) – intermediaries and agents liable for fraud unless they can prove “due diligence”
  - Issuers are strictly liable
  - Secondary market: Exchange Act Section 10(b), Rule 10b-5

Mandatory disclosure and the 3 missions

- Premium placed on investor protection
- But assumes if accurate and material information is disclosed
  - Investors will make informed investment decisions (investor protection mission)
  - Markets are more efficient with such information (efficiency mission)
  - Companies can more easily raise capital (capital formation mission)

Regulation of capital raising: IPOs

- Applicable provisions of Securities Act of 1933 for IPOs

Gun-jumping: rules against "conditioning" the market

- Timeline of a public offering
  - Pre-registration; "in registration"; effective date
  - Strict regulation of what issuers can say
- Chief concern of gun-jumping rules is to prevent "conditioning" of market during period before sale of IPO (pre-effective date)
- Rules tightly regulate issuers' and underwriters' communications unless:
  - mandated disclosure items are available to the market (accuracy ensured by anti-fraud liability)
  - content does not "condition" market

Provisions applicable to IPOs

- Securities Act reflects broad remedial philosophy to correct perceived market failures in public offering market
  - Q – Is this focus on investor protection mission obsolete in today's world given wide availability of information?
- Areas of regulatory focus
  - Disclosure: mandates extensive disclosure
  - Registration: what is an "offer" of a security
  - Draconian liability: strict liability for issuers
  - Content-regulation: no conditioning; not purely disclosure-based (gun-jumping rules)
    - Strict limit on information relating to future prospects of the issuer ("forward-looking" information)

Section 5(c) of the Securities Act of 1933: regulation of "offers" of securities

- §5(c) requires registration of securities
  - It shall be unlawful for any person ... to offer to sell or offer to buy ... any security, unless a registration statement has been filed as to such security ...
- Term "offer" defined broadly in Section 2(a)(3)
  - "every attempt or offer to dispose of, or solicitation of an offer to buy . . . for value."
- Securities Act regulates all offers of securities unless there is an available exemption
  - Exemptions for private offerings, offerings outside U.S., and offerings of certain exempt securities
- Of particular concern – offers made to the general public without the protections of the Securities Act
  - Broad dissemination in public market: what is solicitation?

"Offer" defined broadly

- Section 5(c) of Securities Act prohibits "offers" prior to filing of registration statement
- "Offer" not limited to formal offer to sell the security but includes many types of publicity, through media, that can be construed as part of selling effort
  - Concern about "speculative frenzy"
- Distribute an "unsound security" at inflated prices – precisely the evil which the SA seeks to prevent
- Broadly defined to accomplish regulatory purpose of preventing prospective issuers from conditioning the market
- *In the Matter of Car M. Loeb Rhoades & Co.* (1959)
  - Discusses nationwide distribution techniques of underwriters, seeking "indications of interest"

Costs and benefits of private offerings

- Costs of public offerings v. investor protection
- Bank loans the mainstay of financing for small businesses
  - For less-creditworthy companies, banks require covenant protections (e.g., max debt/equity ratios, dividend restrictions, etc.)
- Private offerings avoid costly disclosure and other requirements imposed on public companies
- Social and private costs of private offerings
  - Greater potential for fraud, although §10(b) and Rule 10b-5 under Exchange Act, §17(a) of Securities Act apply
  - Less disclosure but assume sophisticated investors can bargain for more information
  - Low liquidity; restricted securities (can't easily transfer to other investors)

Jumpstart Our Business Startups (JOBS) Act of 2012

- Reduce burden of IPO capital raising

  Which of SEC's 3 "missions"?

  Emerging growth companies

  crowdfunding

Purpose: reduce regulatory burdens in capital raising

- Reduce restrictions on small companies' capital markets capital raising
- Balance between capital raising and investor protection missions
  - Efficient, fair, and orderly markets not really at issue
- Addresses burdensome IPO regulation
  - Costly, extensive registration process
  - Detailed items in registration statement and prospectus
  - Strict issuer liability for material misstatements
  - Highly technical gun-jumping rules
  - Post-IPO periodic reporting under Exchange Act
  - Heavy existing framework for public companies (e.g., Sarbanes-Oxley Act (SOX))

Rationales for JOBS Act

- Narrow private offering exemptions limited sale of securities primarily or solely to institutional and high-net-worth individual investors
  - Must qualify as "accredited" investors ($1m net worth; $200K income)
  - Reg D, other exemptions, limited ability to raise funds by small companies
  - Each relies on sophistication of investors and/or limited solicitation
- Many companies turned to donation-based crowdfunding platforms established by companies such as Kickstarter and Indiegogo
  - But such platforms couldn't be used to sell securities, a term that is broadly defined by the Securities Act
- JOBS Act focus is decidedly on SEC mission (3) (capital formation)
- But reducing disclosure requirements and lessening liability can negatively impact (1) (investor protection)

Emerging growth companies (EGS)

- JOBS Act designed to reduce barriers to going public
  - Extensive periodic disclosures and SOX
  - Provides 5-year window during which EGC does not have to comply
- EGS threshold is based on revenues ($1b)
  - But many relatively large companies are just under $1b. Do they really require the benefits of EGCs?
- Exemptions from say on pay, CEO pay parity disclosure, the Items 301 and 303 disclosures (relating to audit committees, etc.), § 404 (internal controls and procedures) of the Sarbanes Oxley Act, as well as PCAOB rules relating to mandatory auditor rotation and auditor disclosures
- Still, subject to extensive disclosure obligations in 10-K and 10-Q (and 8-K), and also subject to 10b-5 liability
- Why relief to small companies?
  - Congress's fraud and conditioning concerns are strongest here but they can easily do private placements
  - May be better to have venture capitalists vet these companies first!
  - By reducing costs of going public, JOBS Act may increase fraud

“Regulation crowdfunding”

- SEC adopted rules on Oct. 30, 2015 allowing “mom and pop” investors to participate in securities-based crowdfunding through online platforms (effective May 16, 2016)
  - Securities-based crowdfunding extends to both accredited and non-accredited investors
- Rules permit companies to raise $1 million in a crowdfunding offering during a 12-month period
- Each issuer is required to provide basic information (e.g., price of the security, target investment size, use of proceeds, etc.)
  - Permit public to make an educated investment decision
- Crowdfunding issuer must file with SEC (and post on their websites) annual report with financial statements within 120 days after end of fiscal year
- Rule intended to help facilitate capital formation among small businesses without subjecting them to the morass of regulations imposed on public companies
  - If issuer’s assets exceed $25m and issuer has 500 or more unaccredited shareholders (or 2,000 or more total shareholders), it will be granted 2-year transition period before being required to register

Transition to EGC

- Crowdfunding issuer entering the more extensive Exchange Act reporting obligations will be considered EGS if otherwise qualifies
- Likely some issuers won't pursue crowdfunding as a result of this potential regulation, even if less than full Exchange Act status
- Investor protection:
  - Over a 12-mo. period, the aggregate investment by any individual investor across all crowdfunding offerings capped at
    - (1) greater of $2,000 or 5% of lesser of investor's annual income or net worth if either annual income or net worth is less than $100,000; or
    - (2) 10% of lesser of investor's annual income or net worth, not to exceed a total investment of $100K, if both annual income and net worth equal $100K or more

Criticisms and proposals relating to capital raising

- SEC slow to act
  Choice Act v.2

Slow and plodding SEC

- Republicans: overcautious SEC has dithered in issuing JOBS Act rules
  - **Implementation dependent on SEC rulemaking**
- Make JOBS Act more effective
  - JOBS Act meshes with Trump Administration's focus on business expansion through reducing regulation that curtails financing – either through loans (banking industry) or through capital markets
- Republicans seek to use existing JOBS Act framework to further lift burden on issuers' capital raising

The evidence on public companies

- Number of "public" companies at historic low
  - At peak in 1996: 7,322 listed companies
  - In 2015 only 3,700, and 1,000 less than in 1975
  - Number of U.S. listings fell from 8,025 in 1996 to 4,101 in 2012, whereas non-U.S. listings increased from 30,734 to 39,427.
- Total number of businesses remained little changed, and number of startups actually increased
  - Regulations made it more expensive to list?
    - But account for only small portion of decline
  - Delistings due to mergers and acquisitions, failure to meet exchange listing requirements, and going private
- Counters argument that cost, complexity of regulation drove companies out of public status
  - Delistings due to mergers and acquisitions: 4,957 of 8,327 delistings due to M&A (45%)
  - Pools of private capital much larger than in 1996 (e.g., Uber an dother "unicorns")

Doidge, Karolyi, Stulz, "The U.S. listing gap" (2015)

Choice Act v.2

- Repeals and replaces the JOBS Act's crowdfunding title with text more aligned with crowdfunding legislation proposed in 112th Congress (2011-13)
- Streamlines shareholder threshold requirements for all issuers and provides SEC authority to unilaterally increase it further
- Removes the non-accredited investor threshold, and increases the deregistration threshold for issuers consistent with that of banks
- Extends to <u>all issuers</u> (not just EGCs) the JOBS Act's Title I provisions for
  - "Testing the waters" – oral or written communications with potential large institutional investors to determine if they might have an interest in a contemplated securities offering
  - Confidential submission of registration statement before an IPO

Dodd-Frank's reform of derivatives market structure and trade reporting rules

- Swap data repositories (SDRs)
- Swap execution facilities (SEFs)
- Role of disclosure in "leveling the playing field" in OTC swap market and in insider trading regulation

Historical lack of transparency in bilateral OTC swap market

- Historically, swap market was dominated by small group of the largest banks and broker-dealers that primarily negotiated and agreed to swap transactions with their customers (and each other)
  - Privately (i.e., bilaterally), often over the telephone
- As of Dec. 31, 2012, five largest US banks accounted for 95% of cash and trading activity in US swaps market
- Common perception: bilateral nature of the market has not typically allowed for sufficient flow of information about transactions to mid-market participants, community banks and commercial end users of derivatives
  - Market participants were deprived of access to swap pricing information necessary for informed investment and risk-management decisions
  - Big banks thrived through lack of transparency: bigger spreads

"Final Dodd-Frank Swap Execution Facility (SEF) Rules Adopted by CFTC," Practical Law (Thomson Reuters) (May 20, 2013)

Dodd-Frank objective – level the playing field in swap markets

- Title VII created framework for regulating swap markets
- Lack of disclosure and flow of information have plagued derivatives markets, privileging largest participants
- Lack of transparency of derivatives books was a significant regulatory issue in the financial crisis
- Regulators didn't have a composite view of trading books of SIFIs
  - Commodities Futures Modernization Act of 2000: most OTC derivatives transactions between sophisticated parties would not be regulated as "futures" under CEA or as "securities"
- Arguably contributed to Fed's and Treasury Department's panic during Bear Stearn's near failure in March 2008
- Therefore:
  - Mandated reporting by all primary and intermediary participants to "swap data repositories" (SDRs) that will make pricing and data publicly available

Reporting to "swap data repositories" (SDRs)

- All swap transactions, whether cleared or uncleared, must be reported to a registered SDR
  - A central facility for swap data reporting and recordkeeping for executed trades
- SDRs are intended to mitigate systemic risk
- Regulators need to be able to monitor level of systemic risk generated by counterparty risk between SIFIs

Reporting obligations under SDR rule

- Trade reporting will now apply to nearly <u>all</u> derivatives products, OTC as well as exchange-traded
- Counterparties to a derivative trade are obligated to report the trade to an approved SDR
- Derivatives reporting must be done on intraday basis ("as soon as technically practical")
- Reporting obligation only applies to largest financial institutions with significant volume and notional risk (>$50 billion in assets)

OTC trading venue requirements: “swap execution facilities” (SEFs)

- Dodd-Frank’s goal is to promote the trading of swaps on SEFs and promote pre-trade price transparency in swap market
- SEF is a platform for financial swap trading that provides pre-trade information (i.e. bid and offer prices) and a mechanism for executing swap transactions among eligible participants
- Interest rate swaps and credit default swaps (CDS) must be traded on approved SEFs

Rationale behind SEF registration: level playing field

- Level the playing field for swap market participants by allowing smaller traders increased access to markets and information
- CFTC has granted registration to about 30 SEFs
- SEF rules are designed to:
  - Increase liquidity and transparency in the swap markets
  - Remove large banks and broker-dealers as gatekeepers to the swaps market
- Among most important core principles meeting objectives of Dodd-Frank:
  - Monitor trading and trade processing
  - Have the ability to obtain necessary information from market participants
  - Publish trading information in a timely manner
  - Engage in required swap data recordkeeping and reporting
  - Possess the financial resources to fulfill its obligations

"Final Dodd-Frank Swap Execution Facility (SEF) Rules Adopted by CFTC," Practical Law (Thomson Reuters) (May 20, 2013)

Insider trading regulation: “level the playing field”

- Insider trading is prosecuted under Rule 10b-5: trading or tipping in breach of fiduciary duty
- Reg FD: issuers can’t selectively disclose material information (typically to Wall St. analysts, other institutions
- Critics: SEC’s enforcement policy devotes disproportionate resources in prosecuting insider trading – high-profile cases
  - In particular, hedge fund industry
- “Level the playing field” in insider trading regulation has entirely different impetus than OTC swap market regulation
  - Ensure average, retail investor has same access to information as Wall Street
- Is this an efficient outcome? Institutional investors have more skill in integrating myriad pieces of information about an equity security (“delicate merchandise”)
  - Balance of investor protection against efficiency mission

Compare "level playing field" in insider trading regulation

- "Level the playing field" appears to be a demonstrably rational regulatory objective in OTC swap market. Objectives:
  - Break the oligopoly in OTC swap market
  - Promote efficient pricing, lower bid-ask spread
  - Impetus public interest, not public choice?
- "Level the playing field" in insider trading regulation is more questionable in both substance and regulators' motives
  - Budgetary politics: "law enforcement agency" – "cop on the beat" against Wall St.

Concluding remarks

- Overreaction in Choice Act v.2 to need to increase capital raising?

  Reducing asymmetries in OTC swap market v. insider trading regulation

Concluding remarks

- Will Administration and Congress shift the balance too far toward capital formation?
  - Both in banking and capital markets regulation
- Will Administration and Congress de-regulate the derivatives markets?
- Is insider trading enforcement wrongly conceived?