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DERIVATIVES

SEC Proposes New Rules for Security-Based Swaps

By Robin L. Barton, *Hedge Fund Law Report*

On December 15, 2021, the SEC released proposed rules (Proposed Rules) intended to prevent fraud, manipulation and deception in connection with security-based swaps (SBSs) and undue influence over the CCOs of SBS dealers and major SBS participants (SBS Entities). The Proposed Rules would also require any person with a large SBS position to publicly report certain information related to the position. In the press release announcing the Proposed Rules, SEC Chair Gary Gensler noted some of the swap-related risks that, at least partly, motivated the proposal. "The 2008 crisis had many chapters, but a form of [SBSs] – credit default swaps – played a lead role throughout the story," he said. "In March [2021], when Archegos Capital Management collapsed, we saw once again the risks that might arise from the use of another [SBS] – total return swaps."

The Hedge Fund Law Report spoke to Fabien Carruzzo, partner at Kramer Levin, about the drivers and main goals of the Proposed Rules; concerns they may raise for hedge fund managers that engage in SBS transactions; the validity of concerns raised by Commissioner Hester M. Peirce; and the importance of submitting comments on the proposal – the deadline for which is March 21, 2022.

For additional insights from Carruzzo, see "Implications of the SEC-European Central Bank MOU on Security-Based Swaps" (Oct. 14, 2021).

Overview of the Proposed Rules

According to a fact sheet released by the SEC, the Proposed Rules would address misconduct in the SBS market, promote compliance with the federal securities laws by SBS Entities and increase transparency in the SBS market. The fact sheet summarizes the three key provisions of the Proposed Rules.

1) Anti-Fraud and Anti-Manipulation Provision

Proposed new Rule 9j-1 under the Securities Exchange Act of 1934 (Exchange Act) would:

- prohibit a range of misconduct and attempted misconduct in connection with SBSs, including misconduct in connection with the exercise of any right or performance of any obligation under an SBS;
- prohibit manipulation or attempted manipulation of the price or valuation of any SBS, or any payment or delivery related thereto;

- provide limited safe harbors for certain specified conduct; and
- provide that a person cannot escape liability for trading while in possession of material nonpublic information about a security by purchasing or selling an SBS based on that security and cannot escape liability under the proposed rule by purchasing or selling the underlying security (as opposed to purchasing or selling an SBS that is based on that security).

2) CCO Independence Provision

Proposed Rule 15Fh-4(c) under the Exchange Act would prohibit any officer, director, supervised person or employee of an SBS Entity – or any person acting under that person's direction – from taking any action to coerce, manipulate, mislead or fraudulently influence the SBS Entity's CCO in the performance of the CCO's duties under the federal securities laws.

3) Reporting Provisions

Proposed Rule 10B-1 under the Exchange Act would:

- require any person, or group of persons, with an SBS position that exceeds a specified reporting threshold to promptly file a Schedule 10B disclosing certain information related to that position;
- provide that any Schedule 10B be filed promptly but in no event later than the end of the first business day following the day of the execution of the SBS transaction that results in the SBS position exceeding the threshold; and
- require reporting persons to file amendments promptly in the event of any material change to a previously filed Schedule 10B.

Schedule 10B would require persons to disclose certain information, including the identity of the reporting person and the SBS position, as well as the underlying loans or securities and any related loans and securities. Those filings would be publicly available.

The Drivers Behind and Main Goals of the Proposed Rules

HFLR: What's the main driver behind the Proposed Rules? Is it simply finalizing the Dodd-Frank rulemaking? Is it trying to address things that have happened recently in the market? A combination of factors?

Carruzzo: Dodd-Frank is not really the main driver, although Dodd-Frank provides some of the basis for the Proposed Rules. The Proposed Rules are really a response to activities and issues that the SEC has been observing in the market, not only recently but also over the last few years. For example, some issues date back to the Hovnanian credit default swap (CDS) situation that started in December 2017.

Basically, there are three market issues that the SEC is trying to address here. One is what I would call opportunistic credit strategies in the CDS market that the SEC considers to be potentially manipulative. There are a lot of pages in the proposal dealing with those issues.

The second one is what has been labeled "net short debt activism," which deals with what happened in the Windstream saga a few years ago. Windstream was a situation in which a

bondholder prosecuted a breach in an indenture. The market perceived that as an attempt to favor the CDS buy positions presumably held by the bondholder in excess of the amount of debt it owned (making it a "net short" investor). As a result of Windstream, a number of sponsors and issuers in the debt market started incorporating provisions in the debt documentation to prevent debt holders that are net short in the credit from taking certain actions against the company, such as prosecuting a covenant or voting their debt, in an effort to protect the company.

[For more on Windstream, see "Disenfranchisement Provisions in Debt Instruments: A Practical Guide for Hedge Funds" (Aug. 1, 2019).]

The SEC apparently did not like that and wants more transparency in the market. The reporting provision of the Proposed Rules is what it's using against that strategy to show the market who may have positions in some issuers that may be large enough to justify or incentivize them to run those kinds of strategies.

And, the third driver is Archegos, which was ultimately a risk-management failure by the banks involved. The SEC feels that by providing greater transparency to market participants as to what any single market participant's positions in the securities or related products of a particular issuer are, it enables the market to identify issues and better manage risk.

[For more on Archegos and SBSs, see "The SEC's 2021 Reg Flex Agendas: Key Items for Private Funds and the Rulemaking Process (Part Two of Two)" (Aug. 26, 2021).]

HFLR: You mentioned increased transparency as one of the main goals of the Proposed Rules. What are some of the other goals that the SEC is trying to achieve with the Proposed Rules?

Carruzzo: Another goal is to prevent fraudulent and manipulative conduct or activities in these markets. The SEC wants to deter aggressive market participants from taking certain actions that the regulator may view as being manipulative. I'm emphasizing that the SEC may view certain activities as being manipulative because, even if it does hold that view, that doesn't necessarily mean that, under the applicable laws, those activities are, in fact, manipulative.

We've seen that in a number of different cases – not in the securities markets but in the commodities market, when the CFTC went after certain market participants and essentially lost because the court ruled that the behavior by the market participant involved was actually not manipulative. So, the views of the regulators as to what is manipulative or fraudulent may extend beyond what the applicable law is in that respect.

Hovnanian is really the genesis for the anti-fraud rules that have been proposed. In Hovnanian, there were two main actors:

1. GSO Capital had purchased CDS protection on Hovnanian; and
2. Solus Capital, another hedge fund, had sold CDS protection on Hovnanian.

In the context of the refinancing of certain notes, what happened in Hovnanian is that GSO proposed a debt exchange that would have caused Hovnanian to default on a piece of debt that would have remained outstanding after the refinancing took place and that was actually held by one of Hovnanian's subsidiaries. That default would have triggered the CDS contract on Hovnanian, and because GSO had purchased CDS protection on Hovnanian, it was going to monetize those

CDS positions. The payout of the CDS was going to be relatively significant because the debt exchange also involved the issuance of long-dated debt, which would have traded at a somewhat significant discount to par.

We've called that an unconventional credit event; regulators have called that manipulative. Solus also viewed it as manipulative and sought to enjoin GSO and Hovnanian from closing the debt exchange transaction. Ultimately, the CFTC and the SEC got involved, and the parties ended up settling.

The CFTC was more vocal than the SEC in Hovnanian – at least publicly – because the commodities laws are to some extent slightly broader than the securities laws in terms of anti-fraud and anti-manipulation provisions. Also, Hovnanian was in the CDS index that is subject to CFTC regulation. The securities laws talk about fraud or deceit in connection with the sale or purchase of a security, but the CDS was already in place at the time the restructuring took place. So, that made it difficult for the SEC to claim that any alleged fraud, if there was any, would have been in connection with the purchase or sale of a security. That's why in the Proposed Rules, you see a lot of references to the purchase and sale of securities because what the SEC wants to do is broaden the scope of the regulations to create the basis for it to go after that kind of behavior by market participants.

HFLR: If the Proposed Rules had, in fact, been the law at the time of the Hovnanian litigation, would that impediment have been removed?

Carruzzo: It would have created less of an impediment for the SEC to go after who it perceived to be the bad actors, but that doesn't necessarily mean that the SEC would have prevailed. What is noteworthy here, however, is that the CFTC officials have essentially said that they know that their views on what is manipulative may be broader than what courts have held. Nevertheless, they may still investigate. And, the costs associated with having to entertain an investigation by the regulator – not only the out-of-pocket expenses but also the diversion of resources from trading and investment activities – may be enough of a disincentive for market participants to not do whatever they think the regulators might not like. In fact, in the CDS market, a number of asset managers have taken that message very seriously because they don't want to entertain any sort of investigation. That may also be detrimental to the economy, as market participants may not engage in activities that are perfectly legitimate out of fear that they become the target of an investigation.

HFLR: Are the Proposed Rules likely to achieve the SEC's goals?

Carruzzo: If they're finalized as published, there would be more transparency in the market, as people would see large securities positions. Currently, it's very straightforward in terms of transparency in the CDS market – there's almost no transparency, at least to other market participants. The regulators know who has positions on any given name because of the reporting rules under the swaps and SBS regulations. So, the regulators have access to that information but not the rest of the market. Under the Proposed Rules, the rest of the market would have access to that information, assuming the market participants reach the reporting threshold.

Likelihood of Proposed Rules Being Enacted

HFLR: One of the three proposed rules was first proposed back in 2010. Why did the SEC decide not to go forward with it then?

Carruzzo: There were a number of market participants that provided negative comments or reactions to the proposal back then. Ultimately, the SEC came to the conclusion that the proposed rule back in 2010 may have gone beyond its statutory authority. Given what's happened in the market since then – primarily Hovnanian and Windstream – it has taken a different view. Actually, the SEC spends a fair amount of ink in the new Proposed Rules to explain why its position now is not an overreach in terms of exceeding the statutory provisions – and I do not find their explanations particularly convincing.

HFLR: Given all of that and given the three drivers that you mentioned earlier, are we likely to see more progress on the Proposed Rules this time around?

Carruzzo: I think so. There is a widespread view in the markets generally, and in the SBS market specifically, that Hovnanian was at least stretching the boundaries of what is tolerable and what I would call the spirit of the CDS contract. In fact, the CDS contract was amended, so that now a failure to pay credit event has to be related to a credit-worthiness deterioration. That was not a requirement before. If you just manufacture a failure to pay credit event now, unless the determinations committee finds that it's in connection with a credit-worthiness deterioration, it can't trigger the CDS contract. So, the market has already reacted to those kinds of strategies.

Because of that reaction from the market and the fact that people really thought that those kinds of strategies should not really exist, this time around, you're going to see people saying, "We see some benefit to enabling the regulators to prosecute certain activities that definitely are not appropriate." There is still going to be pushback, but there's probably going to be less or more targeted pushback – at least on the anti-fraud and anti-manipulation provisions. My sense is that the reporting portion of the Proposed Rules and the added transparency provisions will attract a fair amount of comments.

Key Concerns

HFLR: What are the key concerns raised by the Proposed Rules?

Carruzzo: Asset managers don't want to disclose their investment strategies; they view that as proprietary – and rightly so. Thus, they try to avoid pretty much anything that could create an opportunity for someone to reverse engineer or identify what their positions are on any company in which they're invested. With the Proposed Rules, if you're active in the CDS market and you pass certain thresholds, you would have to disclose not only all of your CDS positions but also all your positions in the securities or loans of that particular issuer. Basically, that means that you have to tell the entirety of the market what you own in the capital structure of that company.

That's very broad. People would not like having that disclosed to the whole market, in particular, in the distressed market where opportunities have become a bit more scarce in recent years, which is one of the reasons why the trades and strategies have become more sophisticated. Hovnanian is an example of that.

HFLR: Would raising that threshold or limiting the scope of what had to be reported address any of those concerns?

Carruzzo: If you increase the threshold, that means that fewer entities would have to report. I think the SEC estimated that there would be around 400 entities that would have to report based on the numbers. Of course, if you increase the threshold to a level that is too high, the likelihood that people will reach that threshold is reduced so much so that the rules lose their relevance, as no one may have to report. As always, there needs to be some balance between deterring manipulative activities and hurting certain market participants because their investment strategies may become more visible.

HFLR: One of the Proposed Rules would require you to report the first business day after the transaction that puts you over the designated threshold. Is that a reasonable deadline?

Carruzzo: It's too fast. Already, when you're dealing with Schedule 13D and 13G reporting under the securities laws, it's always a rush just to get that filing made in time. The likelihood that you're not going to make a timely report within one business day is very high, so I think they're going to get a lot of comments on that. I don't see how forcing market participants to report so fast would really be beneficial compared to the burden it places on the market.

[For more on filing Schedules 13D and 13G, see "How Fund Managers Can Navigate Sections 13(d) and 16 of the Exchange Act" (Feb. 28, 2019).]

HFLR: The Proposed Rules would also bar anyone from taking any action to coerce, manipulate, mislead or fraudulently influence the SBS Entity's CCO in the performance of his or her duties. What was the motivation for that provision? Was there a sense that CCOs were being manipulated in this aspect of the market and needed some extra protection?

Carruzzo: The SEC disclosed that there was one commenter to the 2010 rules who had suggested that this should be done. I was a little surprised to see that as part of the package, but at the same time, I don't really view it as objectionable for asset managers because it's primarily going to apply to SBS dealers – the sell side. Having an independent CCO is important, and making it clear that it's illegal to convince the CCO to adopt a different view on certain matters would foster that independence.

In a large financial institution, if you're trying to influence the CCO's views on a specific issue and that coercion results in noncompliance, ultimately, the person who lobbied the CCO should also be held responsible for that. Now, the SEC is just stating that if that happens, it's going to go after both the financial institution and the persons who took those actions.

[See "Personal Liability and Compliance Resourcing Are Top Concerns Among CCOs, Surveys Show" (Jan. 13, 2022).]

HFLR: When the SEC announced the Proposed Rules, Commissioner Peirce issued a statement opposing them, arguing that they go too far; they're not going to be effective in deterring fraud; and, in fact, they may interfere with legitimate market activity. Is there some validity to her position?

Carruzzo: Peirce is raising a number of interesting points. For example, there are a number of safe harbors that are provided

under the Proposed Rules, and that's another area where I expect to see some comments from market participants. She's saying that those safe harbors are not broad enough, and I agree with her in that respect.

She also recognizes that drawing lines between improper conduct and conduct taken in the normal course of business is very difficult, and it all comes down to facts and circumstances. Although the SEC will take that into account, she mentions that the unpredictability of any outcome will most likely create a bias toward market participants' not taking certain actions, which, in turn, will further hurt struggling companies at a time when help is most needed.

The way I'm reading her statement is that she tends to agree that there are other ways to prosecute illegal activity; you don't need to change the regulations and deter legitimate activity because of the uncertainty that is created by the Proposed Rules and how the SEC will enforce them. You can investigate an activity that you think is illegal and let a court decide whether there's indeed wrongdoing.

Of course, Peirce clearly is not in line with the other Commissioners, who see this very differently. They probably think more regulatory power is better because it serves as a deterrent, but the Proposed Rules may go beyond what the statutory provisions provide, which Peirce recognizes as well.

[For coverage of other statements by Peirce, see "SEC Commissioner Peirce Shares Views on Personal Liability for CCOs" (Nov. 5, 2020); "SEC Officials Clarify the Commission's Stance on ESG Investing and the Role of Disclosure" (Oct. 15, 2020); "SEC Commissioner Peirce Discusses Enforcement Efforts and Reforms" (Feb. 20, 2020); and "The Power of 'No': SEC Commissioner Peirce on Enforcement as Last Resort" (Jun. 21, 2018).

Importance of Submitting Comments

HFLR: These are only Proposed Rules, and they are open for comments. How important is it for market participants to raise their concerns during the formal comment period?

Carruzzo: It's important that market participants identify issues that they perceive because the anti-manipulative provisions are extremely broad, and some of them apply a negligence standard. Some traders at SBS desks at financial institutions will very likely feel uncomfortable having ordinary course of business conversations about the prospects of a particular issuer because they may be viewed as negligently making a misstatement of a material fact, which is one of the prongs of those provisions. Market participants should look at the breadth of those provisions and think about whether and how that impacts any of their daily activities.

The other issue relates to the reporting provisions. Investment managers need to think about the burden that is imposed – not only the burden in terms of actually making the reports but also the burden on investment activity. Will that deter investment activity? Asset managers will be forced to disclose information that they have a legitimate interest in maintaining confidential, and the SEC needs to demonstrate that the additional burden created is outweighed by the benefits of the Proposed Rules.