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## INDUSTRY INSIGHTS

# Bracing for More Regulation in the Security-Based Swaps Market

By Yanling Fang and Elizabeth Legg

For over a year, the financial services industry has been bracing for the Securities and Exchange Commission (SEC) to finalize its latest set of rules on transparency and integrity in the security-based swaps (SBS) market. The industry has weighed in on three rules proposed by the commission in December 2021, warning of a possible chilling effect on the market and suggesting important changes. Now, with the public comment period closed, a final decision is pending—with or without further deliberation.

Regardless of any modifications the SEC might make, the new regulatory regime will require market participants to embark on a multi-year program to bring their systems and processes into compliance. It is imperative for them to prepare for this significant challenge now.

## Why It Matters: A New ‘New Era’ for Security-Based Swaps

Swaps represented the largest dark pool in financial markets when the 2008 global financial crisis hit. “More than a decade later, we’ve continued to see the relevance of this market,” SEC Chair Gary Gensler told the International Swaps and Derivatives Association’s (ISDA’s) 2022 annual meeting.

In his speech, Gensler described the lead role played by credit default swaps (CDSs) in triggering the \$180 billion bailout of AIG and accelerating the financial crisis. Back then, as the chair of the Commodity Futures Trading Commission, Gensler was responsible for developing swap reforms in response to the 2008 financial crisis, in what he referred to as “a new era of transparency and commonsense rules of the road for the swaps market.”

Now, as head of the SEC, Gensler is focusing on total return swaps and other security-based swaps. He told the ISDA meeting the cautionary tale of Archegos Capital Management. The private investment firm went under in March 2021 after using total return swaps to build up massive and concentrated positions in underlying stocks, and then failing to meet margin calls when the stocks suffered a sharp devaluation. The SEC charged Archegos with stock price manipulation.

The Archegos incident and other “market jitters” underscore the need to continue to “shine light” on the security-based swaps market before any future tremors arise, Gensler said. The SEC has already

implemented some security-based swaps market reforms to increase market transparency and lower market risks. As of November 2021, for example, 47 security-based swaps dealers had completed the dealer registration with the SEC.<sup>[5]</sup> This process alone involved a huge effort to complete a package including capital, margin, compliance, risk management, supervision, trade acknowledgment and confirmation, recordkeeping, and financial reporting requirements.

Now, “we are embarking on yet another ‘new era,’” Gensler said. Despite swaps market reforms to date, “we have work to do to further fulfill our obligations under Dodd-Frank and update rules for this marketplace.”

### Go Deeper: Rule Requirements and Industry Views

The three SEC rules proposed in December 2021 are:

- **9j-1:** to prevent fraud in connection with SBS transactions
- **15Fh-4(c):** to prohibit undue influence over Chief Compliance Officers (CCOs)
- **10B-1:** to require reporting of large SBS positions

During the public comments period, the ISDA joined with the Institute of International Bankers and Securities Industry and Financial Markets Association in submitting an industry view of the proposed rules. Below, we describe each rule and its critique by the three associations.

- **9j-1:** This rule would prohibit fraudulent, deceptive, or manipulative conduct in connection with all transactions in security-based swaps, including misconduct in connection with the exercise of any right or performance of any obligation under a security-based swap.
- **The industry's view** is that 9j-1 is a vague liability standard and might cause some chilling effects on legitimate market activities. As the industry comments, “It fails to correctly assess its expected costs and benefits by overlooking the costs to SBS market participants of entering into transactions in the face of vague liability standards; it does not go far enough to recognize certain legitimate market activities; and it mis-identifies certain market events or activities as manipulative merely because some of their effects may be unanticipated by some market participants.” The industry highlights the fact that a well-functioning SBS market is key to providing credit and financial risk management opportunities for corporations and institutional investors. The overly broad definitions proposed for prohibited conduct would discourage investors from entering security-based swap transactions, reducing market participation and liquidity. The industry suggests the commission narrow the scope of activities considered manipulative and adopt safe harbors for beneficial legitimate market activities.
- **15Fh-4(c):** This rule would prohibit personnel of an SBS entity from taking any action to coerce, mislead, or otherwise interfere with the SBS entity's CCO.
- **The industry's view** is that the scope of the rule is unclear in terms of which market activities are prohibited and suggests the commission specify the type of conduct that would result in a violation.

- **10B-1:** This rule would require any person or group owning a security-based swap position that exceeds a set threshold to promptly file a statement with the SEC containing information required by Schedule 10B on the commission's EDGAR filing system. The threshold calculations are complicated and differ based on the type of SBS transaction. There are two threshold amounts for debt securities. For CDSs, the threshold is the lesser of: (i) a long notional amount of \$150 million; (ii) a short notional amount of \$150 million; or (iii) a gross notional amount of \$300 million. For non-CDS debt securities, it is a gross notional amount of \$300 million. There are also two requirements for calculating equity securities. The first requirement is based on the notional amount of the SBS position (\$300 million), and if the gross notional amount of the SBS position exceeds \$150 million, then such calculation should also consider the number of equity securities of the same issuer held by such person as well as securities underlying other derivatives based on the same class of equity securities. The second requirement is based on the percentage of outstanding shares attributable to the applicable position (5% of a class of equity securities). If the position represents more than 2.5% of a class of equity securities, the calculation should also consider the number of equity securities of the same issuer held by such person as well as securities underlying other derivatives based on the same class of equity securities.
- **The industry's view** is that these thresholds and other mechanics of the proposed rule would impose an extremely complex and expansive framework for market participants to determine when an SBS position (or related positions) need to be reported. It is also difficult to determine who needs to report, since the proposed rule requires reporting by any person who controls, is controlled by, or is under common control with a person who directly or indirectly is the owner or seller of a reportable SBS position. Additionally, there is a list of U.S. nexus criteria that market participants need to consider when calculating in-scope positions. As proposed, 10B-1 also requires market participants to submit filings to the SEC in the next business day, and to make subsequent filings when material SBS position changes occur. [The 39-page industry comment letter](#) on this rule lists potential risks under the proposed rule, including:
  - Public disclosure might pose the risk of front running and other opportunistic strategies and drive up the costs of transactions for all market participants.
  - Capital formation could be negatively impacted, since front running behavior would increase hedging costs for lenders and dealers relying on the CDS market to hedge their risks.
  - Investors could be discouraged from engaging in the SBS market.

The industry also makes six suggestions for the commission to consider, including:

- Recalibrate and clarify reporting threshold amounts.
- Align with Section 13's reporting deadlines.
- Clarify when an amended report would be required.
- Clarify the range of "related" instruments covered by Schedule 10B.
- Recalibrate Rule 10B-1's territorial scope.
- Adopt appropriate and phased transition periods.

# INDUSTRY INSIGHTS (CONTINUED)

## How Can Treliant Help?

Now is a good time to reassess your firm's security-based swap activities and map out the extensive changes required to bring your systems and processes into compliance with these forthcoming rules. Treliant is a group of seasoned consultants with regulatory program management skill and data expertise. Whether your firm needs help with program governance setup, operating model design, gap analysis, data analysis, or project execution, our subject matter experts are here to support you.



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