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SEC proposes rules to prevent fraud and promote transparency in the use of credit default swaps and other security-based swaps

Some investors have used credit default swaps in recent years to manufacture credit events and for other purposes related to activist conduct. In response to criticisms of these practices and in particular to a perception that their use may reflect fraudulent or manipulative practices, the SEC on December 15 proposed three new rules under the Exchange Act related to its oversight of the market for credit default swaps (CDS) and other security-based swaps (SBS) that fall within the SEC's jurisdiction. If adopted in the form proposed, the new rules could have a significant impact on the credit default swap market and the use of these products by hedge funds and private equity investors.

Proposed new Rule 9j-1 would prohibit fraudulent, deceptive, or manipulative conduct in connection with SBS transactions, including misconduct in connection with the exercise of any right or performance of any obligation under any SBS, with a focus on curtailing certain strategies related to credit default swaps. Under proposed new Rule 10B-1, any person, or group of persons, with a security-based swap position that exceeds the applicable reporting threshold would be required to file promptly with the SEC a statement on a new Schedule 10B disclosing information about that position and positions in related instruments. Proposed new Rule 15Fh-4(c) would prohibit personnel of security-based swap dealers and major security-based swap participants from taking any action to coerce, mislead, or otherwise interfere with the firm's chief compliance officer.

The proposed rules are subject to a comment period that will remain open for 45 days after publication of the proposing release in the Federal Register. The release (Release No. 34-93784) can be viewed [here](#).

Description of proposed rules

Security-based swaps regulated by the SEC include certain credit derivatives based on either a single security or loan or on a narrow-based security index (consisting of nine or fewer securities) or of an issuer of securities in a narrow-based security index, as well as equity derivatives, total return swaps, and contracts for differences on a single security, loan, or narrow-based security index.

Prohibition of fraudulent, deceptive, or manipulative conduct in connection with SBS transactions

Building on a 2010 rule proposal that it never acted upon, the SEC proposes to prohibit the use of material nonpublic information relating to a security in connection with the effecting of certain transactions in, and the purchase or sale of, an SBS. Although the SEC notes that it believes that such conduct is already prohibited under Section 10(b) of the Exchange Act and Rule 10b-5, the SEC adds that it "also believes that market participants would benefit from a clarified interpretation of that statutory provision."

In reproposing this rule, the SEC has not altered its terms to reflect prior comments from industry associations that had requested modification or deletion of the part of the rule that went beyond prohibiting fraudulent conduct in the purchase or sale of an SBS. Proposed Rule 9j-1 extends to a range of transactions in security-based swaps, such as "actions to exercise any right, or any action related to performance of any obligation, under any security-based swap, including in connection with any payments, deliveries, rights, or obligations or alterations of any rights thereunder; or to terminate (other than on its scheduled maturity date) or settle any security-based swap." The commenters had argued

that the provision's broad scope could reach ordinary course matters in the servicing of a credit default swap, such as margin calls, and could adversely affect the ability of counterparties to exercise their contractual rights and remedies.

The SEC indicates that it believes the limited safe harbor contained in the rule should address commenters' concerns. The safe harbor would protect actions taken in accordance with binding contractual rights as reflected in the SBS transaction documents as long as a counterparty can demonstrate that the SBS was entered into or amended before the counterparty became aware of the material nonpublic information, and that the entry into, and the terms of, the SBS themselves do not violate the rule. The safe harbor also would extend to certain portfolio compression exercises.

The SEC also proposes a prohibition on price manipulation to address what it characterizes as "opportunistic" strategies that have developed in the credit default swap market. These strategies include working with the reference entities to create "technical" defaults to trigger payouts, influencing the timing of credit events to affect timing of payments, offering financing to reference entities that "orphans" the CDS, or otherwise taking actions as part of a larger restructuring to affect the likelihood of a credit event and the price of the CDS. The SEC underscores that the prohibition would apply only to circumstances in which the CDS payment is "intentionally distorted" and is not intended to curb actions within the ordinary course of a "typical lender-borrower relationship."

The proposed rule, however, does not establish a bright line to guide compliance. The SEC's statement that "an action that appears to be designed *almost exclusively* to harm one or more CDS counterparties would likely fall within the prohibition" (emphasis added) provides an ambiguous gloss on the proposed rule and may discourage the use of such "opportunistic" CDS strategies, which could be the intended result.

Reporting of large SBS positions

The SEC has expressed concern in the past that investors could effectively evade beneficial ownership reporting under Exchange Act Section 13 by holding security-based swap positions that enable the investors to exert control similar to that incident to actual beneficial ownership. The SEC proposes a new Rule 10B-1 to extend to the SBS market, for disclosure of economic exposure obtained through derivatives, reporting requirements analogous to those under the

Section 13 regime. The proposed rule would require the reporting of large SBS positions on a new Schedule 10B filed with the SEC. The SEC believes that the reporting requirement may have the effect of curtailing some of the "manufactured or opportunistic" CDS strategies described in relation to the prohibition on price manipulation described above.

The proposed rule would require the position holder to file a Schedule 10B promptly, and in no event later than the end of the first business day, following the execution of the SBS transaction that results in the "Security-Based Swap Position" first exceeding the "Reporting Threshold Amount." The rule would aggregate positions in both the CDS market and the cash market falling within the ambit of the term "Security-Based Swap Position." A "Security-Based Swap Position" would include "all security-based swaps based on: (a) a single security or loan, or a narrow-based security index, or any interest therein or based on the value thereof; (b) any securities issued by the same issuer (each, an "issuing entity") of the securities, loans, or securities included in the narrow-based index (including any interest therein or based on the value thereof) described in (a); or (c) any narrow-based security index that includes any of those issuing entities or their securities (including any interest therein or based on the value thereof), in each case as applicable."

The proposed rule includes various "Reporting Thresholds Amounts" that depend on whether the SBS is on a credit default swap, on equity securities, or on debt securities that are not credit default swaps, such as total return swaps. The tests for calculating the threshold amounts are intricate, and the formula and numerical amounts are sure to generate comment. The proposed test for debt securities that are not credit default swaps would be based on a "gross" notional amount, while the test for credit default swaps would include a long, a short, and a gross notional amount test. For an SBS on equity securities, the proposed test would require reporting upon attainment of the lesser of two thresholds, one based on a gross notional amount and the other based on a percentage ownership.

We expect that comments on the design and application of these thresholds will address a range of issues, including in particular:

- the aggregation of cash and derivatives markets;
- the potential to net long and short positions;

- the application of the rule to security-based swaps and credit default swaps on certain narrow-based security indices that may be rules-based indices controlled by third parties where the ability of the CDS or SBS investor to exercise control over individual securities in the index may be limited or non-existent; and
- the applicability to CDS positions held by non-U.S. persons where the counterparty is a non-U.S. dealer and all sales and execution activity occur outside the United States but the issuer is incorporated or establishes or has its principal place of business in the United States or is a reporting company under the Exchange Act.

Prevention of undue influence over chief compliance officers

Proposed Rule 15Fh-4(c) would make it unlawful for any officer, director, supervised person, or employee of a security-based swap dealer or major security-based swap participant, or any person acting under such person's direction, to directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence the chief compliance officer in the performance of such officer's duties under the federal securities laws or the rules and regulations thereunder. The SEC had considered a similar requirement in 2016, and is reconsidering the mandate now in light of the rule proposals described above as well as the implementation of the SEC's security-based swap rules since 2016. The new rule would be relevant to the small number of firms that are registered with the SEC as security-based swap dealers, which, in the SEC's view, are critical to the integrity of the SBS market.

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