Statement

Flexibility at the Expense of Clarity: Statement on Adoption of Exchange Act Rules 9j-1 and 15fh-4(c)

Commissioner Hester M. Peirce

June 7, 2023

Thank you, Mr. Chair. As we have just heard, today the Commission will vote on finalizing Rule 9j-1, which would prohibit fraud and manipulation involving purchases and sales of security-based swaps, and Rule 15fh-4(c), which would prohibit coercion, manipulation, or deception of a security-based swap entity's chief compliance officer. Although I agree with the objectives of these rules—namely, to reduce the incidence of misconduct in the security-based swap markets—these final rules leave unaddressed concerns I had at the proposing stage about their breadth, and I accordingly cannot support them.

The version of Rule 9j-1 before us today is better than the proposed version. The final rule would adopt a considerably narrower definitions of purchase and sale than the expansive proposed definitions that would have covered the performance of obligations arising out of a security-based swap for the life of the transaction. The definitions in the final rule instead generally tracks the Dodd-Frank definitions of these terms. This change should reduce the likelihood that every action taken by a counterparty to a security-based swap during the life of the transaction, including actions required under the swap's terms, will expose it to liability. In another positive change, the release also makes clear that attempted violations of the rule require scienter. Finally, the affirmative defenses should mitigate—even if they do not eliminate—the risk that the rule might make it impossible for a lender, which will often possess material non-public information on its borrowers, to use credit default swaps to hedge the risks of those loans.

Notwithstanding these improvements, the final rule is still overly broad. The affirmative defenses may not provide market participants with sufficient clarity to allow them, for example, to feel confident somebody on a firm's trading desk can hedge a loan using security-based swaps when the firm has obtained material non-public information in connection with the loan. As another example, the negligence standard applicable to paragraphs (a)(3) and (a)(4) of the rule may facilitate second-guessing in enforcement actions.

Most concerning, however, is an overbroad anti-manipulation provision directed at manufactured credit events and other types of opportunistic trading strategies. This provision, too, has been narrowed since the proposal; the provision no longer contains the "directly or indirectly" language, and the release makes clear that violation of this provision requires scienter. But the release describes the scope of the provision in the same broad and ambiguous terms to which I objected when the rule was proposed.[1] Indeed, in words nearly identical to those in the proposal,

the release explains that this provision would apply to "an action taken for the purposes of avoiding or causing, or increasing or decreasing, a payment under a security-based swap in a manner that would not have occurred but for such actions."[2]

As did the proposing release, the adopting release does attempt to provide assurance to market participants that the Commission will use this provision to pursue only "actions taken outside the ordinary course of a typical lender-borrower relationship."[3] Yet, as one commenter noted, market participants must look to the text of the rule, [4] which makes no reference to (and offers no safe harbor for) actions taken in the ordinary course. Moreover, the Commission repeatedly notes in this discussion that whether an action is taken in the ordinary course is a "facts and circumstances" inquiry under which the Commission will review "all relevant facts."[5] Although this approach does ensure maximum flexibility for the Commission to pursue misconduct that is hard to describe ex ante, it does so at the expense of clarity for firms that will have to guess at what facts the Commission may, in hindsight, determine to be relevant.

The Commission feels compelled to preserve maximum flexibility for itself because it is trying to prohibit harmful but exceedingly difficult-to-define behavior that has occasionally appeared in the credit default swap markets. This behavior includes manufactured credit events and other opportunistic trading strategies that can cause the market to question whether these instruments will serve the purposes for which they were designed. Drawing in advance a line that cleanly distinguishes between manipulative conduct and actions taken in the normal course of business, even if they are unseemly and potentially unfair, is difficult. That the opportunistic trading strategies the rule targets have occurred relatively infrequently, and that each generally has presented distinct facts, makes the rule-writing task more difficult.

Preserving discretion for the Commission could chill, unnecessarily, perfectly legitimate trading strategies or exercises of a counterparty's rights under a security-based swap.[6] Moreover, as one commenter noted, security-based swaps are often used to hedge complex financing arrangements that involve heavily negotiated terms providing the lenders with a range of options to protect themselves from the borrower's default.[7] Lenders worried that they may not be able to exercise such rights without affecting the value of the security-based swap in a way that the Commission later might view as manipulative may be less willing to provide financing in the first place.[8] Moreover, because the release suggests that action—such as rescuing a failing firm—will be subject to greater scrutiny than inaction—such as letting a failing firm collapse—the rule risks spurring inaction and thus reducing market efficiency.[9]

Some circumstances might warrant a rule with these chilling effects, but no such circumstances are present here. The targeted misconduct has occurred only relatively infrequently in this market. Our anti-fraud rules likely already prohibit some of that conduct.[10] And, in a demonstration of the power of private ordering, market participants themselves have addressed some of the offending conduct. Sophisticated repeat players are well-placed to police one another for undesirable conduct, even if it is not illegal. In 2018, the International Swaps and Derivatives Association publicly acknowledged that these manufactured credit event strategies could affect negatively the security-based swap market and in 2019 made its Narrowly Tailored Credit Event Protocol available for adherence by counterparties.[11] This Protocol appears to have eliminated much of the destructive behavior simply by introducing greater uncertainty that these strategies could succeed. As the release notes, this Protocol does not address every possible such strategy, but, the release also does not challenge one commenter's assertion that these strategies have become "extremely infrequent."[12] In short, the Commission's desire to maximize its own flexibility in this anti-manipulation provision does not seem to further any regulatory objective. To the contrary, this rule likely will deter far more entirely legitimate activity than it will prevent truly manipulative activity. The Commission instead should delay taking any action here and wait to see whether the problem of opportunistic trading strategies is significant enough to warrant a solution as blunt as the one before us today.

We can all agree with the sentiment of Rule 15fh-4(c): coercing, manipulating, or deceiving a CCO is bad behavior. But regulation—even regulation that prohibits bad things—always involves trade-offs. Will subjecting every

interaction between employees and a CCO to potential legal liability empower the CCO to do her job or simply make employees less likely to approach the CCO to seek her input on compliance-related issues?

I do have a few questions:

- If a bank provides a loan to a customer and, in the process of negotiating the terms of that loan comes into possession of material non-public information, would the affirmative defenses permit the bank to hedge that loan exposure through a credit default swap? If so, under what conditions?
- LSTA noted in its March 2022 letter that the broad language of the anti-manipulation provision coupled with the use of a facts and circumstances test to determine whether a transaction was in the ordinary course would likely chill perfectly legitimate exercises of a lender's rights expressly provided for in heavily negotiated financing arrangements.[13] Can you provide me any comfort that these fears are groundless?
- The economic analysis suggests that Rule 9j-1 will benefit the market by reducing fraud and manipulation, including opportunistic trading strategies, and thereby increase confidence in the security-based swap market. In July 2022, the Managed Funds Association submitted a comment letter presenting data that it claimed suggested that there was no evidence of any lack of confidence among market participants.[14] The economic analysis seems to wave this evidence away as not persuasive, but does not provide any countervailing evidence that the market is laboring under a significant risk of fraud or manipulation. Is there any such evidence? What evidence, if any, do we have that manufactured credit events or other opportunistic trading strategies continue to present a risk to the market?
- One law firm submitted a comment letter identifying different types of market activity it described as "legitimate" that "would be threatened by" Rule 9j-1.[15] I'd like to understand better how the staff would view these examples from that letter:
  - "An investor who holds CDS (either long or short) participating in an ad hoc restructuring group."
  - "An investor who holds bonds and has bought CDS refusing to consent to a restructuring, choosing to rely on CDS protection."
  - "An investor who owns bonds and has sold CDS selling bonds back to the Reference Entity."
  - "An investor who has sold CDS providing rescue financing to distressed issuers."
- The release states that "misconduct that affects the payments and deliveries under one security-based swap could be prohibited by final Rule 9j-1 if that misconduct occurs in connection with effecting or attempting to effect transactions or purchasing or selling or attempting to induce the purchase or sale of any security-based swap, and not just the security-based swap that was the subject of the misconduct."[16] Could you provide an example of what type of misconduct this might encompass?
- The final rule prohibits manipulation of the price or valuation of a security-based swap. The release states that "the pricing and valuation of security-based swaps are intrinsically connected."[17] If this is the case, why is it necessary to prohibit manipulation of valuation, given that manipulation of valuation would also almost certainly result in manipulation of price?

Although I cannot support today's adoption of these rules, I do appreciate the effort that the staff put into reviewing the comments and taking to heart those comments in an effort to make the rule more workable. I especially appreciate the time that Carol McGee spent with me to answer my questions about the rule and Pam Carmody's work on drafting it. I also want to acknowledge the contributions of the Office of the General Counsel.

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[1] *See* Commissioner Hester M. Peirce, Dissenting Statement on Proposed Security-Based Swap Rules (Dec. 15, 2021), https://www.sec.gov/news/statement/peirce-statement-proposed-security-based-swap-rules-121521.

[2] Prohibition against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition against Undue Influence over Chief Compliance Officers, Exchange Act Rel. No. 97656 (June 7, 2023) ("Adopting

Release") at 55.

[3] *Id*.

[4] *See* Letter from Managed Funds Association (March 21, 2022) ("MFA Letter") at 18 n. 48, https://www.sec.gov/comments/s7-32-10/s73210-20120732-272888.pdf.

[5] Adopting Release at 57.

[6] *See* MFA Letter at 17-18 (stating that "the Commission has provided no meaningful standards for distinguishing appropriate financing activities from those that may be in violation of" the proposed rule and asking that the rule text be amended to reflect the Commission's intent to limit its scope).

[7] *See* Letter from Loan Syndications and Trading Association ("LSTA Letter") (Mar. 17, 2022) at 6.

[8] *See id*. (noting that "[t]he use of a facts and circumstances determination as to what is ordinary course conduct introduces additional uncertainty into routine business decisions of loan market participants[as] any conduct with a perceived impact on the price or valuation of a security-based swap or any related payment or delivery could subject a party to the threat of liability"). *See also* MFA Letter at 18 (noting that "hesitat[ion] to engage with the issuer or other creditors . . . as they currently do in the ordinary course . . . could negatively impact efforts to manage potential default scenarios in a coordinated and constructive manner").

[9] *See* Adopting Release at 56-57.

[10] *See* LTSA Letter at 4.

[11] *See* ISDA, ISDA Board Statement on Narrowly Tailored Credit Events (Apr. 11, 2018), https://www.isda.org/2018/04/11/isda-board-statement-on-narrowly-tailored-credit-events/; ISDA, ISDA Launches NTCE Protocol for Adherence (Sept. 16, 2019), https://www.isda.org/2019/09/16/isda-launches-ntce-protocol-for-adherence/.

[12] *See* Adopting Release at 103-105. The release notes in response only that, even if this is the case, the rule will prevent other types of misconduct as well.

[13] *See* LSTA Letter at 5.

[14] *See* Letter from Managed Funds Association (July 8, 2022), https://www.sec.gov/comments/s7-32-10/s73210-20133907-303833.pdf.

[15] Letter from John R. Williams, Milbank (Mar. 21, 2022) at 4, https://www.sec.gov/comments/s7-32-10/s73210-20120766-272949.pdf.

[16] Adopting Release at 28.

[17] *Id*. at 59.