Statement

Dissenting Statement on Proposed Security-Based Swap Rules

Commissioner Hester M. Peirce

Dec. 15, 2021

Thank you, Chair Gensler.

In 2010, Congress passed the Dodd-Frank Act, which established a comprehensive framework for the regulation of the security-based swap market. Over the past four years, the Commission took the final steps required to implement the core components of this framework. The first security-based swap dealers began registering this fall, and market participants finally began reporting details of their security-based swap transactions to security-based swap data repositories last month. I expect that this new regulatory regime will require significant changes in the way market participants do business, but I am reasonably confident that these changes will enhance the quality of the market and increase investor confidence and transparency.

I am less confident that the recommendations we are considering today will achieve similar benefits. Certainly, proposed Rules 9j-1 and 10B-1 address important issues—namely, fraud, manipulation, and transparency in the security-based swap market. In doing so, however, both proposed rules take a maximalist approach that seems disproportionate to the regulatory concerns they are designed to address and that may exceed our statutory authority. The expansive scope of both rules risks disrupting a market in which sophisticated participants have developed a set of norms that, on the whole, appear to meet their investment and hedging needs and that satisfy their commercial expectations.

Proposed Rule 9j-1 is an anti-fraud rule for the security-based swap market that draws on existing language in Exchange Act Rule 10b-5 and in Section 17(a) of the Securities Act,[1] while expanding its scope in significant ways. The prohibitions of the rule reach not just activity around the entry into a security-based swap, or the novation or termination of a security-based swap, but to any actions taken (or, in some cases, not taken) in connection with a obligations or rights under security-based swaps, including, for example, margin payments or early terminations of the transaction.[2] To take one example, every time a dealer issues a margin call, it may expose itself to potential liability under the proposed rule. The proposed rule prohibits not just the fraud, deceit, and manipulation already prohibited under Exchange Act Rule 10b-5 and Section 17(a) of the Securities Act. For the first time in the Commission's rules, as far as I am aware, attempted fraud, deceit, and manipulation are also covered, which may create additional uncertainty for market participants who may be concerned about how the Commission or counterparties will assess even innocuous conduct in retrospect.

The proposal recognizes that the application of the rule to every action taken pursuant to a transaction may interfere with market participants' normal use of security-based swaps and offers two limited safe harbors to

mitigate these effects. The safe harbors would allow firms to perform certain routine actions in connection with security-based swaps even when in possession of material non-public information. These safe harbors are important concessions to market practicalities, but they almost certainly will prove insufficient to avoid market disruption. For example, the safe harbors provide no comfort to lenders seeking to enter into a credit default swap to hedge credit exposure to borrowers, and it is unclear whether the safe harbors would apply to margin payments that have been the subject of dispute and negotiation between the parties to a transaction. Moreover, the narrow scope of the safe harbors highlights the extensive compliance framework that firms will need to implement to ensure that they do not fall afoul of the rule's prohibitions each time they take action—or refrain from taking action—in connection with their rights and obligations under each security-based swap if they do not fall within the safe harbors.

Other elements of this proposed antifraud rule also cause me concern. For example, the release devotes particular attention to concerns about manufactured credit events and other opportunistic strategies involving security-based swaps. I am not convinced that these problems are significant enough to warrant Commission rulemaking or even susceptible of being addressed through Commission rulemaking or guidance. Drawing lines that distinguish between conduct taken to effect such strategies and conduct taken in the normal course of business is exceedingly difficult. The release attempts to do so by articulating several indicia of improper strategies that the proposal is designed to address (as distinct from actions taken in the ordinary course of a security-based swap transaction). However, these indicia are necessarily broad and ambiguous and will likely discourage firms from taking actions that would interfere with the natural course of a security-based swap transaction. The proposal identifies, for example, the following indicator of impropriety: "when a party takes action 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."[3]

In addition to being a little circular, that statement could describe a legitimate and ordinary course of action, a point that the proposing release acknowledges. The release notes, however, that whether the rule reaches such conduct all comes down to facts and circumstances. Don't worry, there will be a fair consideration of those facts and circumstances during the enforcement investigation. The potential for Commission scrutiny of any action that affects payment under the security-based swap—and the unpredictability of the outcome of any facts-and-circumstances inquiry—will almost certainly create a bias toward market participants' taking no action as the termination of the security-based swap draws nearer. The consequence may be to deprive struggling firms of assistance from those most able or willing to provide it.[4]

Proposed Rule 10B-1 likewise may serve to squelch legitimate market activity. It requires firms to report publicly large security-based swap positions, along with their positions in any related securities. I appreciate the proposal's objective of providing the Commission and the public greater transparency into large, concentrated positions in particular reference entities.[5] I do not appreciate the proposal's method of achieving this objective. Given that reporting under the Commission's security-based swap data reporting rules began only last month, it seems premature to issue a proposal to require additional disclosures until the Commission has had some experience with the data reported and publicly disseminated under these existing rules.

In addition, as is apparent in the economic analysis of this proposal, because transaction reporting under our rules has only just begun, the Commission lacks the necessary information to determine with any confidence whether the thresholds for reporting under this proposal are appropriate and whether the firms required to report are likely to be the firms that raise the concerns motivating the proposal in the first place. For example, if, as the economic analysis suggests, many of the reports likely will be filed by security-based swap dealers,[6] how will their reporting advance the stated objectives of the rule? The release provides no evidence that security-based swap dealers are more likely than other market participants (or, indeed, likely at all) to engage in opportunistic strategies.[7] More fundamentally, the fact that a security-based swap dealer holds large, concentrated security-based swap positions in any particular reference entity is unlikely to be breaking news to us or to market participants.[8] Given the information the Commission currently has available to it, it is entirely possible that this new disclosure regime will result primarily in continuously updated reports of positions held by security-based swap dealers. Other firms that

need to monitor their positions pursuant to the complicated calculations required under the rule's thresholds will face significant compliance costs, and any firm that exceeds the thresholds will be forced to disclose information that these firms may have a legitimate interest in keeping confidential.[9] I cannot support a proposed rule that would produce so little at such great cost.[10] In any event, the regulatory concerns driving this rule are not so urgent that we could not have waited until we had a year or two of security-based swap transaction data to consider a recommendation for additional transparency measures.

Although I cannot support this proposal, I would like to conclude by expressing my appreciation to the staff in Trading and Markets and in DERA, as well as in the Division of Enforcement and Office of General Counsel, for their hard work over the last several months. In particular, I would like to thank Carol McGee and Andrew Bernstein in the Office of Derivatives Policy for your extensive engagement with my office, your responsiveness to my many concerns with the recommendation, and your unceasing hard work on a very difficult set of issues. I do hope the entire team is able to get some well-deserved rest over the coming holidays.

---

[1] See Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition against Undue Influence over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions ("Proposing Release"), Exchange Act Rel. No. 93784, Dec. 15, 2021, at 27-29.

[2] See id. at 29.

[3] Id. at 48.

[4] In addition to these concerns, I am not convinced that the Commission has the authority under Section 9(j) of the Exchange Act to promulgate proposed Rule 9j-1(c) or (d). The release notes that proposed Rule 9j-1(c) is modeled on Section 20(d) of the Exchange Act, which provides that trades in certain derivatives are unlawful if made while in the possession of material non-public information if a trade in the underlying security would be unlawful if made while in possession of such information. See 15 U.S.C. 78t(d). The release, however, gives no weight to the possibility that Congress specifically determined not to include security-based swaps in that provision, even though the proposal's inclusion of limited safe harbors demonstrates why Congress might have chosen not to include them.

Similarly, nothing in Section 9(j) of the Exchange Act appears to give us authority to apply rules promulgated under that provision to the equities or fixed income markets. Although the proposal contains language attempting to cabin application of the provisions of proposed Rule 9j-1(a) and (b) to those markets to very limited circumstances, it is unclear that the rule language itself so limits application of these provisions or why our existing antifraud provisions are not up to the task of addressing the concerns used to justify proposed Rule 9j-1(d).

[5] See Proposing Release at 20-23.

[6] See id. at 160. Because of limitations in the data about the bond holdings of firms with CDS positions and the very narrow data set available to the Commission regarding equity swaps, the Commission has insufficient data to reach even this conclusion with any degree of confidence.

[7] See id. at 20-23 (stating that purposes of proposed Rule 10B-1 include providing more information about market participants that may intend to use their positions to engage in net-short debt activism or in manufactured or other opportunistic strategies).

[8] Moreover, security-based swap dealers are subject to a comprehensive regulatory framework that includes capital and risk management requirements, as well as to ongoing supervision by the Commission.

[9] The usefulness—either to the Commission or to market participants—of any position-related information reported under the rule is also questionable. The rule generally requires these positions to be reported on a gross basis, meaning that the reports are likely to be too noisy to provide any useful information regarding either the

reporting person’s likelihood of engaging in an opportunistic strategy or the risk that the person may present to counterparties.

[10] In addition to the direct costs of complying with the proposed rule, there are likely to be indirect costs. In particular, some number of market participants will likely reduce their use of security-based swaps to avoid the extensive disclosure of those positions and related positions required by the rule. Decreased participation in the market will likely decrease market efficiency and deter capital formation as market participants find it more difficult to hedge risks associated with their investment and financing activities.