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SEC Proposes New Rules for the Security-Based Swap Market, with Implications for CDS and TRS Holders and an Emphasis on Debt Default Activism

In our previous memo, Regulators Eye "Opportunistic Credit Strategies," we highlighted regulators' increasing concerns with the security-based swap market, and in particular the threats posed by certain opportunistic credit strategies employed by debt default activists and others. Last week, the Securities and Exchange Commission moved to address those concerns by proposing new rules for the security-based swap market, which includes credit default swaps ("CDS") and total return swaps ("TRS"). Two of these proposed rules, Rules 9j-1 and 10B-1, would expand the SEC's role by authorizing enforcement actions against parties engaging in fraudulent, deceptive or manipulative conduct in the market, as well as by imposing new reporting requirements on market participants.

The SEC originally proposed rules for the security-based swap market in the wake of the financial crisis in 2010. The current proposed rules revive that effort by implementing general antifraud and anti-manipulation rules for the security-based swap market that largely mirror the rules that have long applied to the non-swap securities market.

This time, the SEC has also proposed new rules that more directly target opportunistic credit strategies. Rule 9j-1(b) would specifically prohibit the intentional distortion of security-based swap prices, and, notably, would reach *beyond* the security-based swap market itself to prohibit transactions in the underlying debt or equity markets that would distort swap prices. Rule 10B-1 would impose new reporting requirements, including on any CDS holder that either (1) is long (on net) *or* short (without offsetting) more than a notional amount of $150 million in a CDS position or (2) holds a *gross* notional amount exceeding $300 million in such position, whether long or short, as well as holders of significant TRS positions. As a result, previously opaque holdings in CDS, TRS and equity-based swaps would become knowledge available to issuers and other market participants. (We also look forward to the SEC's upcoming rulemaking to modernize beneficial ownership reporting, including as to 13D and derivative positions, which may shed further light on such and other holdings.)

If implemented, the proposed rules could deter CDS buyers and sellers, including debt default activists and "net short" activists (phenomena we have previously discussed in The Rise of the Net-Short Debt Activist, Default Activism in the Debt Markets, and Debt Default Activism: After *Windstream*, the

Winds of Change), from inducing or forestalling credit events in order to profit from their CDS positions. The SEC proposal cites the 2018 *Hovnanian* transaction – in which a fund holding a large CDS position offered Hovnanian, a home building company, below-market financing in exchange for Hovnanian triggering a default on one of its loans, which caused a payout to CDS holders – as one of the types of transactions which Rule 9j-1(b) could address. The CFTC signaled skepticism of the *Hovnanian* transaction when it was implemented, which had a chilling effect on such "manufactured defaults;" proposed Rule 9j-1(b) clarifies the SEC's views regarding these types of transactions moving forward. Additionally, the SEC's proposal cites *Windstream* as support for the new swap position reporting requirements in proposed Rule 10B-1. In that case, a "net short" activist reportedly amassed a large short position in CDS on the communications company Windstream, together with a smaller long position in Windstream's debt, and used the long position to assert (successfully) that Windstream was in default, triggering gains on the CDS short position and plunging Windstream into bankruptcy. Although the proposed rules would not necessarily preclude such a strategy, the reporting requirements would provide the issuer and other stakeholders with notice that they may be at risk.

It will be important, as the SEC further develops the rules and definitions, for it to retain sufficient discretion to address harms flexibly in what is an adaptive and bespoke market, through both reporting requirements and enforcement action. And it is of course important that in seeking to rein in practices it views as harmful to the market, the SEC not impede *bona fide* swap transactions, which may be used to hedge risks and create needed liquidity, as the SEC itself acknowledged in its commentary. But, in light of the proposed rules and the commentary around them, it is clear that the regulatory risk attendant to debt default and other activist strategies employing security-based swaps will now require consideration by those who would pursue them.

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