ISDA Safe, Efficient Markets

March 21, 2022

Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Notice of Proposed Rulemaking on the 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 (File No. S7-32-10)

Dear Ms. Countryman:

The Institute of International Bankers ("IIB"), the International Swaps and Derivatives Association ("ISDA"), and the Securities Industry and Financial Markets Association ("SIFMA") (together, the "Associations")[1] appreciate the opportunity to provide comments to the Securities and Exchange Commission (the "Commission" or "SEC") on the proposed security-based swap ("SBS") anti-fraud and anti-manipulation rule, set forth in proposed Rule 9j-1 under the Securities Exchange Act of 1934 (the "Exchange Act"), as reflected in the above-captioned proposed rulemaking (the "Proposed Rule").[2]

We support the Commission's goal of ensuring that appropriate disincentives to fraud and manipulation exist in the SBS market. Importantly, the rules must not inhibit legitimate commercial conduct. If the standards by which liability is determined are too broad or vague, market participants will avoid entering into SBS transactions – or the securities and lending transactions to which such SBS transactions relate – altogether. Diminished liquidity in SBS markets will result in reduced liquidity in the capital markets, making it more expensive and difficult for companies to raise money and for investors to meet their goals. For these reasons, we respectfully suggest changes to the

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1 Descriptions of the Associations are included in the attached Appendix.

2 SEC Release No. 34-93784 (December 15, 2021), 87 Fed. Reg. 6652 (February 4, 2022).

Proposed Rule that would create a more effective, robust legal framework to deter fraud and manipulation while protecting legitimate activity in these critical markets.

Proposed Rule 9j-1 would extend existing anti-fraud prohibitions, which already apply to SBS because the Exchange Act defines them as securities, by expanding the range of actions that could result in liability beyond affirmative actions that constitute investment decisions to include a broad range of post-execution activities. To mitigate potential problems that this expansion could pose, the rule would include two limited safe harbors for post-execution activities that take place when a person came into the possession of material non-public information ("MNPI") after executing an SBS. The Proposed Rule would also expand liability to attempted fraud or manipulation, and introduce a new prohibition, in a manner not previously applied to the securities markets, of activities in respect of any underlying security or loan that could be considered to manipulate the value or price of any SBS.

INTRODUCTION AND EXECUTIVE SUMMARY

We support the Commission's goal of ensuring that appropriate disincentives to fraud and manipulation exist in the SBS market. As the Commission recognizes in the proposing release, the SBS market provides important benefits to the U.S. economy, including reducing borrowing costs and providing credit and financial risk management opportunities for corporations and institutional investors. A regulatory framework that reduces the scope for fraud or manipulation in the SBS markets should generally improve the utility of these important financial tools. We support these important policy goals.

On the other hand, the rules must not create the risk that liability may attach to legitimate commercial conduct. If the standards by which liability is determined are vague, market participants will avoid entering into SBS transactions – or the securities and lending transactions to which such SBS transactions relate – altogether. Commercial lenders often extend credit to clients that is beyond internal enterprise risk guidelines with the expectation that they can hedge their exposure down to an acceptable level of risk. This practice is particularly important in times of economic stress, where large borrowers may not have the ability to raise sufficient debt capital in the public markets. Lenders are only willing to take on this initial exposure, which can be in the tens of billions of dollars, based on an expectation that they can effectively hedge their risks. If the current proposal were to decrease firms' willingness to transact due to vague or overly broad definitions of prohibited conduct, such a result would decrease market liquidity and increase the cost of CDS hedges (which would ultimately be passed on to securities issuers and consumers). Further, without unfettered access to a liquid CDS market, lenders will reduce their lending capacity to individual clients, which could significantly disrupt markets in the event that borrowers are unable to replace this source of borrowing in a timely and cost-effective manner. We believe that market participants need clarity that they can enter into legitimate trading and funding activities without risk of liability, otherwise these valuable market activities will be inhibited.

Respectfully, we believe the Commission's proposed rule fails this test in several respects:

- it does not reflect existing securities law recognition of the benefits and effectiveness of using information barriers to limit access to MNPI, nor does it reflect other established safe harbors from insider trading liability;
- it applies to conduct, including conduct lacking scienter, with respect to actions to exercise rights, actions related to performance of obligations, or the settlement of SBSs;
- it applies to attempts to engage in prohibited conduct, including conduct lacking scienter;
- it subjects legitimate commercial activities involving securities and loans, if undertaken by holders of SBS contracts that reference such instruments, to new, untested and vaguely defined sources of liability for manipulation – a concept not otherwise present in the securities markets;
- 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.

As a consequence, the Proposed Rule would foster significant uncertainty in the SBS markets as to whether many longstanding and good faith practices are no longer permissible. What is more, in many instances firms could not readily strengthen their practices to reasonably avoid liability given the ambiguities created by the confluence of expanding liability to cover attempted conduct, negligent conduct, and conduct related to the performance of pre-existing, non-volitional obligations that occurs during the life of an SBS. In this context, the potential to face liability in hindsight for conduct that appeared reasonable *ex ante* could very well push many participants to curtail, or potentially exit, the SBS markets. Diminished liquidity in SBS markets will also severely diminish liquidity in the capital markets, making it more expensive and difficult for companies to raise money. The failure to include robust information barrier defenses consistent with existing securities laws, would also serve to impair lending and capital formation. At the very least, ambiguities and calibration issues this significant seem equally likely to deter desirable activity as illegitimate behavior.

In light of these material issues, the Commission should: (a) narrow the scope of activities that would be caught under Proposed Rule 9j-1(a) or, in the case of post-execution actions covered by Proposed Rule 9j-1(a) provide additional affirmative defenses to prevent liability for inadvertent mistakes; (b) clarify that the same affirmative defenses that apply to existing insider trading prohibitions, including the use of information barriers, apply to Proposed Rule 9j-1(a); and (c) acknowledge a range of

legitimate market activities in the SBS markets (including with respect to the related securities and loans) that should not result in liability under the Proposed Rule.

DISCUSSION

I. The Commission Should Clarify That Longstanding Affirmative Defenses to Insider Trading Liability Apply to Proposed Rule 9j-1(a)

In 2000, in order to provide clarity to what was then a somewhat unsettled area of insider trading law, the Commission adopted Rule 10b5-1 under the Exchange Act.[3] That rule clarifies several matters, including the Commission's view that, subject to specified affirmative defenses, a purchase or sale of a security of an issuer is "on the basis" of MNPI about that security or issuer if the person making the purchase or sale was aware of the MNPI when the person made the purchase or sale. Rule 10b5-1 then codified two affirmative defenses, one for certain written trading plans and other arrangements that commit a person to purchases and sales before the person became aware of MNPI, and a second for organizations that use information barriers to separate individuals engaged in trading activity from those who possess MNPI.[4]

The information barrier defense, in particular, already reflected several longstanding practices in existence at the time of its adoption, and it has been a foundation for how market participants, and investment and commercial banks in particular, have organized their dealing and other trading operations for many decades. Specifically, Rule 10b5-1(c)(2) provides an affirmative defense for any person (other than a natural person) to demonstrate that a purchase or sale of securities is not "on the basis of" MNPI while such legal entity is in possession of MNPI so long as: (1) the individual making an investment decision on behalf of a legal entity to purchase or sell securities is not aware of the MNPI and (2) the legal entity has reasonable policies and procedures in place, such as those that prevent such individual from becoming aware of MNPI, to ensure that individuals making investment decisions would not violate the laws.

Rule 10b5-applies to insider trading cases brought under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The defenses summarized above and set out therein would not explicitly apply to Rule 9j-1(a) for SBS. This omission is curious, considering the extent to which the Commission took steps in other respects to ensure consistency between Rule 9j-1(a) and Rule 10b-5. Although the need for defenses based on Rule 10b5-1, including for the use of information barriers, was previously raised in

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[3] 65 Fed. Reg. 51737 (Aug. 24, 2000).

[4] Notably, although the Commission recently proposed to amend the first of these affirmative defenses, it has overall left it in place, and it has not proposed any modifications to the second affirmative defense.

SIFMA's comment letter of July 8, 2011 on the Commission's 2010 proposal of Rule 9j-1,[5] the current proposal does no more than recite this comment without response.[6]

It is difficult to understate the negative consequences that would flow from a decision to fail to provide the robust information barriers defense for the SBS markets.[7] Most SBS dealers are parts of global financial firms that, in reliance on Rule 10b5-1 and the precedent it codified, divide their organizations into public-side and private-side businesses. These firms primarily conduct SBS dealing activity as part of their public-side businesses along-side market-making and dealing in equity, debt, and other securities. For example, a firm may enter into SBS transactions in a public side business, operated by individuals who are separated by appropriate information barriers from others working in the private side of the firm. Without recognition of an information barrier defense, the public side of the firm could be effectively prevented from trading SBSs where individuals on the private side of the firm possess MNPI, even though the individuals on the public side are unaware of it. Faced with this conundrum, it would essentially be impossible to conduct SBS dealing activity within an overall firm that also engages in investment banking, lending or similar businesses that regularly come into possession of MNPI.

There is no indication that the Commission intended for this result. Indeed, the consequences for capital formation and SBS markets would be extreme. Nor is there any policy justification for why this critical element of securities market regulatory infrastructure should not continue to apply in the context of SBS transactions. The omission of the information barriers defense from proposed Rule 9j-1 also creates further confusion and regulatory uncertainty given that Rule 10b5-1(c) would also apply by its terms to any action involving SBS that is brought under Section 10(b) and Rule 10b-5 due to the fact that SBS falls within the definition of "security" in Section 3(a)(10) of the Exchange Act. An outcome where two Commission rules address identical conduct but provide inconsistent safe harbors is untenable and could drive arbitrary enforcement actions under one rule versus the other even if the relevant conduct were to fall squarely under both antifraud rules.

Accordingly, Rule 9j-1 should incorporate the same affirmative defenses to Rule 10b5-1(c), which should apply to all of the activities within the scope of Rule 9j-1(a) (to the extent they extend beyond purchases and sales).

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5 That letter set out the need for these defenses as well as giving several examples of the impact of the previous proposal's application to non-volitional actions (those in accordance with contractual rights and obligations). The Commission recognized the concern for non-volitional actions by providing a safe harbor for a person taking actions in accordance with binding contractual rights and obligations under an SBS. While this is welcome, it does not address the broader need for Rule 10b5-1 defenses. Those defenses are available in the securities markets for volitional actions, and similarly required for volitional actions in the SBS markets.

6 Proposed Rule at p. 6660, n.80.

7 The most relevant defense for the SBS markets is likely to be the use of information barriers, but we believe that each of the defenses in Rule 10b5-1 should also be available under Rule 9j-1(a) for SBS.

II. The Commission Should Limit the Scope of Rule 9j-1(a) to Misconduct in Connection with Purchases and Sales of, and Effecting Transactions in, SBSs

Proposed Rule 9j-1(a) is modeled on Rule 10b-5, but expands the scope of covered conduct beyond purchases and sales to include several other activities relating to SBSs. These include taking any action to exercise any right, or any action related to performance of an obligation under an SBS, or settlement of an SBS. The Commission also considers the meaning of the terms "purchase" and "sale" at length in the release, and concludes that they should be interpreted more broadly than their ordinary meaning, even as expanded in the context of SBS transactions.

In our comment letter on the earlier proposal of Rule 9j-1 in 2010, we raised these issues for the Commission to consider, and in response the Commission proposed two limited safe harbors for conduct while in possession of MNPI. While these safe harbors are welcome, the scope of activity covered by Proposed Rule 9j-1(a) continues to extend significantly beyond the statutory perimeter established by Congress in Section 9(j) of the Exchange Act. In so doing, the Proposed Rule would create significant uncertainty in the SBS markets and cast doubts on the legitimacy of this very important rule.

A. As Drafted, Proposed Rule 9j-1(a) Would Exceed the Commission's Statutory Authority

Section 9(j) states as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange, **to effect any transaction in, or to induce or attempt to induce the purchase or sale of,** any security-based swap, in connection with which such person engages in any fraudulent, deceptive, or manipulative act or practice, makes any fictitious quotation, or engages in any transaction, practice, or course of business which operates as a fraud or deceit upon any person" (emphasis added).

Nowhere does this statutory mandate address an "action to exercise any right," or an "action related to performance of any obligation," or to "settle" an SBS. Nonetheless, the Commission seeks to justify this aspect of the Proposed Rule by reference to the Exchange Act's definitions for "purchase" and "sale," as set forth in Sections 3(a)(13) and (14) of the Act.[8] In relevant part, those definitions provide as follows:

> "For security-based swaps, such terms include the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap, as the context may require."

8 Proposed Rule at p. 6661.

The Commission then states its belief that the aforementioned actions are not "limited to actions involving *all* of the rights and obligations under a security-based swap," but rather "incorporate actions that have an impact on some, but not all, rights and obligations," such as partial executions, terminations, assignments, exchanges, transfers, or extinguishments of rights or obligations.[9]

We concur with this reading, insofar as it would extend Proposed Rule 9j-1(a) to an affirmative action relating to an investment decision and affecting a material term of an SBS, for example a partial termination or assignment. This interpretation would be consistent with the Commission's prior guidance regarding when an amendment or modification to an SBS would be treated as a new transaction. Specifically, in the preamble to the 2012 joint swap definitional rulemaking by the Commission and Commodity Futures Trading Commission ("CFTC"), the two Commissions explained that "[i]f the material terms of a Title VII instrument are amended or modified during its life based on an exercise of discretion and not through predetermined criteria or a predetermined self-executing formula, the Commissions view the amended or modified Title VII instrument as a new Title VII instrument."[10] In the almost ten years since that rulemaking, market participants have arranged their affairs to treat such an exercise of discretion to amend a material term of an SBS as tantamount to the "purchase" or "sale" of an SBS, including for anti-fraud purposes.

The Commission recognized the principles set forth in the 2012 joint swap definitional rulemaking,[11] but inexplicably chose to go further, proposing that "fraudulent or manipulative conduct would be in connection with the purchase or sale of a security-based swap if it either alters any material terms of the security-based swap (as set forth in the applicable trading relationship documentation) **or has a material impact on any payment or delivery under the security-based swap**, such that it would not be consistent with what a reasonable person would have expected to pay, deliver, or receive absent such conduct."[12] The Commission also asserts that the Exchange Act's "purchase" and "sale" definitions "incorporate actions that have an impact on some, but not all, rights and obligations, **such as a margin payment that represents only part of what one counterparty owes the other**."[13] And as noted, the text of Proposed Rule 9j-1(a) itself would extend to any action to exercise any right, or any action related to performance of an obligation under an SBS, or settlement of an SBS.

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9 *Id.*

10 77 Fed. Reg. 48207, 48286 (Aug. 13, 2012), and see example in related footnote 894. We think that this guidance recognizes that some amendments are economically equivalent to entering into a new SBS transaction or terminating an existing SBS transaction (*e.g.*, an agreement to increase or decrease the size of an existing SBS), but other amendments are not. In this regard, entering into or terminating an SBS is a price-forming event, and so we would suggest that amendments that occur at zero cost are unlikely to be a "purchase" or "sale".

11 Proposed Rule at p. 6661.

12 Proposed Rule at p. 6661 (emphasis added).

13 *Id.* (emphasis added).

Such expansion cannot be supported by the statutory "purchase" or "sale" definitions. The principal actions set forth in those definitions—"execution, termination (prior to its scheduled maturity date), assignment, [or] exchange"—all involve a *volitional* or *discretionary* act by the parties, consistent with the 2012 guidance excerpted above. Further references in such definitions to a "transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap" are prefaced by the word "similar." So, for example, a novation (partial or full) is a "transfer or conveyance" of an SBS that is "similar" to an "assignment" or "exchange." Likewise, an amendment to an SBS to reduce its size or maturity is an "extinguishing of rights or obligations" that is "similar" to a "termination." But a mere margin payment is not "similar" to any of these actions because it is non-volitional, non-discretionary, and/or occurs solely as a result of predetermined criteria or rights. Indeed, a margin payment does not even involve any amendment or modification at all.

The Commission goes on to bootstrap its authority to extend Proposed Rule 9j-1(a) beyond any natural reading of the terms "purchase" or "sale" to its further mandate in Section 9(j) to "define, and prescribe means reasonably designed to prevent, such transactions, acts, practices, and courses of business as are fraudulent, deceptive, or manipulative, and such quotations as are fictitious."[14]

Congress intended for the Commission to identify specific transactions, acts, practices, and courses of business—not to broadly, and ambiguously, extend its anti-fraud and anti-manipulation prohibitions to cover a wide range of non-volitional actions falling outside Congress's carefully drafted "purchase" and "sale" definitions. Any other reading would render the initial scoping language in Section 9(j) ("to effect any transaction in, or to induce or attempt to induce the purchase or sale of" an SBS) superfluous, and therefore would be inconsistent with the statutory mandate and legislative intent.

We are concerned that basing as important a rule as Rule 9j-1 on a stretched interpretation of Congressional intent could weaken its effectiveness in setting appropriate market conduct standards in connection with offers, purchases and sales of SBSs. This is particular true considering that (as explained below) such an overly broad approach is not necessary to prohibit the relevant misconduct.

B. Applying Proposed Rule 9j-1(a) to Non-Volitional Conduct Would Result in Undesirable and Unnecessary Consequences

Even putting aside the statutory infirmities set out above, Proposed Rule 9j-1(a)'s application to non-volitional conduct under an SBS would not be appropriate because it would cast uncertainty on a wide range of *bona fide* conduct necessary to the operation of the capital markets. In particular, the standard articulated by the Commission – "conduct that has a material impact on any payment or delivery under the security-based swap, such that it would not be consistent with what a reasonable person would have expected to pay, deliver, or receive absent such conduct" – seems exceedingly difficult to apply.

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[14] *Id.*

In light of the lack of a scienter requirement in Proposed Rule 9j-1(a)(3) and (4), this standard would require a party contemplating some conduct to determine the impact of that conduct on any SBS that might be in existence between any parties unknown to it, and what a reasonable person would have expected to pay or deliver under that SBS in the absence of such conduct. Even if the interpretation were limited to SBS that the party itself has entered into at the time of the conduct, determining what a reasonable party would expect would be very uncertain. This expansion will make the anti-fraud rule confusing and difficult to apply. It therefore risks chilling legitimate market conduct as market participants try to determine whether conduct unrelated to an affirmative investment decision could be judged after the fact to be prohibited.

These consequences are not only undesirable. They are also unnecessary. The Commission need not extend Proposed Rule 9j-1(a) to any action to exercise any right, or any action related to performance of an obligation under an SBS, or settlement of an SBS, in order to capture illegitimate conduct.

Most notably, Proposed Rule 9j-1(b) would independently prohibit manipulation of "any payment or delivery related" to an SBS. The Commission describes various examples of market conduct of concern in its release, and later in this letter we make several recommendations on how that conduct should be analyzed in order to ensure that legitimate conduct is not caught by overly-broad descriptions of manipulation. But this prohibition in Proposed Rule 9j-1(b) would, standing alone, be sufficient to cover the remaining illegitimate conduct. Unlike Rule 9j-1(a), it would appropriately do so through application of a scienter standard sufficient to distinguish illegitimate conduct from merely negligent acts that affect payment or delivery obligations.

We also note that much of the illegitimate conduct described in the release actually involves a purchase or sale of securities. For example, the credit event under a credit default swap ("CDS") typically settles through an auction process that involves purchases and sales of securities. And many of the transactions with reference entities identified by the Commission are securities transactions. One need not expand the scope of existing anti-fraud and anti-manipulation rules at all to address fraud or manipulation in connection with such transactions.

Further, as the Commission notes, Section 9(j), and accordingly Rule 9j-1, extends to "effecting" transactions, a concept that "has been interpreted broadly," and "includes more than just executing trades or forwarding orders for execution," such as "screening potential participants in a transaction for creditworthiness, facilitating the execution of a transaction, and handling customer funds and securities."[15] So, for example, the misappropriation of customer margin would already be covered by the rule even without sweeping in "any action related to performance of an obligation" under an SBS.

We also question why the SBS market, alone among the securities markets, should be subject to such broad prohibitions. Nearly every securities transaction involves

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[15] *Id.* at p. 6662.

ongoing payment or delivery obligations: coupons on bonds; dividends on stocks; the exercise or settlement of an option; delivery of securities under a forward; exchanges of collateral for margin loans, securities loans, and short positions, etc. As the Commission observes, there is value in maintaining alignment between the anti-fraud rules for SBS and other securities.[16] Against this backdrop, there is no indication that the Commission's existing anti-fraud rules have been too narrow because they solely apply to offers, purchases, and sales. Indeed it is curious that the Commission would single out the SBS market, considering that, unlike the other securities markets, it is purely institutional, limited generally to eligible contract participants. These sophisticated parties are better positioned to protect themselves than the retail investors in the stock and bond markets.

C. If the Commission Does Not Retarget the Scope of Rule 9j-1(a), Then It Should Provide Affirmative Defenses for Good Faith, Non-Volitional Conduct

In our previous comment letter, we argued that the negligence standard of previously-proposed Rules 9j-1(c) and (d) (now proposed as Rules 9j-1(a)(3) and (4)) does not account for unique aspects of the SBS market. We provided an example of a mistaken calculation of a payment due under an SBS, which could be seen as a party "obtaining" money by means of a negligently untrue statement. We noted that anti-fraud provisions typically require scienter or at least recklessness. A lesser standard, such as negligence, is inherently inconsistent with the concept of fraud.

The Commission recognizes these concerns, but dismisses them by analogizing Rule 9j-1(a)(3) and (4) to existing, negligence-based prohibitions in Sections 17(a)(2) and (3) of the Securities Act of 1933 ("Securities Act").[17] But the two rules are not analogous, due to the difference in the scope of covered actions between Section 17(a), which is limited to offers, purchases and sales of securities (based on the ordinary and more commonly-understood definitions of "purchase" and "sale"), and Proposed Rule 9j-1(a), which covers a much broader range of actions, including "any action related to performance of any obligation, under any security-based swap."

The Commission did recognize the breadth of conduct covered by Rule 9j-1(a) in providing a safe harbor for actions taken in accordance with binding contractual rights and obligations under an SBS. However, this safe harbor only relates to the possession of MNPI, and so would not be relevant to the negligent misstatement example provided. Nowhere does the Proposed Rule address the specific issue of a mistake becoming a fraud, even in the absence of a party making a trading decision.

We continue to believe that merely negligent performance of contractual obligations should not lead to potential fraud liability. Accordingly, should the Commission retain Rule 9j-1(a)'s proposed scope, we ask that the Commission recognize the significant differences between the scope of conduct under the securities and SBS anti-fraud rules, and provide an affirmative defense for actions taken by a person in

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[16] *Id.* at 6660.

[17] *Id.*

accordance with binding contractual rights and obligations under an SBS (as reflected in the written SBS documentation governing such transaction or any amendment thereto) or to fulfill a regulatory obligation in connection with an SBS (such as delivery of a daily mark) if the person did not act intentionally or recklessly in connection with such action and, in the case of an action to fulfill a regulatory obligation, the person complied in good faith with written policies and procedures reasonably designed to meet the obligation.[18]

III. The Commission Should Adopt Safe Harbors for Beneficial Centralized Market Activities

The Commission provided a safe harbor for portfolio compression exercises, noting that "reducing the number of outstanding contracts provides important operational benefits and efficiencies for market participants".[19] We believe that similar benefits accrue from other centralized market activities, in particular multilateral amendment exercises, such as an ISDA protocol, and the use of Credit Derivatives Determinations Committees ("DCs"). A similar safe harbor should protect these activities.

A. The Commission Should Adopt a Safe Harbor for Multilateral Amendment Exercises (Including ISDA Protocols) or Bilateral Equivalents

A multilateral amendment exercise can be used to amend SBS agreements where multiple parties want to make the same amendments to contracts between them. ISDA has run several Protocols that facilitate such amendments by offering a centralized adherence mechanism.[20] Market participants may also opt to effectuate the same amendments bilaterally rather than via the multilateral exercise.

In line with the argument offered above that an amendment effected at zero cost should not be considered material, the amendments effected by a Protocol or a bilateral equivalent would not involve a "purchase" or "sale". Parties adhering to a Protocol make an open offer to make the relevant amendments with any party without the opportunity of conditioning that adherence on payment of any fee, which indicates there is no material change in the value of the transactions being amended by the Protocol. However, there could be cases where there is doubt as to whether a term amended in a Protocol or a bilateral equivalent might be considered "material" under the proposed interpretation. If an amendment could be considered "material", then a party in possession of MNPI would not be able to adhere to the Protocol or its bilateral equivalent under the interpretation of "purchase" and "sale" outlined in the Proposed Rule and above.

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[18] This safe harbor would be analogous to the one adopted by the CFTC in connection with non-scienter fraud and manipulation prohibitions adopted as part of its swap dealer business conduct standards. *See* 17 C.F.R. § 23.410(b).

[19] Proposed Rule at p. 6662.

[20] For example an ISDA Protocol was recently used to facilitate remediation of parties' documentation to comply with the Commission's regulations for SBS.

Because the potential for amendments contained in a Protocol or its bilateral equivalent is essentially fixed, and market participants are willing to enter into the changes with all counterparties, we consider that there is not an opportunity for a firm to benefit from possession of MNPI at the time of adherence to a Protocol.[21] There would be a cost of that firm not adhering, which would be borne by the firm's counterparties, by preventing them from being able to make the relevant amendments with that firm by Protocol or equivalent bilateral amendment.

We therefore request a safe harbor for adherence to ISDA Protocols (inclusive of bilateral equivalents) and other similar multilateral amendment exercises, similar to that provided by the Commission for portfolio reconciliation exercises.

B. The Commission Should Adopt a Safe Harbor for Participation in Determinations Committees

DCs have been used in the CDS markets for several years to provide CDS markets with a centralized mechanism that facilitates uniform determinations including settlement of transactions by ensuring contracts on the same terms react in the same way to credit market events.

The DCs were structured with regulatory restrictions on the use of MNPI and information barriers firmly in mind. Under the DC rules, each DC member firm is subject to confidentiality restrictions as well as requirements on identifying and managing conflicts of interest associated with its role as a DC member firm. In practice, this means that firms use information barriers to allow individuals representing a firm to participate in DC discussions.

The DCs are governed by rules setting out these requirements, including requirements for firms to maintain policies and procedures to support compliance. DC firms contribute their time and support the costs of the DC without compensation. The impact of new rules with uncertain scope could provide a disincentive for firms to participate.

Because of the specific arrangements already in place around the DC process, the benefits it offers to the CDS market as a whole, and the uncertainties over the application of Proposed Rule 9j-1 highlighted in this letter, we recommend that participating in the

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[21] Protocols may apply to both SBSs and to swaps that are also security-based swap agreements. We note the reference in footnote 97 of the Proposed Rule to the application under Section 20(d) of the Exchange Act of securities anti-fraud provisions to swaps that are security based swap agreements. An example is given of a swap on the S&P 500 while in possession of MNPI about a single component of the S&P 500. We believe that the materiality of the non-public information should be assessed in the context of the transaction, so non-public information in respect of a single component of an index would only be material for purposes of securities anti-fraud rules if it is material to the index as a whole. As footnote 97 is phrased as a negative statement ("cannot avoid liability"), we believe it is consistent with this understanding, and it not intended to suggest that MNPI in respect of a single index component would automatically be considered material for the index.

DCs in accordance with the DC rules and any applicable codes of conduct should be safe harbored from further compliance requirements under Rule 9j-1.

IV. The Commission Should Clarify the Intent Standard Applicable to Attempted Fraud or Manipulation

As noted above, the Commission has proposed to adopt non-scienter prohibitions in Rules 9j-1(a)(3) and (4) against obtaining money or property by means of material misstatements or omissions or engaging in any act, practice or course of business which operates as a fraud or deceit, respectively. In addition, those provisions would prohibit *attempts* at such misconduct.

Although Rules 9j-1(a)(3) and (4) are similar to Sections 17(a)(2) and (3) of the Securities Act, and thus the Commission reasons they should not incorporate a scienter requirement, Sections 17(a)(2) and (3) do not prohibit *attempts*. It is accordingly entirely unclear what intent standard should apply to attempts to engage in conduct violative of Rule 9j-1(a)(3) or (4). For example, would a merely negligent misstatement in the course of negotiating an SBS (*e.g.,* a junior salesperson mis-describing one of the SBS's material terms because he or she inadvertently did not refer back to the latest draft transaction confirmation) be actionable under Rule 9j-1(a)(3) even if ultimately the mistake is corrected and the party making the misstatement obtains no money or property?

Such a result would be untenable. Parties cannot be held to a standard of strict liability with regards to fluid discussions in the course of negotiating complex transactions—not to mention the potential for good faith mistakes to arise in connection with ongoing payment and delivery obligations, such as calculation of margin payments, where those mistakes are subsequently corrected.

Nor would this result be consistent with other precedents. For example, CFTC Rule 180.1, which Proposed Rule 9j-1(a) generally follows in prohibiting attempted fraud or manipulation, applies solely to intentional or reckless misconduct.

In light of these considerations, the Commission should either eliminate the reference to attempts in Rules 9j-1(a)(3) and (4), or it should clarify that a person will not face liability for an attempt to engage in the practices prohibited by those provisions unless the person had an intent to make a material misstatement or omission or to engage in fraud or deceit.

V. The Concept of Manipulation Should be Narrowly Circumscribed to Reduce its Chilling Effect on Legitimate Market Activity

Before considering the specific provisions of the anti-manipulation rule proposed in 9j-1(b), we set out some general considerations below. Rule 9j-1(b) sets out a manipulation standard that is new to securities markets. As a new standard, its effect is not easy to assess and further guidance or definition should be given in order to reduce the chilling effect that a poorly-understood standard could have on legitimate conduct. If it is too difficult for market participants to understand what is permitted in these markets,

then the avoidance of the costs and risks associated with compliance will lead investors and traders to reduce their activity and perhaps exit the SBS markets entirely, thus reducing market participation and liquidity. The negative impacts of such liquidity reduction are also likely to be felt beyond the SBS markets. For example, lenders frequently rely on the CDS markets to hedge their risks and thereby increase their lending capacities. The legal uncertainty and potential increased hedging costs resulting from overly-broad or vague conduct standards would either reduce lending capacity or increase borrowing costs, which would, in either case, diminish the efficiency and utility of the SBS markets to the broader economy.

These concerns are particularly acute for credit markets. The nature of credit markets is that large unexpected losses sometimes occur, and market participants expect to use – and should be permitted to use – all legal tools at their disposal to negotiate over how losses from a default should be allocated among creditors, relying on rights contained in detailed debt documentation and bankruptcy rules. The terms of debt arrangements are precisely-negotiated contracts that balance the interests of borrowers and lenders, permitting capital to flow to the real economy while managing credit risk. Transferring this risk in SBS therefore also requires careful understanding of the risks involved. Investors and market makers in these products take care to understand ahead of time what events may transpire to affect their investment and what the precise limits of those contractual and legal tools will be. Often, market participants negotiate or utilize both the provisions of the underlying security or loan and an SBS (as a hedge or otherwise) to achieve their investment objectives. The opportunity to use these different instruments in tandem incentivizes investors to carefully read and analyze the provisions of each. Other investors benefit from the price and value information that this work generates. But it is to be expected that sometimes some parties will suffer losses they did not anticipate, but which others may have foreseen. This fact alone does not constitute manipulation.

The Commission should take care in implementing any new rule for this market – particularly one that includes any new and untested concept such as the manipulation standard included in 9j-1(b) – to ensure it is correctly analyzing the potential impact of its rule on the market. In our view, this means that the Commission should articulate as precisely as possible (a) what potential conduct or activity is targeted, (b) which market participants would be harmed by it, and (c) why it is that the existing market infrastructure (whether the existing anti-fraud rules or the provisions of the relevant contracts) does not already provide sufficient protection. At the same time, the Commission should consider the cost to market participants of engaging in a particular transaction if they cannot clearly understand whether that transaction might be viewed afterward as being manipulative.

Because the proposal creates a new rule for SBS that does not apply to securities markets generally, it is also important to note that the economic link between CDS and cash debt markets should be maintained. Activity in one market is expected to have an impact on the other to keep the two markets in line. The mere fact that conduct in one market influences another should not be treated as indicative of any manipulation, and in fact that linkage should be protected. Unfortunately, that is precisely what the proposed

rule would do if it were to assign liability to any market actor who causes the value of an SBS to change “in a manner that would not have occurred but for such action”.[22] This is not the only statement of the manipulation standard in the proposal, and other statements are narrower (e.g. “intentionally distorted”), but this explanation of the standard would effectively require market actors to categorically avoid transacting in the underlying cash instruments while holding a related SBS and vice versa.

VI. The Commission Should Recognize Legitimate Market Activities and Ensure that Descriptions of Illegitimate Behavior Do Not Unintentionally Capture Those Legitimate Activities

We support the Commission’s efforts to deter fraudulent and manipulative conduct in SBS markets. As the Commission observes, ISDA has noted the negative impacts that narrowly tailored defaults could have on the CDS market, and taken steps to ensure that CDS settlements cannot be driven by narrowly tailored Credit Events and artificially cheap deliverable obligations. To achieve this outcome, an ISDA working group of CDS market participants spent almost a full year working to implement mechanisms that would thwart artificial and distortive conduct, while also articulating guidance to ensure that legitimate conduct could continue. This careful balancing of costs and benefits resulted in publication of a set of amendments to CDS contracts[23] (the “NTCE Supplement”).

Specifically, the NTCE Supplement: (1) amends the “Failure to Pay” Credit Event by adding a requirement that the relevant non-payment “must directly or indirectly result from, or result in, a deterioration in the creditworthiness or financial condition” of the applicable company (similar to the requirement that already applied to the “Restructuring” Credit Event); and (2) makes certain changes to the method used to calculate the outstanding principal balance of obligations issued with large amounts of original issue discount in order to ensure that an artificially cheap obligation cannot be used to increase CDS settlement payments. Satisfaction (or failure) of the “deterioration in creditworthiness” requirement is not directly observable or conditioned solely on objective facts. The guidance note that is included as part of the NTCE Supplement identifies a number of factors that should be taken into account in determining whether a payment failure is due to deterioration in creditworthiness, but intentionally does not set any sufficient conditions for the test to be satisfied.[24] The result is that typical payment failures will clearly meet the requirements, but it is not possible to identify precisely how or whether an artificial payment failure would or would not meet the requirement. This limited uncertainty of outcome is an effective disincentive to attempting to create an

[22] Proposed Rule at p. 6655.

[23] The 2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions

[24] It is the specific payment failure itself that must “result from” or “result in” credit deterioration. The fact that a payment occurs during a general decline in creditworthiness does not mean that this requirement is automatically satisfied.

artificial payment failure, and so such strategies are no longer an area of concern for the CDS market.

With the modifications above now in place, we believe that the scope for executing an opportunistic trading strategy is quite limited, particularly if it relies on a party taking a loss in one market in order to make a gain in another. We believe it is important that examples of misconduct should focus on realistic scenarios – taking accurate account of the protections now in place in this market – to limit the risk of unintentionally describing legitimate market conduct.

The Proposed Rule is designed to prevent conduct that "intentionally distorts", or "artificially influence[s]" SBS, and for "actions taken outside the ordinary course of a typical lender-borrower relationship". The Commission notes however that "any such determination would be based on the facts and circumstances of a particular situation". We are concerned that a "facts and circumstances" test makes it difficult for market participants to assess the risk of actions later being challenged as potentially manipulative.

Elsewhere in the Proposed Rule, the Commission describes the issue of manufactured or other opportunistic strategies in CDS as those that "generally involve CDS buyers or sellers taking steps, with or without the participation of a [reference entity] to avoid, trigger, delay, accelerate, decrease, and/or increase payouts on CDS" ,[25] and goes on to give some examples. This general description of the issue is overly broad, and could capture legitimate market conduct. Later descriptions of the rule itself are narrower, such as: "re-proposed Rule 9j-1(b) is designed to capture situations when a payment under the security-based swap is *intentionally distorted*".[26] The Commission should ensure that the final rule resolves these contradictions and clarifies the intent.

To help accomplish this, and in order not to chill legitimate market conduct by implementing a vague "facts and circumstances" test, we ask the Commission to re-consider, and then further elaborate upon, examples of conduct or activities that it intends to prohibit under the proposed rule and those that it does not intend to constrain. Below we offer some comments on the examples cited in the proposed rule in the hope that these will be helpful in the Commission's explanation of the final rule. We set out some general principles for an analytical framework to help identify legitimate market activities and potentially distortive activities. We then use those principles to identify behaviors that we request the Commission to recognize as legitimate. We also offer some refinements to the descriptions of problematic conduct contained in the proposal.

A. General Principles

The CDS contract (like other SBS contracts) anticipates that an issuer of securities may take various actions that impact the price of those securities and therefore the value of the SBS. For example these would include mergers, issuing/repurchasing debt or

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[25] Proposed Rule at p. 6655.

[26] *Id.* at 6663 (emphasis in original).

defaulting on debt. These events will often be the result of negotiations between investors and securities issuers. Sophisticated investors in securities and SBS anticipate these events and price the related risks into their contracts.

Some of the examples described in the proposal involve making changes to debt terms or structure. Changes to debt terms must involve an entity that holds debt entering into an arrangement with the reference entity. These arrangements may be executed publicly or privately as discussed further below, but for an entity on which CDS is traded, their existence will typically become public.

To help identify distortive or artificial conduct, we believe it is helpful to distinguish between **publicly executed strategies**, where multiple parties or an independent body (such as a court or a regulator) are involved, and **privately executed strategies**[27], such as a single market participant entering into an agreement with a reference entity. Because publicly executed strategies are driven by the incentives of a broader group of participants than privately executed strategies, it would be more difficult for a single participant with an incentive to manipulate SBS prices to effect a distortive transaction for that purpose – for instance, it would be very difficult to obtain agreement from regular debtholders to terms that are materially off-market or would be irrational in the absence of SBS. For this reason, we believe the final rule should provide a safe-harbor from liability under Rule 9j-1(b) for publicly executed strategies.[28]

Even a strategy that is ultimately executed privately may include a public element that strongly indicates the conduct is not manipulative or distortive. For example, if there is public information that a company has a need for additional capital or to refinance existing debt, market participants can assess the types of strategies that might be employed to provide the needed financing, even if those are ultimately executed privately.

ISDA developed similar considerations in the context of the NTCE Supplement to help determine whether a payment failure was the result of a deterioration in the creditworthiness or financial condition of the reference entity, or occurred due to some other reason.[29] In general, we believe that factors indicating that a non-payment was the result of a deterioration in the creditworthiness or financial condition of the reference

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[27] We use the term "privately executed strategies" to refer to whether a strategy can be executed by a by a single creditor, as distinguished from "publicly executed strategies" where multiple creditors are involved, such that the general creditor/debtor incentives can be relied on to avoid distortive conduct. The use of "private" and "public" here is not intended to distinguish between a public or private issue of securities, or turn on whether the company is a public filer.

[28] While private execution can make it possible for an arrangement to include an element that is materially off-market or would be irrational in the absence of SBS, the overwhelming majority of privately executed transactions are legitimate. Accordingly, private execution must not be viewed as presumptively manipulative.

[29] See e.g. Exhibit F to the NTCE Supplement sections 1.10 (c), (d), (e), (f), and 1.11(a) – (f).

entity would also indicate that the conduct involved in that non-payment would not be distortive or manipulative.

B. The Commission Should Explicitly Recognize Legitimate Activities

We request that in the final rule release, the Commission clarify that the following examples of credit market conduct are generally legitimate and therefore not per se indicative of fraudulent or manipulative conduct, even though they may have a foreseeable impact on the value of an SBS or related security.

Investors holding SBSs should be entitled to make investment and trading decisions having regard to their overall portfolio, taking account of the net effect of those decisions on their securities, SBSs and other assets/liabilities. This would include the following examples of legitimate conduct.

- An investor who has bought (or, in the situation where such investor does not have MNPI, is considering buying) CDS on a company asking for a debt term to be changed to make the loan deliverable for CDS. Protection buyers have a natural incentive to help a reference entity to increase the availability of deliverable obligations for CDS.

- An investor who owns bonds and has sold CDS selling bonds back to the reference entity. Protection sellers have a natural incentive to help a reference entity to decrease the availability of deliverable obligations for CDS.

- An investor who holds bonds and has bought CDS refusing to consent to a restructuring, choosing to rely on CDS protection (this is recognized in the proposal on page 47).[30] As noted elsewhere in this letter, retaining the freedom to exercise (or refrain from exercising) all available contractual rights during a restructuring process is of particular concern to investors, and any anticipated or potential restrictions imposed by Proposed Rule 9j-1 would significantly undermine the benefit of hedging a cash position with SBS.

- A debtholder who also has a CDS position deciding whether or not to enforce any rights it may have under the terms of the debt. Enforcement of rights could lead to a default and a payout on CDS, but enforcement of contractual remedies is one of the most critical protections available to debtholders and any potential limitations imposed by the proposed rule would be problematic for the reasons described with respect to restructuring activities above.

- A party physically settling a CDS choosing whether to enter a physical settlement request into a CDS settlement auction and what deliverable

[30] This is recognized in the Proposed Rule on page 6663.

obligation to deliver. CDS contracts allow (but do not require) any obligation meeting certain deliverable obligation criteria to be delivered for settlement, and the purpose of the CDS settlement auction is to find a clearing price for the relative demand of CDS buyers and sellers for physical settlement, which is then used to determine the relevant settlement payments. There is no requirement for CDS holders to participate in settlement auctions, and participants should not be faulted for decisions as to whether or how to participate, which may involve complex judgments regarding the relative value of the applicable debt obligations and predictions of the bidding behavior of other participants.

- A party entering into a standstill agreement with a company during a restructuring, whereby the company does not make a payment after having agreed with creditors that they will not enforce their rights resulting from that non-payment for some defined period.[31]

Parties should be entitled to trade interactively between cash and derivatives instruments, understanding that actions in the cash market can be expected to affect pricing in the derivatives market and vice versa. This would cover the following examples of legitimate conduct.

- Trading the basis between the cash market and the CDS market, where a trade in the CDS market could be anticipated to affect the cash price and vice versa.

- Choosing whether to put on a market position using derivatives or cash instruments.

C. The Commission Should Refine Descriptions of Conduct in the Proposal that are Overly-broad and Capture Legitimate Market Activities

Below is a list of the opportunistic trading strategies identified by the Commission in the Proposed Rule, and some observations on each. We request that the Commission refine its descriptions of these trading strategies in adopting the final rule.

(1) A CDS buyer working with a reference entity to create an artificial, technical, or temporary failure-to-pay credit event in order to trigger a payment on a CDS to the buyer (and to the detriment of the CDS seller).

[31] A standstill agreement executed for bona fide commercial reasons should not indicate that the failure to pay is artificial or technical, particularly if the standstill is publicly executed. This is explicitly recognized in paragraph 1.13 of Exhibit F to the NTCE Supplement, and we specifically mention it here as an example of the interaction between CDS and activity in cash instruments that market participants widely felt needed to be individually addressed in order to ensure that CDS markets could continue to function properly.

This strategy was addressed in the NTCE Supplement via the inclusion of the "credit deterioration" requirement discussed above, so it is no longer an area of concern.

> *(2) The strategy above (as well as other strategies) can be combined with causing the reference entity to issue a below-market debt instrument in order to artificially increase the auction settlement price for the CDS (i.e., by creating a new "cheapest to deliver" deliverable obligation).*

As described above, this strategy was also addressed in the NTCE Supplement (and is generally very difficult to implement without an accompanying credit event), so this is also no longer an area of concern.

> *(3) CDS buyers endeavoring to influence the timing of a credit event in order to ensure a payment (upon the triggering of the CDS) before expiration of a CDS, or a CDS seller taking similar actions to avoid the obligation to pay by ensuring a credit event occurs after the expiration of the CDS, or taking actions to limit or expand the number and/or kind of deliverable obligations in order to impact the recovery rate.*

We believe it is important to distinguish several different issues described together in this example:

First, to distinguish between pushing a company into default from potentially saving a company from default.

Second, for comments on limiting versus expanding the number and/or kind of deliverable obligations to be treated separately, and also distinguished from a later description of conduct in the proposal.

<u>*Company Defaults*</u>. Below we consider different types of default that are relevant for common CDS contracts. For the reasons described below, and because of the limited universe of defaults that are relevant for common CDS contracts, there are very limited circumstances in which an artificial CDS credit event is possible.

- Bankruptcy is very public and a court-supervised event, so does not present a real risk of being a technical or artificial event. For U.S. entities, note that a restructuring is typically implemented with court supervision under Chapter 11, and is a bankruptcy event for purposes of CDS.
- Failure to Pay, and specifically the timing of a Failure to Pay, is based on the payment dates included in debt terms. As noted above, Failure to Pay was addressed in the NTCE Supplement through the credit deterioration requirement. Further, non-payment on a payment date fixed well in advance should generally not raise any concern of manipulation,[32] particularly because payment defaults

[32] *See* section 1.11(f) of Exhibit F to the NTCE Supplement.

will often trigger cross-defaults on other debt obligations and negatively impact the company's ability to access capital markets going forward.

- The Restructuring Credit Event (not typically relevant for the CDS on US reference entities[33]) deals with out of court restructurings, and is triggered by binding changes to the terms of debt contracts. As an out-of-court amendment process, there is more scope for a negotiated agreement to impact SBS in less-predictable ways. Recognizing the risks presented by an out-of-court restructuring, the CDS contract already has protections built in to limit unforeseeable effects. These include a multiple holder requirement (more than three unaffiliated holders, with the consent of at least two thirds required) for an amendment to trigger the Restructuring Credit Event, a requirement that the event directly or indirectly results from a deterioration in the creditworthiness or financial condition of the company, and the bucketing of CDS by maturity to avoid a long dated obligation being used to settle short term CDS. These protections mean that CDS is unlikely to be distorted by an out of court restructuring.
- Governmental Intervention covers resolution of a bank reference entity, which is implemented by a bank regulator, and so does not present risk of distortion.

Saving Company from Default. We believe that saving a company is beneficial. Reference entities should be able to seek, and capital providers should be able to provide, short, medium, or long term financing, without fear that short term financing could be characterized as manipulation of CDS contracts. In a later part of the proposal, the temporary rescue of a company is described in the following terms: "a CDS protection seller could offer financing to the company to avoid a credit event and subsequent CDS payout, with the financing timed so that the company's bankruptcy is merely delayed until after the CDS expires".[34] We believe that the CDS protection seller would be putting additional capital at risk in this example, with no guarantee that the company would (or would not) default within any particular timeframe, and would be doing so in a situation where risk of loss is high and any negotiated lender protections would be subject to significant risk of litigation challenge during bankruptcy. And a company filing for bankruptcy should not indicate manipulation, even if it occurs shortly after a CDS maturity date, for the reasons set out in the discussion of bankruptcy above.

The corollary of this position is that, where a potential lender is asked to extend further financing to a company in distress (or otherwise), the lender should be entitled to take account of the net effect of such extension on its securities, SBS and other

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[33] CDS on US reference entities is generally traded on "Standard North American Corporate" terms, which do not include Restructuring as a Credit Event.

[34] Proposed Rule at p. 6663.

assets/liabilities in deciding whether to do so. This is already explicitly recognized by the Commission.[35]

<u>Deliverable Obligations</u>. The concerns around limiting the number of deliverable obligations should be stated separately from the company default discussion. We believe the concern being identified here is likely that a party that has sold CDS protection may hoard substantially all deliverable obligations, so that protection buyers wanting to settle the CDS to claim payment following a credit event will have nothing to deliver. [36] This conduct does not involve the reference entity, except that it may create additional demand for deliverable obligations from CDS protection buyers, allowing the reference entity to access additional funding. This example should also be distinguished from a party that has sold CDS protection agreeing to sell debt back to the reference entity. As described in the general legitimate conduct above, a party in this position should be able to consider its entire portfolio of CDS and debt in deciding how to act.

We consider that actions to expand available deliverable obligations are likely to result from CDS buyers' natural demand for deliverable debt (see discussion of legitimate trading above). This should not be considered manipulation, because a well-functioning CDS market relies on there being sufficient liquidity in the cash instruments to facilitate settlement, and generally there is no benefit to CDS purchasers from additional supply of deliverable obligations other than ensuring proper settlement and potentially increased liquidity in the contract. Put another way, to the extent that the Commission has identified a concern with the potential for a CDS protection seller to reduce the supply of deliverable obligations by hoarding to influence the auction settlement price, there is not a corresponding issue created by an increase in supply of deliverable obligations.

Finally there is a reference later in the proposal to "actions that serve little to no economic purpose other than to artificially influence the composition of the deliverable obligations in a CDS auction".[37] From the context, we believe this comment refers to the issuance of artificially cheap debt, and not the overall composition or volume of deliverable obligations available to settle in a CDS settlement auction. This should be clarified, however as discussed above, we do not believe this type of activity is practically possible following the adoption of the NTCE Supplement.

> *(4) CDS sellers offering financing to restructure a reference entity in such a way that "orphans" the CDS – eliminating or reducing the likelihood of a credit event by moving the debts off the balance sheets of the reference entity and*

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[35] "To be clear, a person simply profiting from a CDS position after a company's bankruptcy, which such person could have prevented by participating in a financing to the company, without more is not in and of itself improper conduct for purposes of re-proposed Rule 9j-1(b)". *Id.*

[36] While simple to describe, this activity would be quite difficult and risky to manage and execute because the relevant CDS market participant must accumulate a very large position across all relevant deliverable obligations while taking the risk that the company will not issue additional obligations and that there are no other deliverable obligations outstanding that are unknown to the market participant.

[37] Proposed Rule at p. 6663.

onto the balance sheets of a subsidiary or an affiliate that is not referenced by the CDS.

A key consideration in determining whether actions around changing the financing entity within a reference entity group is whether the information and the execution is public. If a reference entity undertakes a public debt exchange/transfer, *i.e.* issues a public consent request, to move the debt, then this should not be in scope as potential manipulation, because it will likely have involved other debtholders who, unmotivated by CDS considerations, agreed to the terms of the offering. Further, as noted above, protection buyers and protection sellers will have naturally diverging incentives as to whether debt should be deliverable or not deliverable for CDS, and if the strategy is public, parties can predict the results of the interaction of those incentives.

Private execution of an orphaning strategy would require holding a very large amount of the reference entity's debt. We could envisage a situation where information on holding a very large proportion of a reference entity's debt could be relevant to regulators in examining the private execution of a potential "orphaning" transaction.

(5) Taking actions, including as part of a larger restructuring, to increase (or decrease) the supply of deliverable obligations by, for example, adding (or removing) a co-borrower to existing debt of a reference entity, thereby increasing (or decreasing) the likelihood of a credit event and the cost of CDS.

As described above, the existence of CDS creates a natural demand for securities that are deliverable. If a reference entity group suggests a change to its main debt-issuing entity, there will be natural demand from protection buyers for the existing CDS reference entity to be a co-borrower. This is legitimate conduct and is essential to a well-functioning CDS market that foundationally fosters and supports robust capital formation in its various forms for all market participants.

* * *

We appreciate the opportunity to provide comments in response to the Proposed Rule and the Commission's consideration of our views. If you have any questions or would like additional information, please contact the undersigned.

Very truly yours,

Bridget Polichene
Chief Executive Officer
Institute of International Bankers

Scott O'Malia
Chief Executive Officer
International Swaps and Derivatives Association

Kenneth E. Bentsen, Jr.
CEO and President
Securities Industry and Financial Markets Association

cc: The Hon. Gary Gensler, SEC Chairman
The Hon. Hester M. Peirce, SEC Commissioner
The Hon. Allison Herren Lee, SEC Commissioner
The Hon. Caroline A. Crenshaw, SEC Commissioner

Director Haoxiang Zhu, SEC Division of Trading and Markets
David Shillman, Associate Director, SEC Division of Trading and Markets

APPENDIX

Overview of the Associations

The **Institute of International Bankers** is the only national association devoted exclusively to representing and advancing the interests of the international banking community in the United States. Its membership is comprised of internationally headquartered banking and financial institutions from over 35 countries around the world doing business in the United States. The IIB's mission is to help resolve the many special legislative, regulatory, tax, and compliance issues confronting internationally headquartered institutions that engage in banking, securities and other financial activities in the United States. Through its advocacy efforts the IIB seeks results that are consistent with the U.S. policy of national treatment and appropriately limit the extraterritorial application of U.S. laws to the global operations of its member institutions.

Since 1985, the **International Swaps and Derivatives Association** has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 960 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: https://www.isda.org/. Follow us on Twitter, LinkedIn, Facebook and YouTube.

The **Securities Industry and Financial Markets Association** is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.