

MEMO# 33972

December 21, 2021

SEC Proposes Public Reporting Requirements for Large SB Swap Positions; ICI Member Call on January 10 at 1:00 p.m. ET

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TO: Derivatives Markets Advisory Committee

Equity Markets Advisory Committee RE: SEC Proposes Public Reporting Requirements for Large SB Swap Positions; ICI Member Call on January 10 at 1:00 p.m. ET

Last Wednesday, the SEC issued a rule proposal to implement additional Dodd-Frank requirements for security-based swaps (SB swaps). The proposal includes (i) proposed Rule 10B-1 to require any person with a SB swap position exceeding a threshold size to promptly file with the SEC a publicly-disclosed schedule that provides information about that position; (ii) a re-proposed Rule 9j-1 to prohibit fraudulent, deceptive, or manipulative conduct in SB swap transactions; and (iii) proposed Rule 15Fh-4(c) to prohibit undue influence over the chief compliance officer (CCO) of a SB swap dealer or major SB swap participant (SB swap entity). The SEC describes concerns about certain market developments in the credit default swap (CDS) market, such as manufactured credit events and other "opportunistic strategies" intended to affect CDS payouts, as its rationale for these proposed rules. This memo summarizes the proposal, with a focus on proposed Rule 10B-1.

Comments on the proposal are due 45 days after publication in the Federal Register. ICI will have a call to discuss the proposal and potential comments on Monday, January 10 at 1:00 pm ET. We will send a calendar invite with dial-in details shortly. In the meantime, please contact me at nhan.nguyen@ici.org with any questions or feedback.

I. Large SB Swap Position Reporting

The SEC has proposed a new Rule 10B-1 to require the public reporting of large SB swap positions on a Schedule 10B filing, as authorized by Section 10B of the Exchange Act.^[1] The SEC cites several benefits of large position reporting to market participants and regulators, which include (i) signaling fraud or manipulation, or in the case of CDS, signaling a potential incentive for a CDS holder to vote against its interests as a debt holder, even if such conduct is not inherently fraudulent; and (ii) alerting the existence of concentrated

exposures to a limited number of counterparties, which would allow counterparties to risk manage and better price the SB swap transactions vis a vis the holders of such large positions.

As proposed, a Schedule 10B filing must include the following information related to (i) the identity of the reporting person, including the type of reporting person (e.g., investment company or investment adviser); and (ii) the SB swap position, the loans or securities underlying that position, any related securities and loans, and other SB swaps related to the SB swap position.^[2] The SEC emphasizes that the proposed rule is not intended to publicly disclose sensitive or proprietary information about SB swap positions. Therefore, it notes that Schedule 10B only requires reporting of aggregate positions and does not require a reporting person to identify their counterparties, among other aspects.

Scope of Reporting Person

The proposed rule would require "any person,"^[3] regardless of whether they are registered with the SEC in any capacity, or group of persons,^[4] that after acquiring or selling directly or indirectly any SB swap, is directly or indirectly the owner or seller of a SB swap position that exceeds the Reporting Threshold Amount (described further below), to file a Schedule 10B report on EDGAR. The proposed rule also specifies that any person who uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement or device to evade the reporting requirement would be deemed to be an owner of the SB swap position.^[5]

Scope of "SB Swap Position"

A SB swap position subject to reporting would consist of all SB swaps based on (i) a single security or loan, or a narrow-based security index; (ii) any securities issued by the same issuer of the securities, loans or securities included in the applicable narrow-based index;^[6] or (iii) any narrow-based securities index that includes any of those issuing entities or their securities, in each case as applicable.^[7] Further, a reporting person must report the SB swap position on a gross basis,^[8] and aggregate the positions that have the same reference entity, security, loan, or group or index of securities or loans across different counterparties.

The SEC notes that SB swap reporting would otherwise occur separately (with separate thresholds) among three types of positions: (i) a SB swap position based on a single class of equity securities issued by a reference entity; (ii) a non-CDS SB swap position based on the debt securities of the same reference entity; and (iii) a CDS SB swap position based on the debt securities of that reference entity would be reported separately. However, the SEC also specifies that these securities are related to one another, which affects the manner in which Schedule 10B would need to be filed.^[9]

Reporting Thresholds

The SEC has proposed the following SB swap position reporting thresholds in the chart below. In the case of SB swap positions based on equity securities, the SEC notes that the proposed thresholds are based on its review of information that included a subsample of total return swap data obtained from Form N-PORT filings.

Category

Reporting Threshold Amount

SB swaps based on debt securities (CDS)[10]

The lesser of (i) a long notional amount of \$150 million;[11] (ii) a short notional amount of \$150 million; or (iii) a gross notional amount of \$300 million.

SB swaps based on debt securities (non-CDS)

A gross notional amount of \$300 million.[12]

SB swaps based on equity securities

The lesser of

- i. a SB swap position meets or exceeds \$300 million on a gross basis.[13] However, once a position exceeds a gross notional amount of \$150 million, then the position calculation shall include the value of all the underlying equity securities owned by the SB swap position holder based on most recent closing share price, as well as the delta-adjusted notional amount of any options, security futures, or any other derivative instruments based on the same class of equity securities.
- ii. a "SB swap equivalent position"[14] that represents more than 5% of a class of equity securities. However, once a SB swap equivalent position represents more than 2.5% of a class of equity securities, the position calculation shall include in the numerator all the underlying equity securities owned by the holder of the SB swap position, as well as the number of shares attributable to any options, security futures, or any other derivative instruments based on the same class of equity securities.[15]

Timing Requirement

A Schedule 10B must be filed promptly to the SEC and no later than the end of the first business day following the execution of the SB swap that led the position to exceed the applicable threshold. Upon filing, the Schedule 10B would immediately become publicly available. Material changes to an existing filing, which would include a material increase in a SB swap position or a decrease to below the applicable threshold amount, would need to be filed promptly, but no later than the end of the first business day following the material change. An acquisition or disposition equal to 10% or more of the previously disclosed position would be deemed "material."

Cross-Border Application

To ensure that cross-border SB swap transactions are subject to reporting, proposed Rule 10B provides that the requirements apply to all SB swap positions as long as any of the transactions underlying the position would be required to be reported under Rule 908 of Regulation SBSR;[16] or (ii) the reporting person holds any amount of reference securities underlying the SB swap position (or would be deemed as beneficial owner of such reference securities pursuant to Section 13(d) of the Exchange Act) and (a) the reference security issuer is organized, incorporated or established under US law or has its principal place of business in the US, or (b) the reference security is part of a class registered under Section 12 or 15(d) of the Exchange Act.

II. Anti-Fraud and Manipulation Prohibition for SB Swaps

Re-proposed Rule 9j-1 would prohibit fraudulent, deceptive, or manipulative conduct in connection with all transactions in SB swaps, including misconduct in connection with the

exercise of any right or performance of any obligation under a SB swap.^[17] Specifically, the rule would

- prohibit a range of misconduct and attempted misconduct in connection with SB swaps, including misconduct in connection with the exercise of any right or performance of any obligation under a SB swap;
- prohibit manipulation or attempted manipulation of the price or valuation of any SB swap, or any payment or delivery related thereto;
- provide limited safe harbors for certain specified conduct; and
- provide that a person cannot escape liability for trading based on possession of material non-public information about a security by purchasing or selling a SB swap based on that security and cannot escape liability under the proposed rule by purchasing or selling the underlying security (as opposed to purchasing or selling a SB swap that is based on that security).

Specifically, the proposed rule would apply not only to the "purchase" or "sale" of security-based swaps, as defined in the Exchange Act, but also to: (1) transactions, or attempts to effect transactions in, security-based swaps, (2) actions to exercise any right or actions related to performance of any obligation pursuant to any security-based swap including any payments, deliveries, rights, or obligations or alterations of any rights thereunder, or (3) terminations (other than on its scheduled maturity date) or settlements of any security-based swap, in connection with which a person engages in the specified fraudulent, manipulative, or deceptive conduct.

III. CCO Independence

Proposed Rule 15Fh-4(c) would prohibit any officer, director, supervised person or employee of an SB swap entity, or any person acting under such person's direction, to take any action to coerce, manipulate, mislead, or fraudulently influence the SB swap entity's CCO in the performance of their duties under the federal securities laws.

Nhan Nguyen
Assistant General Counsel, Securities Regulation

endnotes

^[1] The Dodd-Frank Act added Section 10B of the Exchange Act. Subsection (d) authorizes the SEC to adopt a rule or regulation to "require any person that effects transactions for such person's own account or the account of others in any [SB] swap or uncleared [SB] swap and any security or loan or group or narrow-based security index of securities or loans ... to report such information as the Commission may prescribe regarding any position or positions in any [SB] swap or uncleared [SB] swap and any security or loan or group or narrow-based security index of securities or loans and any other instrument relating to such security or loan or group or narrow-based security index of securities or loans...." 15 U.S.C. 78j-2(d).

^[2] See *infra* note 9.

^[3] "Any person" would include any entity controlling, controlled by or under common

control with such a person.

[4] "Group of persons" would include persons with a "contract, arrangement, understanding or relationship."

[5] According to the SEC, if several entities agreed to acquire separate positions that were each below the applicable threshold, then each party to that arrangement would be deemed as an owner of the aggregated position.

[6] If a SB swap position is based on a single security or loan that is included in a narrow-based index, then the calculation of that position with respect to that component would be based on its weighting in the index.

[7] These three categories would also include any interest therein or based on the value thereof.

[8] According to the SEC, "gross" means the sum of the absolute values of notional amounts outstanding of all the SB swaps with the same reference entity or security.

[9] If a position in one related type exceeds its applicable threshold and there is a position of another related type that does not meet its applicable threshold, then these positions would be reported on the same Schedule 10B. If both positions exceeded their applicable thresholds, then they would need to be reported on separate Schedule 10B filings, albeit with a cross-reference to one another.

[10] This would include CDS where the underlying reference is a group or index of entities or obligations of entities that is a narrow-based security index.

[11] This amount would be calculated by subtracting the long notional amount of any long positions in a deliverable debt security underlying a SB swap included in the SB swap position from the long notional amount of the SB swap position.

[12] This amount would be without regard to the direction of the person's CDS positions and without excluding any debt securities underlying a SB swap included in the SB swap position.

[13] The proposed rule specifies that for the \$300 million gross notional amount, an intermediary (e.g., a broker-dealer or bank) that is a member of a registered exchange would not be deemed the owner of any equity securities that they hold directly or indirectly on behalf of another person solely because such person is the record holder of those securities and, pursuant to the exchange's rules, may direct the vote of such securities, without instruction, on other than contested matters or matters that may substantially affect the rights and privileges of the holders of the securities to be voted (but is otherwise precluded by the exchange's rules from voting without instruction). The SEC proposed this approach based on its view that there would be limited value that would be obtained by including in the calculation equity securities held by an intermediary in street name for the benefit of the person with the actual economic or beneficial ownership of such securities.

[14] "SB swap equivalent position" is defined as the "number of shares attributable" to all the SB swaps comprising a SB swap position. "Number of shares attributable" to a derivative instrument means the larger of (as applicable) (i) the number of shares of the reference equity security that may be delivered upon or the exercise of the rights under the derivative instrument, as determined by applicable documentation; (ii) the number of

shares of the reference equity security determined by multiplying the number of shares by reference to which the amount payable under the derivative instrument is determined by the delta of the applicable derivative instrument; and (iii) the number of shares of the reference equity security determined by dividing the notional amount of such derivative instrument by the most recent closing price of shares of the reference equity security, and then multiplying that quotient by the delta of the applicable derivative instrument.

[\[15\]](#) These calculations would apply to SB swap based on a single equity security as well as those based on a narrow-based security index containing the reference security. The number shares of the reference entity included in the index-based SB swap (determined based on the methodology in applicable documentation or specified calculation method in the proposed rule).

[\[16\]](#) Rule 908 of Regulation SBSR specifies that a SB swap is subject to regulatory reporting and public dissemination if (i) there is a direct or indirect counterparty that is a US person on either or both sides of the transaction; or (ii) the SB swap is accepted for clearing by a clearing agency having its principal place of business in the US. A SB swap that is not included in (i) or (ii) is subject to regulatory reporting alone if there is a direct or indirect counterparty on either or both sides of the transaction that is a registered SB swap dealer or major SB swap participant.

[\[17\]](#) The SEC previously proposed Rule 9j-1 in 2010 but did not finalize the rule. Several commenters to the earlier proposal argued that the Commission exceeded its statutory authority by explicitly applying the rule to activities involving the exercise of any rights and performance of any obligations during the life of a SB swap, as opposed to limiting the proposed rule to misconduct taking place in connection with the "purchase" and "sale" of a SB swap. The SEC, however, has maintained a similar approach as the earlier proposal.