March 21, 2022

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: 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, RIN 3235-AK77)

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Proposed Rule ("Proposal" or "Release").[2] The Proposal has three components. It would prohibit fraud or manipulation in connection with security-based swap ("SBS") transactions; it would require public reporting of large SBS positions, and it would prohibit coercion or deception of the chief compliance officer ("CCO") of an SBS entity. The anti-fraud provision was first proposed by the Securities and Exchange Commission ("SEC" or "Commission") in November 2010,[3] and it is now being reproposed. The other two elements are being released for comment for the first time.

All three components of the Proposal are important reforms in the SBS market that will help prevent fraud and abuse, increase transparency in the interest of systemic stability, and deter acts aimed at weakening the role of the chief compliance officer ("CCO"). However, as discussed

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 87 Fed. Reg. 6652 (Feb. 4, 2022).

3 75 Fed. Reg. 68,560 (Nov. 8, 2010). We reiterate and incorporate by reference, our comments on the original proposal. Better Markets Comment Letter on Prohibition Against Fraud, Manipulation, and Deception in Connection With Security-Based Swaps (Jul. 22, 2013), https://www.sec.gov/comments/s7-32-10/s73210-27.pdf; Better Markets Comment Letter on Prohibition Against Fraud, Manipulation, and Deception in Connection With Security-Based Swaps (Dec. 23, 2010), https://www.sec.gov/comments/s7-32-10/s73210-13.pdf. In those letters, we emphasized the need to expand the antifraud provisions to fully encompass fraud in connection with SBS transactions, including fraud that affects the value of any right or the performance of any obligation under an SBS over time. That enhancement should be implemented in any final rule that arises from the Proposal.

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below, the SEC must reconsider the safe harbor from liability for fraud and manipulation. It rests on faulty assumptions advanced by the industry, and it is likely to do far more harm than good, as it will actually immunize and therefore facilitate fraud and manipulation in SBS transactions through the use of material nonpublic information.

BACKGROUND

Security-based swaps ("SBS"), and in particular single-name credit default swaps ("CDS"), have featured prominently in some of the biggest financial stories and events of the last few decades. CDS are insurance-like contracts in which a "protection seller" agrees to make a payout to a "protection buyer" if a particular company, or other reference entity, experiences a "credit event," such as a default on its debt. In turn, the protection buyer pays premiums to the protection seller.[4] Unlike insurance, however, the protection buyer is not necessarily protecting itself against any risk of loss of an asset it owns. For example, you can purchase fire insurance to protect yourself against the risk that a home you own will be destroyed by fire. However, under the insurable interest requirement, you cannot, as a general rule, purchase fire insurance on your neighbor's house.[5] However, while a protection buyer in a CDS could be someone who actually owns the debt of a particular company and seeks to hedge that exposure, it could also simply be someone who thinks the company will default on its debt and wants to make money from that expectation, i.e., a speculator. This distinction between the traditional insurance market and instruments such as CDS has key implications for the regulation of fraud and manipulation in the SBS market.

When CDS burst onto the scene in the early 1990s, many stakeholders in the financial industry, including regulators, thought they would have an enormous and positive impact on the financial system. Essentially, the thinking went, CDS allows lenders, primarily heavily regulated (and highly leveraged) banks, to better fulfill their lending-oriented purpose. If banks can easily offload much or all of the risk of making loans onto entities with a greater ability and willingness to absorb that risk, then banks can make more loans to people who can put that money to productive use. Moreover, the subsequent dispersal of that risk would purportedly make the financial system safer.[6] This confidence in the beneficial impact of CDS and other types of swaps led to a concerted and successful push to exempt them from meaningful regulation, on the argument that government regulation of these supposedly innovative products could only be harmful. This ultimately misguided view was accompanied and justified by the belief that market self-discipline and self-

[4] Adam Reiser, *Should Insider Trading in Credit Default Swap Markets Be Regulated? The Landmark Significance of Sec v. Rorech*, 9 DEPAUL BUS. & COM. L.J. 531, 534 (2011).

[5] Thomas Lee Hazen, Filling A Regulatory Gap: It Is Time to Regulate Over-the-Counter Derivatives, 13 N.C. BANKING INST. 123, 131–32 (2009) ("An insurable interest has long been a requirement of insurance law. It requires an insurable interest in the contingency insured against in order to uphold the insurance contract."). The policy considerations underlying the insurable interest doctrine include the need to differentiate insurance contracts from wagering contracts and to reduce the moral hazard arising from the incentive to destroy the insured property or other interest to benefit from the insurance contract.

[6] Adam Reiser, *Should Insider Trading in Credit Default Swap Markets Be Regulated? The Landmark Significance of Sec v. Rorech*, 9 DEPAUL BUS. & COM. L.J. 531, 534 (2011).

interest would be all the regulation needed to prevent serious systemic risks or patterns of abuse from arising.[7]

Ultimately, the CDS promoters were half right. CDS did have an enormous impact on the financial system. But that impact was not in improving the financial system but in nearly destroying it, making the need for strong regulation of the CDS market, and in particular of fraud and manipulation in the CDS market, abundantly and tragically apparent.

The Central Role of CDS in the $20 Trillion Financial Crisis

It did not take long to reveal that the assumptions underlying the decision not to regulate CDS and other swaps were hopelessly naïve. To the extent that CDS (and other related innovations such as mortgage-backed securities and adjustable-rate mortgages) facilitated increased lending, it did so through moral hazard that incentivized reckless and often illegal conduct. Lenders (especially non-bank lenders) that no longer were going to hold mortgage loans on their books felt that they no longer needed to engage in robust underwriting of those loans. Indeed, not only did this moral hazard lead to the deterioration of underwriting practices, it also incentivized lenders to engage in outright fraud. The widespread proliferation of so-called "NINJA" loans, which were extended to borrowers with "no income, no job, and no assets" in the runup to the crisis, illustrates both the negligence and fraud that the CDS-facilitated increase in lending helped create.[8] Similarly, while CDS promoters thought that CDS would facilitate greater dispersal of risk, instead, CDS facilitated greater interconnectedness. This interconnectedness increased systemic risk by linking the fortunes of systemically significant institutions with each other, such that instability at one inevitably led to instability at others. This is how a downturn in the housing market nearly brought down the financial system.[9]

CDS did not just facilitate fraud and manipulation in the mortgage markets. The CDS market itself became a breeding ground for significant fraud in CDS transactions, notwithstanding the assertion that the sophisticated players in the derivatives markets could and would protect and regulate themselves. Perhaps the most infamous example of fraud in the CDS market in the runup to the crisis involved Goldman Sachs and a set of synthetic collateralized debt obligations ("CDOs") collectively known as "ABACUS." Goldman Sachs structured and marketed the ABACUS CDOs, telling investors that the residential mortgage-backed securities in them had been independently selected by a collateral manager.[10] In fact, Goldman had created the ABACUS CDO at the request of another client, hedge fund manager John Paulson, who wanted to **short** the housing market. Accordingly, he wanted Goldman to create the ABACUS CDOs so that he could then purchase a CDS from Goldman ostensibly protecting against their failure. In fact, he wanted

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[7] Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES (Oct. 8, 2008), https://www.nytimes.com/2008/10/09/business/economy/09greenspan.html; *See also* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 (2000).

[8] Mark Ireland, *After the Storm: Asymmetrical Information, Game Theory, and an Examination of the "Minnesota Model" for National Regulation of Mortgage Brokers and Tomorrow's Predatory Lenders*, 36 WM. MITCHELL L. REV. 1, 14 (2009).

[9] Steven L. Schwarcz, *Regulating Derivatives: A Fundamental Rethinking*, 70 DUKE L.J. 545, 564–65 (2020) (explaining how CDS create "an interconnectedness that drives systemic risk" because the "failure of a systemically important counterparty can lead to a domino effect, triggering a chain of failures.")

[10] Compl. at 1-2, *SEC v. Goldman Sachs & Co.*, No. 10-cv-3229 (S.D.N.Y 2010).

Goldman to create the ABACUS CDOs so he could bet on them to fail.[11] Moreover, Paulson was heavily involved in the portfolio selection process for the ABACUS CDOs, and so was able to populate them with securities he thought would fail, thus ensuring the profitability of his short position (the collateral agent that was ultimately responsible for selecting the securities was under the impression that Paulson was long the CDO).[12]

Naturally, Goldman did not tell the clients to whom it marketed the ABACUS CDOs that it had created them at the behest of another client who wanted them to fail, nor did it disclose that it had allowed that client to be involved in selecting the securities that would go into the CDO to ensure its failure.[13] The CDO transaction closed in April 2007, poor timing (in hindsight) to invest in the housing market. Unsurprisingly, the portfolio, much of which had been hand-selected by Paulson specifically to lose value, lost value—in less than a year **99%** of the portfolio had been downgraded.[14] Goldman settled with the SEC for a then-record $550 million and has been subject to ongoing suits, as a result of its fraud.[15]

Ultimately, CDS and the excessive risk-taking, fraud, and manipulation they enabled contributed directly to the devastating 2008 financial crisis. That crisis resulted in an astonishing $20 trillion in losses to the American economy.[16] Yet that unbelievable number underestimates the true impact of the crisis, because the human cost will always be incalculable, as millions were forced, through no fault of their own, to suffer the fallout from lost jobs, lost houses, lost families, and even lost lives.[17]

Manufactured Credit Events

The aftermath of the financial crisis brought reform to the SBS market, in the form of Title VII of the Dodd-Frank Act. It subjected both swaps and SBS to comprehensive regulation and directed the SEC to implement the new framework through its rules. While this has led to an increase in transparency and accountability in the SBS market, it has not solved all the major issues associated with SBS, with CDS again in the spotlight. As noted above, CDS protects against the loss in value of a particular asset, the debt of a reference company. Because a protection buyer stands to receive a payout in the event of a default or other specified credit event, it reduces the incentive to avoid that event (for example, if the buyer is also a creditor to the referenced asset, by

[11] Compl. at 2, *SEC v. Goldman Sachs & Co.*, No. 10-cv-3229 (S.D.N.Y 2010).
[12] Compl. at 2, *SEC v. Goldman Sachs & Co.*, No. 10-cv-3229 (S.D.N.Y 2010).
[13] Compl. at 2, *SEC v. Goldman Sachs & Co.*, No. 10-cv-3229 (S.D.N.Y 2010).
[14] Jennifer O'Hare, *Synthetic CDOs, Conflicts of Interest, and Securities Fraud*, 48 U. RICH. L. REV. 667, 685 (2014).
[15] *See* SEC Press Release, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime CDO (Jul. 15, 2010), https://www.sec.gov/litigation/litreleases/2010/lr21592.htm. *Goldman Sachs Grp., Inc. v. Arkansas Tchr. Ret. Sys.*, 141 S. Ct. 1951 (2021); *see also* Brief of Better Markets, Inc. as Amicus Curiae in Support of Respondents, *Goldman Sachs Grp., Inc. v. Arkansas Tchr. Ret. Sys.*, 141 S. Ct. 1951 (2021), https://www.supremecourt.gov/DocketPDF/20/20-222/170888/20210304100303497_20-222%20Amicus%20Brief%20of%20Better%20Markets%20Inc.pdf.
[16] BETTER MARKETS, THE COST OF THE CRISIS: $20 TRILLION AND COUNTING (2015), https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.
[17] Shu-Sen Chang, et al., *Impact of 2008 Global Economic Crisis on Suicide: Time Trend Study in 54 Countries*, THE BMJ (Aug. 12, 2013), https://www.bmj.com/content/347/bmj.f5239.

loosening underwriting standards), and may even produce an incentive to trigger that event. While this is similar to the moral hazard present in all insurance transactions, the requirement of an "insurable interest," i.e. a sufficiently significant stake in the asset being insured, mitigates this risk.[18] If I have paid $200,000 for my house and insured it against the possibility of destruction by fire, I have very little incentive to let it be destroyed by fire (or to destroy it myself) just to receive that payout, since the payout would only be replacing the money I have already paid for the asset. However, if I can purchase fire insurance on a house that I did not buy and in which I have no economic stake, then not only do I have no economic incentive to protect the house from burning down, for example by buying and maintaining smoke alarms, **I have an economic incentive to do whatever I can to ensure that the house burns down**.

As noted above, there is no insurable interest requirement to enter a CDS—you need not have any exposure whatsoever to the debt of a reference entity to buy CDS "protection" for that debt. As a result, there will be CDS protection buyers with an incentive to force the reference entity to experience a credit event that will result in a payout on the CDS. As the SEC points out in the Release, since 2010 (i.e., since the year the Dodd-Frank Act, which finally regulated SBS and other swaps, was passed), these sorts of opportunistic trading strategies, typically referred to as "manufactured credit events," have become prevalent in the CDS market.[19] As the Release explains, manufactured credit events "can take a number of different forms but generally involve CDS buyers or sellers taking steps, with or without the participation of a company whose securities underlie, or are referenced by, a CDS . . . to avoid, trigger, delay, accelerate, decrease, and/or increase payouts on CDS."[20] One example of such a strategy is a CDS protection buyer inducing a company to default on its debt, typically a minor or technical default that nonetheless results in a payout to the buyer under the CDS.[21] Some protection sellers have gotten in on these manipulative schemes as well, including by inducing companies to temporarily avoid a default until after a CDS expires, to avoid having to make a payout.[22] Whatever form they take, the SEC and other regulators have recognized that manufactured credit events harm the integrity of the markets by, among other things, frustrating the expectations of market participants.[23]

Archegos Capital Management

Just as fraud and manipulation are still prevalent in the SBS market, so does the SBS market continue to pose risks to the broader financial system. This was clearly illustrated in March 2021 when the hidden bets of an obscure trader managing a company called Archegos Capital

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[18] Thomas Lee Hazen, *Filling A Regulatory Gap: It Is Time to Regulate Over-the-Counter Derivatives*, 13 N.C. BANKING INST. 123, 131 (2009).

[19] Release at 6655-56.

[20] Release at 6655.

[21] Gina-Gail S. Fletcher, *Engineered Credit Default Swaps: Innovative or Manipulative?,* 94 N.Y.U. L. Rev. 1073, 1094 (2019).

[22] Gina-Gail S. Fletcher, *Engineered Credit Default Swaps: Innovative or Manipulative?,* 94 N.Y.U. L. Rev. 1073, 1094 (2019).

[23] Release at 6655; *see also* Gina-Gail S. Fletcher, *Engineered Credit Default Swaps: Innovative or Manipulative?,* 94 N.Y.U. L. REV. 1073, 1104 (2019) (explaining that manufactured credit events harm counterparties to CDS transactions and the public more broadly).

Management exploded, causing huge losses for banks, driving down the stock prices of several companies, and severely rattling markets.

The trader was Bill Hwang, a former manager of a hedge fund that had to settle criminal and civil charges of widespread insider trading.[24] Instead of shuttering his hedge fund after this malfeasance was revealed, Hwang simply converted it into a "family office," a type of investment adviser that deals with the finances of members of a wealthy family rather than the broader public, enabling it to "take bigger risks" while facing "less regulatory scrutiny."[25] Operating as a family office, Archegos built up huge positions in a number of stocks. However, the positions were not taken by buying the stock outright, but through "total return swaps," which "allow a user to take on the profits and losses of a portfolio of stocks or other assets in exchange for a fee."[26] Total return swaps provide the economic equivalent of actually owning the stock. However, the regulatory treatment is different—Archegos's holdings were large enough that it would have had to report its positions had it traded in the actual stock, but because the positions were in total return swaps, they were not required to be reported.[27] Moreover, because they were swaps, Archegos could enter into them using leverage, i.e., borrowed money, which amplified the gains—and losses. This combination of leverage and anonymity proved devastating.

Archegos had large, levered positions in a number of stocks through total return swaps it entered with a number of banks. When the value of those stocks turned against Archegos, the

[24] Illustrating the deficiencies that often mark such settlements, only the hedge fund entity, Tiger Asia Management, which is a legal fiction and not a real tangible individual, "admitted" the SEC charges. *See* SEC Press Release, *Hedge Fund Manager to Pay $44 Million for Illegal Trading in Chinese Bank* (Dec. 12, 2012), https://www.sec.gov/news/press-release/2012-2012-264htm. Hwang was allowed to escape personally admitting to the charges. Similarly, notwithstanding some reporting indicating that Bill Hwang pled guilty in his individual capacity, *see* Emily Flitter, et al., *"Tiger Cub" Manager Pleads Guilty in Insider Trading Case*, Reuters (Dec. 12, 2012), https://www.reuters.com/article/us-crime-insidertrading-tiger/tiger-cub-manager-pleads-guilty-in-insider-trading-case-idUSBRE8BB1RG20121212, only Tiger Asia Management actually pled guilty to the criminal charges, or was even charged. *See* Plea Agreement, *U.S. v. Tiger Asia Management,* No. 12-cr-808 (D.N.J. 2012) ("This letter sets forth the plea agreement between your client **Tiger Asia Management, LLC**…and the United States Attorney for the District of New Jersey") (emphasis added). In addition to a fine of $16 million, Tiger Asia Management, which is again a legal fiction, was "sentenced" to one year of probation, which appeared to consist primarily of notifying a probation officer of certain matters, such as change of address or of litigation against the company (apparently no need for drug testing). Criminal Judgment, *U.S. v. Tiger Asia Management*, No. 12-cr-808 (D.N.J. 2012). The upshot is that Hwang committed millions of dollars of fraud in violation of both civil and criminal laws; escaped significant personal liability by foisting the responsibility onto a fictional entity; and then less than 10 years later caused billions of dollars of losses while seriously rattling the markets. This speaks volumes about shortcomings in an enforcement regime that consistently "punishes" fictional entities instead of the real individuals who actually commit the crimes, a topic that is beyond the scope of this comment letter.

[25] Emily Cadman, *How a Blowup at Hwang's Archegos Is Rattling the Finance World*, BLOOMBERG (Mar. 29, 2021), https://www.bloomberg.com/news/articles/2021-03-29/goldman-block-trade-what-to-know-about-bill-hwang-viacom-discovery-stock-sale?sref=mtQ4hc2k.

[26] Quentin Webb, et al., *What Is a Total Return Swap and How Did Archegos Capital Use It?*, Wall St. J. (Mar. 30, 2021), https://www.wsj.com/articles/what-is-a-total-return-swap-and-how-did-archegos-capital-use-it-11617125839.

[27] Quentin Webb, et al., *What Is a Total Return Swap and How Did Archegos Capital Use It?*, Wall St. J. (Mar. 30, 2021), https://www.wsj.com/articles/what-is-a-total-return-swap-and-how-did-archegos-capital-use-it-11617125839.

banks that had helped Archegos lever up began unloading huge blocks of shares of the companies underlying Archegos's total return swaps, causing the share prices of those companies to plummet. For example, Discovery closed down 27% on March 19, and ViacomCBS closed down 27% on March 22, 2021. Worse, the panic was not limited to stocks in which Archegos was invested. Because no one knew who was responsible for the massive sell-off, traders were worried that the sell-off reflected sector-wide concerns, causing prices of some peer companies of those held in the Archegos portfolio to experience temporary price declines.[28] Moreover, while some of the banks that had helped Archegos lever up managed to escape unscathed, others were not so lucky. Credit Suisse lost $4.7 billion, and Nomura lost around $2 billion.[29] As one commenter explained:

> "It's all eerily reminiscent of the subprime-mortgage crisis 14 years ago. Then, as now, the trouble was a series of increasingly irresponsible loans. As long as housing prices kept rising, lenders ignored the growing risks. Only when homeowners stopped paying did reality bite: The banks all had financed so much borrowing that the fallout couldn't be contained."[30]

Ongoing Compliance Failures at Security-Based Swap Entities

As the SEC notes in the Release, when it adopted business conduct standards for security-based swap dealers ("SBSD") and major security-based swap participants ("MSBSP") over the course of its rulemaking, Better Markets in 2011 requested that the SEC adopt a rule prohibiting undue influence over CCOs, as part of a package of protections that would help ensure CCO independence.[31]

The need for robust protections for CCOs continued to be apparent over the course of the rulemaking. As Better Markets pointed out in a supplemental comment letter, in 2013, the Wall Street Journal reported on a series of compliance failures at J.P. Morgan Chase, including the more than $6 billion London Whale proprietary trading debacle. In a little-noticed section from that

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[28] Emily Cadman, *How a Blowup at Hwang's Archegos Is Rattling the Finance World*, BLOOMBERG (Mar. 29, 2021), https://www.bloomberg.com/news/articles/2021-03-29/goldman-block-trade-what-to-know-about-bill-hwang-viacom-discovery-stock-sale?sref=mtQ4hc2k.

[29] Erik Schatzker, Sridhar Natarajan, & Katherine Burton, *Bill Hwang Had $20 Billion, Then Lost It All in Two Days*, BLOOMBERG (Apr. 8, 2021), https://www.bloomberg.com/news/features/2021-04-08/how-bill-hwang-of-archegos-capital-lost-20-billion-in-two-days.

[30] Erik Schatzker, Sridhar Natarajan, & Katherine Burton, *Bill Hwang Had $20 Billion, Then Lost It All in Two Days*, BLOOMBERG (Apr. 8, 2021), https://www.bloomberg.com/news/features/2021-04-08/how-bill-hwang-of-archegos-capital-lost-20-billion-in-two-days.

[31] *See* Release at 6664-65 ("In the course of that rulemaking, one commenter requested that the Commission adopt a rule prohibiting attempts by officers, directors, or employees to coerce, mislead, or otherwise interfere with the CCO"); *see also* Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 81 Fed. Reg. 29,960, 30,054-55 (May 13, 2016); Better Markets Comment Letter on Business Conduct Standards for Security-based Swap Dealers and Major Security-Based Swap Participants 19 (Aug. 29, 2011), https://bettermarkets.org/wp-content/uploads/2021/07/066-SEC-CL-Business-Conduct-Standards-for-SBS-Dealers-and-Major-SBS-Participants-8-29-11.pdf; Better Markets Comment Letter on Reopening of Comment Periods for Certain Proposed Rulemaking Releases and Policy Statements Applicable to Security-Based Swaps (Jul. 22, 2013), https://www.sec.gov/comments/s7-25-11/s72511-49.pdf.

report, it was revealed that it was not until **more than a full year after** the London Whale fiasco—and a series of other compliance failures leading to over $18 billion in fines and litigation expenses—that J.P. Morgan took the most basic step of ensuring that business heads could not overrule the CCO.[32] Shockingly, the report noted that other rival Wall Street Banks had not taken similar steps despite J.P. Morgan Chase's experience.[33]

Nevertheless, the SEC declined in 2016, when it adopted final business conduct standards, to include a specific prohibition on undue influence over CCOs, reasoning that "requiring a majority of the board to approve the compensation and removal of the CCO is appropriate to promote the CCO's independence and effectiveness."[34] As the Release notes, at that time, the SEC had not yet finalized (or in some cases, even proposed) rules which would establish the relevant responsibilities of CCOs.[35] In any event, various ongoing issues in the SBS market, including the continued prevalence of manipulative manufactured credit events, continue to highlight the need to strengthen compliance functions by ensuring the independence of CCOs.

OVERVIEW OF PROPOSAL

In relevant part, as amended, the Proposal would:

- Add Rule 9j-1 to specifically prohibit fraud and manipulation in connection with SBS transactions, including prohibiting fraud and manipulation with respect to the ongoing rights and obligations that are a distinctive element of SBS;
    - Provide a safe harbor from Rule 9j-1's prohibition on fraud and manipulation in connection with actions taken pursuant to binding rights and obligations of an SBS while in possession of relevant material non-public information ("MNPI"), so long as the person did not have that MNPI prior to entering into the SBS, and satisfies other conditions;
    - Make clear that a person cannot escape liability from illegally trading a particular security on the basis of MNPI by simply trading an SBS related to the underlying security instead;
    - Make clear that a person cannot escape liability under the Proposal by trading in the underlying security instead of an SBS related to that security;
- Add Rule 10B-1 to require public reporting of certain details of large SBS positions;
- Add Rule 15Fh-4(c), which would make it illegal for employees of a security-based swap dealer ("SBSD") or major security-based swap participant ("MSBSP") to attempt to coerce or unduly influence the CCO of the SBSD or MSBSP.

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32 Better Markets Letter on Establishing and Protecting a Meaningful Role for Chief Compliance Officers Under the Dodd-Frank Act Reforms (Oct. 18, 2013), https://www.sec.gov/comments/s7-35-10/s73510-47.pdf; Monica Langley & Dan Fitzpatrick, *Embattled J.P. Morgan Bulks up Oversight*, Wall St. J (Sept. 12, 2013),

33 *Id.*

34 Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 81 Fed. Reg. 29,960, 30,054-55 (May 13, 2016.

35 Release at 6665.

SUMMARY OF COMMENTS

All three of the basic provisions in the Proposal serve valuable regulatory purposes. Proposed Rule 9j-1(a) appropriately recognizes that SBS have unique characteristics in the form of "ongoing payments or deliveries between the parties throughout the life of the security-based swap pursuant to their rights and obligations." Those features create more opportunities for fraud and manipulation than the typical securities transaction, and they, therefore, warrant their own unique anti-fraud rule separate and apart from Rule 10b-5. The anti-fraud and anti-manipulation provisions will be enhanced by the addition of Rules 9j-1(c), which makes clear that if it is illegal for a person to trade a security on the basis of MNPI it is also illegal to trade an SBS with respect to that security, and 9j-1(d), which makes clear that an action that would violate Rules 9j-1(a) and (b) with respect to an SBS also violates those rules if taken with respect to the underlying security. These provisions will help prevent evasion.

Proposed Rule 10B-1, which would establish a public reporting requirement for large positions in SBS is an appropriate response to the type of threat exemplified by the Archegos fiasco, which revealed that the lack of transparency still prevalent in the SBS markets poses a serious danger to the broader financial system. This requirement will appropriately expand upon the existing SBS reporting obligations, which are largely focused on the reporting of SBS *transactions*; reporting on *positions* is also necessary. And Proposed Rule 15FFh-4(c), prohibiting coercion or undue influence of CCOs, will protect these critical employees from interference in their essential work ensuring compliance with relevant rules.

Our principal concern is with Proposed Rule 9j-1(f), which would provide a safe harbor from the prohibition against fraud and manipulation under certain circumstances. As explained below, this carve-out is misguided. At the very least, the SEC must provide a compelling justification as to why a safe harbor from a rule prohibiting fraud and manipulation is necessary at all; it should not just rely on conclusory, dubious assertions that absent a safe harbor, SBS entities will suffer from unfair enforcement exposure for innocent transactions. And the SEC must also account for the harm that the safe harbor would likely cause, as it would be used to immunize what are in fact intentional acts of fraud and manipulation using MNPI.

Finally, we urge the SEC not to raise the proposed position reporting threshold or create exemptions from that important obligation. And we strongly endorse the added layer of protection against coercion or deception that CCOs would receive under the Proposal.

COMMENTS

I. THE SEC HAS NOT DEMONSTRATED THAT A SAFE HARBOR FROM THE PROHIBITION ON FRAUD AND MANIPULATION IS NECESSARY OR APPROPRIATE.

The SEC proposes to include Rule 9j-1(f), a new safe harbor to its proposed SBS anti-fraud and anti-manipulation Rule 9j-1. That provision would preclude liability under those rules under certain circumstances where a person becomes aware of material nonpublic information ("MNPI") after entering an SBS transaction. Specifically, the proposed safe harbor provides that a person

does not violate Rule 9j-1 for performing binding contractual obligations, or exercising binding contractual rights, under an SBS, merely because they came into possession of MNPI prior to those actions (so long as they did not come into possession of MNPI before entering the SBS).[36] Similarly, the proposed safe harbor would also provide that it is not a violation of Rule 9j-1 to conduct a portfolio compression exercise after coming into possession of MNPI.[37] According to the Release, the addition of the safe harbor was in response to "operational concerns" raised by the industry, specifically the application of the rule to situations where an SBS counterparty performs a contractual obligation while in possession of MNPI.[38] Beyond stating that it is "sensitive" to these concerns, the SEC has undertaken no other analysis of these industry arguments.

Simply put, that the industry asked for it is not a sufficient reason for establishing a safe harbor from liability. This is especially true with respect to a rule that prohibits **fraud and manipulation,** which can be readily facilitated through the acquisition of MNPI. The industry is seeking insulation from liability, but the SEC must protect the broader investing public, the integrity of the markets, and ultimately the broader financial system. Therefore, the SEC must independently and critically analyze these "concerns" of the industry before implementing a safe harbor that could exclude a broad swath of SBS transactions from the prohibition against fraud and manipulation.

And, indeed, the concerns of the industry appear less than compelling. For example, in its letter, SIFMA identified a number of innocent, ordinary course, non-volitional actions undertaken throughout the lifetime of an SBS transaction that could purportedly expose SBS counterparties to liability if they happen to come into possession of MNPI prior to taking those actions. These include making interim settlement payments as required by the contract and exercising contractual rights or obligations upon a counterparty default.[39] However, Rule 9j-1 would not, of course, specifically prevent these or other activities, which is appropriate because whether any particular transaction is fraudulent or manipulative depends on the facts and circumstances of the particular situation.[40] Examining the facts and circumstances of the scenarios put forth by SIFMA and others, it does not appear there is any need for a safe harbor such as the one proposed by the SEC, because it is not clear how a prohibition on fraud and manipulation could possibly apply to the performance of completely non-volitional, contractual requirements, of a contract that was entered into without fraudulent, deceptive, or manipulative intent. In fact, far from being a sure win for the SEC, any case alleging fraud on the basis of the transactions in SIFMA's letter would face a number of formidable obstacles. Conversely, if actions taken under the terms of an SBS are subject to judgment or discretion, then a blanket safe harbor such as the one proposed would clearly be

36 Release at 6703-704.
37 Release at 6704.
38 Release at 6662.
39 SIFMA Letter on Proposed Rule 9j-1 (Jul. 8, 2011), https://www.sec.gov/comments/s7-32-10/s73210-24.pdf.
40 *In re aaiPharma Inc. Sec. Litig.*, 521 F. Supp. 2d 507, 512 (E.D.N.C. 2007) ("The court must therefore look to all the facts and circumstances surrounding the alleged securities fraud").

unwise, as it could facilitate and immunize fraud or manipulation through the deliberate use of recently acquired MNPI.

For example, SIFMA claims that Rule 9j-1 would impose liability on a counterparty that is required by an SBS to make an interim settlement payment if they come into possession "of MNPI with respect to the reference underlying" and make the settlement payment notwithstanding the MNPI.[41] But SIFMA does not explain how making a payment that is required by a contract, a contract that presumably was entered into without fraud, could constitute fraud. Importantly, trading based on non-public information only violates the anti-fraud provisions of the securities laws when such trading is **fraudulent**. Thus, trading based on MNPI is typically only illegal where it is done in breach of a duty owed to someone—that breach of duty is the source of the fraud.[42] As one treatise explained:

> "The misappropriation theory rests on the assumption that it is fraudulent and deceptive for a person to misuse information for personal gain that has "been "entrusted" to him. So articulated, the theory first requires a showing that some sort of a fiduciary relationship existed between the defendant and the source of the information, for outside of that sort of relationship, there is no independent duty to observe another 'person's confidences or avoid profiting from information received.'"[43]

This raises the question: Who exactly is being defrauded or deceived in SIFMA's scenario, and how? The counterparty making the payment does not owe a relevant fiduciary duty in this scenario (at least not under the facts as put forth by SIFMA). Nor is there any other deception apparent on the facts. Any theory that a counterparty commits fraud by **making a payment** to its counterparty as required by a contract that was not entered into fraudulently, would seem to be a new theory that the SEC has never advanced. Each of the other scenarios suffers from the same infirmity—none involve facts that indicate a realistic potential for fraud liability and the need for a safe harbor.

Put simply, the proposed safe harbor is a solution in search of a problem. That the SEC or any court would consider any of the imagined scenarios a violation of any anti-fraud or anti-manipulation provision is speculation that the SEC should not accept at face value. The best "safe harbor" from a rule that generally prohibits fraud and manipulation is compliance with the rule—actually refraining from fraud and manipulation. And while the safe harbor appears wholly unnecessary to protect truly innocent transactions from the anti-fraud and anti-manipulation rule, it would almost certainly be used to insulate culpable acts of fraud and manipulation using MNPI.

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41 SIFMA Letter on Proposed Rule 9j-1 (Jul. 8, 2011), https://www.sec.gov/comments/s7-32-10/s73210-24.pdf.

42 § 3:2. Who is an insider?, 18 Insider Trading Regulation, Enforcement and Prevention § 3:2 ("The Supreme Court has made clear that a person has an obligation of disclosure to other traders in the marketplace when he stands in a fiduciary-like relationship with them.");

43 § 6:4. Nature of the fraud—Breach of duty, 18 Insider Trading Regulation, Enforcement and Prevention § 6:4.

This concern is well-founded. Unlike the industry's speculation about excessive exposure to liability for innocent conduct absent a safe harbor, the SEC knows that a safe harbor from anti-fraud and anti-manipulation rules can encourage unlawful behavior, based on its experience with Rule 10b5-1 (which the industry specifically cited when requesting the proposed safe harbor).[44] The SEC promulgated Rule 10b5-1 in 2000, and it included a safe harbor from liability under Rule 10b-5 when insiders trade pursuant to certain pre-arranged plans.[45] The SEC adopted the safe harbor in response to industry concerns similar to those raised here, that Rule 10b-5's anti-fraud and anti-manipulation provisions were too broad and that companies needed a safe harbor to protect innocent transactions from enforcement exposure.[46] Rule 10b5-1 was intended "to cover situations in which a person can demonstrate that the material nonpublic information was not a factor in the trading decision,"[47] and as adopted "the rule seemed to have the virtue of preventing self-dealing conflicts in much the same way as a traditional blind trust."[48]

However, over time it has become clear that the safe harbor established in Rule 10b5-1 has been widely abused, allowing corporate insiders to engage in insider trading and hide behind secretive Rule 10b5-1 plans that can be created, changed, and canceled at will and with no transparency.[49] Multiple studies have shown that insiders trading pursuant to these plans, which are supposed to ensure insiders are not trading on the basis of inside information, have experienced abnormally high returns that are difficult to explain if the trading is truly pursuant to pre-established parameters rather than by use of inside information.[50] Driving home the point, the Wall Street Journal reported on several specific suspiciously-timed transactions by corporate insiders, made pursuant to Rule 10b5-1 plans, that were fortuitously timed to be just ahead of price-moving company announcements, helping those insiders make significant profits or avoid significant losses.[51] The SEC, of course, has recognized the abuses facilitated by this safe harbor, proposing significant revisions to Rule 10b5-1 to address the fact that it is enabling widespread insider trading.[52] The SEC should not adopt another safe harbor that will enable abuse, fraud, and manipulation, especially in light of recent lessons learned from a similarly flawed safe harbor.

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[44] SIFMA Letter on Proposed Rule 9j-1 (Jul. 8, 2011), https://www.sec.gov/comments/s7-32-10/s73210-24.pdf.

[45] Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716 (Aug. 24, 2000).

[46] Daniel J. Morrissey, *Taming Rule 10b-5-1: The Unfinished Business of Texas Gulf Sulphur*, 71 SMU L. REV. 883, 885 (2018) ("executives who wanted to purchase or sell shares in their companies remained concerned. Often, they know significant matters about their firms that are not available to the public.").

[47] Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,728 (Aug. 24, 2000).

[48] Daniel J. Morrissey, *Taming Rule 10b-5-1: The Unfinished Business of Texas Gulf Sulphur*, 71 SMU L. REV. 883, 887 (2018).

[49] Bettert Markets Press Release, The SEC Moves to Abusive De Facto Insider Trading By Corporate Executives Via So-Called Trading Plans (Jun. 7, 2021), https://bettermarkets.org/newsroom/sec-moves-end-abusive-de-facto-insider-trading-corporate-executives-so-called-trading-plans/.

[50] Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders' Strategic Trade*, 55 Mgmt. Sci. 224 (2009); M. Todd Henderson, Alan Jagolinzer & Karl Muller, *Hiding in Plain Sight: Can Disclosure Enhance Insiders' Trade Returns?* at 2-3, (Coase-Sandor Working Paper Series in Law & Econ. No. 411, 2012). Daniel J. Morrissey, *Taming Rule 10b-5-1: The Unfinished Business of Texas Gulf Sulphur*, 71 SMU L. REV. 883, 887 (2018).

[51] Susan Pulliam & Rob Barry, *Executives' Good Luck in Trading Own Stock*, Wall St. J. (Nov. 27, 2012), https://www.wsj.com/articles/SB10000872396390444100404577641463717344178.

[52] Rule 10b5-1 and Insider Trading, 87 Fed. Reg. 8686 (2022).

II. THE SEC MUST NOT RAISE OR CREATE EXCEPTIONS TO THE PROPOSED POSITION REPORTING THRESHOLD.

In the Archegos fiasco, described above, a single obscure trader accumulated huge, hidden, market-moving positions in several stocks through the use of total return swaps. When those positions went south, the result was swift, devastating, and above all confusing. One company that was caught up in the fiasco, Discovery, suffered a decline in its market capitalization of nearly 40% over the course of a single week. This represented over **$15 billion**, an astonishing loss of value for Discovery's shareholders that came out of nowhere and would have been nearly impossible to avoid.[53] The lack of transparency into Archegos's positions also hurt the market more broadly, as confusion surrounding the reason for the sudden selloff in certain stocks caused other stocks, even those in which Archegos had no exposure, to suffer price declines as well.[54] Several of the banks that helped Archegos lever up suffered significant losses as well, with Credit Suisse experiencing losses of $4.7 billion.[55]

Greater transparency can help banks avoid these types of losses, as they will be able to either avoid transactions with counterparties that have built up large, concentrated positions or better price SBS to account for the increased risk.[56] Avoiding these sorts of massive losses and risks to the financial system alone would obviously be an enormous benefit of the reporting requirements in the Proposal. As the SEC points out in the Release, the increased transparency from the Proposal would be expected to confer other benefits as well, including providing the public (and the SEC) with information that can help ferret out fraudulent activity.[57] Meanwhile, the SEC reasonably estimates that the cost to the industry from the reporting requirement would be minimal, especially in light of the enormous benefits—the SEC estimates that the ongoing **costs for the entire industry for an entire year** would represent only 0.41% of the loss of market capitalization a **single stock** (Discover) suffered over the course of a **single week** as a result of Archegos's hidden, risky trades suddenly blowing up.[58]

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[53] Macrotrends, Discovery Historical Market Capitalization, March 19, 2021to March 26, 2021 (last accessed Mar. 11, 2022), https://www.macrotrends.net/stocks/charts/DISCB/discovery-communications/market-cap.

[54] Emily Cadman, *How a Blowup at Hwang's Archegos Is Rattling the Finance World*, BLOOMBERG (Mar. 29, 2021), https://www.bloomberg.com/news/articles/2021-03-29/goldman-block-trade-what-to-know-about-bill-hwang-viacom-discovery-stock-sale?sref=mtQ4hc2k.

[55] Erik Schatzker, Sridhar Natarajan, & Katherine Burton, Bill Hwang Had $20 Billion, Then Lost It All in Two Days, BLOOMBERG (Apr. 8, 2021), https://www.bloomberg.com/news/features/2021-04-08/how-bill-hwang-of-archegos-capital-lost-20-billion-in-two-days.

[56] Release at 6677-78.

[57] Release at 6667.

[58] *See* Release at 6678. The SEC estimates that ongoing compliance costs for entities required to report under the rule would be about $77,000, and estimates that at the proposed thresholds, around 850 would be required to make public reports pursuant to the rule, resulting in a total compliance cost for the industry of $65,450,000. *Id.* Meanwhile, Discovery lost $15.85 billion in market capitalization from March 19, 2021, to March 26, 2021, as a result of the Archegos fiasco. Macrotrends, Discovery Historical Market Capitalization, March 19, 2021to March 26, 2021 (last accessed Mar. 11, 2022), https://www.macrotrends.net/stocks/charts/DISCB/discovery-communications/market-cap.

Quite clearly, the proposed reporting requirement will not represent an undue burden on the industry but will prove enormously beneficial to the markets and the public, provided the reporting thresholds truly and appropriately capture all positions that are large enough to pose a risk to the financial system. Undoubtedly the notional thresholds proposed by the SEC are sufficiently large that they could reasonably pose a risk to the financial system. Accordingly, the SEC must certainly not raise those thresholds in response to industry pressure. The industry will also likely request a host of exemptions to the calculation of the reporting threshold, with arguments that certain transactions, such as hedging transactions, should be excluded when calculating whether a person is required to report. Including such exemptions would significantly increase risk, because the rule would give false comfort that the market has a complete understanding of large, risky positions in SBS, while in fact there would still be unknown, possibly significant pockets of hidden risk. The SEC does not want to find itself in a position where, a year or two after promulgating a rule specifically designed to prevent significant disruptions and widespread losses due to lack of transparency in large SBS positions, another Archegos-like event occurs following opaque trading activity exempted from disclosure at the behest of the industry.

III. THE PROPOSAL TO SPECIFICALLY PROHIBIT COERCION OF CCOs MUST BE PART OF THE FINAL RULE.

The SEC is also proposing to specifically make it illegal for any employee of an SBSD or MSBSP to "to coerce, manipulate, mislead, or fraudulently influence" the CCO of the SBSD or MSBSP.[59] This provision, which Better Markets has been calling for since 2011, is a welcome and important amendment to the SEC's SBS rules. CCOs perform a critical function under inherently difficult circumstances. It is a critical function because CCOs serve as the first line of defense against illegal activity at an SBSD or MSBSP that can harm counterparties and threaten systemic stability. The best way to prevent that harm is for the entity not to engage in the illegal conduct in the first place, and the best way to prevent illegal conduct is to install, empower, and protect a CCO charged with precisely that responsibility.

The CCO's job is inherently difficult because the SBSD or MSBSP that employs the CCO is almost certainly a for-profit company, and CCO's do not contribute directly to that profit; indeed, they often must foreclose business decisions and strategies that would, or could, be highly profitable, were it not for their illegality. Because CCOs are too often seen as impediments to revenue, profits, and therefore bonuses, there is a well-known, long-standing resistance to empowering and protecting the people most important to internal compliance and controls. This can result in an environment in which it is considered acceptable to mislead, pressure, or otherwise induce CCOs to bless or turn a blind eye to unlawful actions. Establishing an independent basis for liability when employees of SBS entities improperly interfere with the CCO's critical duties will help deter this pattern of behavior. The SEC must finalize the Proposal with this provision intact.

[59] Release at 6652.

CONCLUSION

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,

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