Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels

July 8, 2022

Via Electronic Mail: rule-comments@sec.gov

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

Re: Notice of Proposed Rulemaking on the Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; File No. S7-32-10

Dear Ms. Countryman,

Managed Funds Association[1] ("**MFA**") appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**SEC**" or "**Commission**") on its proposed "Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps" ("**Proposal**").[2] This letter provides additional comments on the SEC's re-proposed Rule 9j-1 ("**Rule 9j-1**") under the Securities and Exchange Act of 1934 (the "**Exchange Act**"), which is intended to prevent fraud, manipulation, and deception in connection with effecting transactions in, or attempting to induce the purchase or sale of, any security-based swap. We remain concerned that the overly broad language in Rule 9j-1 will significantly impair the corporate debt market, diminish access to vital funds for issuers, particularly in instances where the issuer is in financial distress, and reduce investment opportunities for fixed income investors.

We write now under separate cover, in part, to present data not available at the time of submission of our original comment letter.[3] The Commission seeks to justify the Proposal on the basis that the perception of fraud and manipulation and opacity in the credit default swap ("**CDS**") market impact the level of CDS activity and pricing. However, the Commission indicated that it lacked data that would show the link between the current CDS market condition (and the degree of adverse selection) and participants' appetite to trade. The following market pricing data

[1] Managed Funds Association ("**MFA**") represents the global hedge fund and alternative asset management industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 150 member firms collectively manage nearly $2.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, Brussels, London, and Asia. www.managedfunds.org.

[2] Exchange Act Release No. 34-93784 (December 15, 2021), 87 Fed. Reg. 6,652 (February 4, 2022).

[3] *See* Managed Funds Association, *Comment Letter re Notice of Proposed Rulemaking on the Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; File No. 37-32-10* (March 21, 2022).

shows that the risk of fraud and manipulation (or any attendant adverse selection) in the CDS market has not been internalized because there is no such perception or decoupling of CDS prices from the credit fundamentals of reference entities. We follow with a discussion of industry efforts to address fraud and manipulation in the CDS market, which obviate the need for the Proposal.

In light of the newly available data, and in consideration of industry efforts to address fraud and manipulation in the CDS market, we recommend that the Commission amend Rule 9j-1(b) to provide meaningful standards for distinguishing appropriate activity in underlying cash markets. As discussed in our original comment letter, we appreciate that the Commission "does not intend for re-proposed Rule 9j-1(b) to apply to taking affirmative actions in the ordinary course of a security-based swap transaction or the underlying referenced security."[4] However, the text of the rule does not reflect the Commission's intent. Without further clarification, legitimate activity, which may impact the price or valuation of a CDS, would fall squarely within the broad prohibition of Rule 9j-1(b). If the text of the rule is not changed, we believe market participants will reduce their activity in the CDS or underlying cash markets, or both.

I. The Commission's cost-benefit analysis does not find support in market data; to the contrary, market pricing supports the conclusion that the perception of fraud is low.

In consideration of the costs and benefits of the Proposal, the Commission reiterated on several occasions its belief that "Rule 9j-1 would reduce the risk of fraud in the security-based swap market, including risk of fraudulent behavior undertaken in connection with opportunistic trading strategies."[5] The Commission theorized that, by reducing these risks, Rule 9j-1 would encourage greater participation in the market.[6] We respectfully submit that the perception of fraud in the CDS market is not supported by data in any meaningful way. Rather, confidence that counterparties do not possess the ability to impact the market using opportunistic strategies is high.

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[4] The Commission further recognizes that,

> …reference entities often rely on financing and other forms of relief to avoid defaulting on their debt, and the proposed rule is not intended to discourage lenders and prospective lenders from discussing or providing such financing or relief, even when those persons also hold CDS positions.

Proposal, at 6,663.

[5] *Id.* at 6,685.

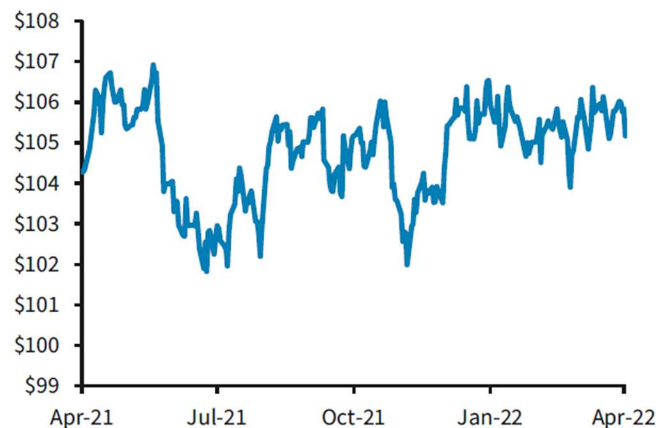
[6] The Commission speculates, without supporting data, that,

> …by reducing these risks, re-proposed Rule 9j-1 could encourage participation in the market, which may result in increased participation. More security-based swap entities would be willing to supply (issue) and/or demand (buy) security-based swaps, with increased confidence that their counterparties would have limited abilities to impact the market using, among other things, opportunistic strategies.

Id. at 6,685-86.

We believe that if CDS protection buyers were concerned about economic incentives for CDS protection sellers to make available to reference entities financing or restructuring options which would enhance the latter's CDS position,[7] the CDS-cash basis[8] for credits trading at stressed levels would be materially below par; CDS would trade tighter than the underlying bond. Market data indicates otherwise. Indeed, in a study of a sample of credits trading at stressed levels conducted by Barclays Research, the basis on average has been above par for the past year (Figure 1). This data indicates little concern about CDS having a different economic outcome than bonds.

FIGURE 1. **The Average Stressed Basis Package is Trading Above Par, Indicating Little Concern About Potential Fraud**



Based on a subset of CDS names trading wider than 10pts upfront in 5y CDS.
Source: Bloomberg, Barclays Research

Similarly, if CDS protection buyers were concerned about strategies involving the migration of debt across a reference entity's affiliated group of entities, resulting in an "orphaned

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7 The Commission references three of such strategies:

"…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."

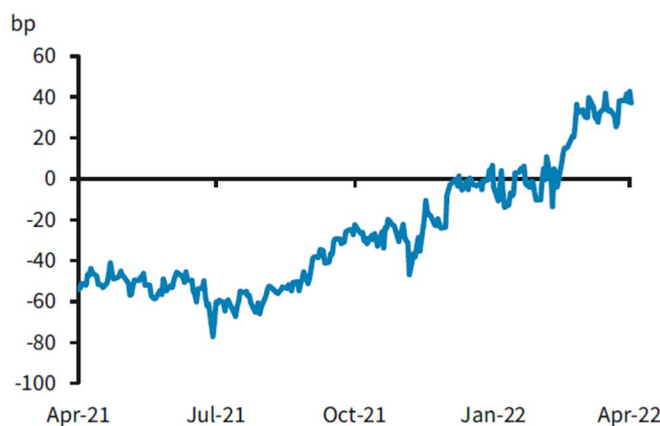
"CDS sellers offering financing to restructure a reference entity in such a way that 'orphans' the CDS – eliminating or reducing the likelihood of a credit event by moving the debts off the balance sheets of the reference entity and onto the balance sheets of a subsidiary or an affiliate that is not referenced by the CDS."

"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."

Id. at 6,655; *see also* text accompanying n.11 (opportunistic strategies of CDS protection buyers).

8 "CDS-cash basis," or "CDS-bond basis," measures the difference between the CDS spread and cash-bond implied credit spread.

CDS," the CDS-cash basis for the overall high yield market would be negative because investors would not pay for CDS protection or purchase basis packages. Again, market data indicates otherwise. The average five-year[9] basis in the high yield market is currently positive; CDS are trading wide to bonds (Figure 2). This data indicates little concern about the prospect of orphaned CDS.



In light of the foregoing, we strongly encourage the Commission to further consider, in the absence of the purported benefits suggested by the Proposal, whether Rule 9j-1 is necessary or appropriate in the public interest and would, in fact, promote efficiency, competition, and capital formation.[10]

II. The Commission failed to consider industry efforts to address opportunistic strategies, which have been effective in reducing the risk of fraud and manipulation in the CDS market.

Rule 9j-1 appears to be a reaction to a few adverse market events—namely, Hovnanian Enterprises, Inc. and Windstream Services, LLC. We appreciate the Commission's concern about the possibility of manufactured credit events and net short debt activist strategies.[11] However, the Commission failed to consider whether industry efforts to address

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[9] We focus on five-year CDS contracts as they are the most popularly traded in the U.S. market.

[10] 15 U.S.C. § 78c(f).

[11] The Commission references three of such strategies:

"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)."

opportunistic strategies post-dating such events would be (and, in fact, are) effective at reducing the risk of future manufactured credit events and net short debt activist strategies. We are not aware of any such strategies following industry responses to the events surrounding Hovnanian Enterprises, Inc. and Windstream Services, LLC. To be sure, we address industry efforts and their impact on each of the above-mentioned events in turn.

A. The 2019 Narrowly Tailored Credit Event Supplement

In July 2019, the International Swaps and Derivatives Association ("**ISDA**") published the 2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions ("**NTCE Supplement**")[12] and, in August 2019, published the ISDA 2019 NTCE Protocol ("**NTCE Protocol**").[13] The NTCE Supplement amended the definition of "Failure to Pay" ("**FTP**") to specifically address "arrangements with corporations that cause a credit event leading to settlement of CDS contracts while minimizing the impact on the corporation." The NTCE Protocol allowed counterparties to apply the changes set forth in the NTCE Supplement to existing CDS transactions.[14]

The amendment to the FTP definition introduced the "Credit Deterioration Requirement" ("**CDR**") which excludes from the FTP definition any non-payments that do not directly or indirectly either result from, or result in, a deterioration in the creditworthiness or financial condition of the reference entity. In other words, the CDR requires there to be a causal link between the non-payment and the deterioration in the creditworthiness or financial condition of the reference entity.[15] The NTCE Supplement includes interpretive guidance with non-exhaustive examples of indicators that the CDR may not be met, including, among others, where:

"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)."

"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…"

Proposal, at 6,655; *see also* text accompanying n.7 (opportunistic strategies of CDS protection sellers).

[12] *2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definition* (July 15, 2019), https://www.isda.org/a/KDqME/Final-NTCE-Supplement.pdf.

[13] *ISDA 2019 NTCE Protocol* (Aug. 27, 2019), https://www.isda.org/a/31AME/08272019-NTCE-Protocol-Publication.pdf.

[14] At the close of the NTCE Protocol, 1,358 market participants had submitted an Adherence Letter. *ISDA 2019 NTCE Protocol – Reopened from January 6,2020 to January 2020 – List of Adhering Parties*, https://www.isda.org/protocol/isda-2019-ntce-protocol/adhering-parties (last updated June 3, 2021).

[15] The financial condition of the reference entity at the time it fails to pay is not conclusive as to whether such non-payment resulted from, or resulted in, a deterioration in the creditworthiness or financial condition of the reference entity.

- the non-payment arises directly from an arrangement between the reference entity and one or more entities where an essential purpose of the arrangement is to create a benefit under a CDS;

- an arrangement is entered into and, as part of such arrangement, the reference entity agrees to issue or incur either: (i) a new debt obligation which is likely to be the cheapest-to-deliver in any auction resulting from the credit event triggered by such non-payment, or (ii) a material amount of additional debt that would constitute deliverable obligations in such an auction;

- the non-payment did not result in the reference entity's other debt obligations generally being accelerated or becoming capable of being accelerated; or

- the reference entity had access to sufficient liquidity to meet its debt obligations as they were scheduled to fall due.[16]

We appreciate that the Commission may be concerned with future opportunistic strategies and other unconventional credit events which are not squarely contemplated by the NTCE Supplement. We note, however, that the NTCE Supplement was not designed to exhaustively describe the universe of unconventional credit events which, as a policy matter, should not be considered a credit event under a CDS. Rather, the primary purpose of the NTCE Supplement is to provide a Credit Derivatives Determinations Committee ("**Determinations Committee**")[17] the tools to determine whether an event constitutes an FTP based on an objective set of criteria applicable to the CDS market. As such, the Determinations Committee is instructed to "have regard to the broader context in which the non-payment occurred: the factors set out are not exhaustive and no single factor is necessarily conclusive."[18] Both the events preceding and the consequences to the reference entity of the non-payment are relevant.

Although the Commission has stated its intent to employ a facts and circumstances analysis to determine whether an action that appears to be designed almost exclusively to harm one or more CDS counterparties falls within the prohibition of Rule 9j-1(b), the prohibition as written does not reflect this intent. In contrast to the NTCE Supplement, Rule 9j-1(b) fails to provide factors or other interpretive guidance based on which CDS counterparties could reasonably expect actions taken with respect to reference entities to be considered

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16 NTCE Supplement, at 5 (Exhibit F to the to the 2014 ISDA Credit Derivatives Definitions, section 1.10(a)-(d)).

17 "The Credit Derivatives Determinations Committees (DCs)…role is to apply the terms of market-standard credit derivatives contracts to specific cases, and make factual determinations on Credit Events, Successor Reference Entities and other issues, based on information provided to the DCs by credit default swap (CDS) market participants." *Credit Derivatives Determinations Committee*, https://www.cdsdeterminationscommittees.org/ (last visited May 26, 2022).

18 NTCE Supplement, at 5 (Exhibit F to the to the 2014 ISDA Credit Derivatives Definitions, section 1.9).

legitimate and beyond the scope of Rule 9j-1(b). As a result, we would expect market participants to restrict their activity in the CDS or underlying cash markets, or both.

I. Hovnanian Enterprises, Inc.

In February 2018, Hovnanian Enterprises, Inc. ("**Hovnanian**") closed a series of transactions to restructure and refinance debt that was to mature in the following year, with significant financing provided by GSO Capital Partners L.P. ("**GSO**"). As described by a court in prior litigation over the transactions,

> The transaction…is one in which GSO has agreed to refinance certain Hovnanian debt through, inter alia, the exchange of certain outstanding Hovnanian bonds for new bonds, some of which bear a substantially below market interest rate and unusually long term. The transaction includes the purchase of some of the currently outstanding bonds by a Hovnanian affiliate. Hovnanian has covenanted, as part of the transaction, to default on an upcoming payment on the bonds that will be held by the affiliate notwithstanding the fact that Hovnanian has sufficient resources to make the payment. Payments to other holders of that bond issue will not be withheld. [GSO and Hovnanian] expect this default to trigger a 'Credit Event' with respect to credit default swap ('CDS') protection contracts that [Solus] and others have sold that are referenced to Hovnanian bonds. [GSO and Hovnanian] also expect that the below-market interest rate long term bonds issued as part of the transaction will come into play in the determination of the CDS protection sellers' liability in connection with the Credit Event, inflating that liability. GSO purchased a substantial position in CDS protection contracts, as well as substantial positions in Hovnanian debt and equity securities, in anticipation of the Hovnanian transaction, and stands to profit significantly on its CDS position in the event a Credit Event is triggered by Hovnanian's default on the bonds held by the affiliate.[19]

The offending steps of the transactions were several. First, the Hovnanian non-payment arose directly from an arrangement with GSO which had as its principal purpose the creation of a benefit to GSO under a CDS, evidenced by the fact that the "anticipated profit was factored into the below-market pricing of the long term bonds and certain other financing that Hovnanian [provided] to GSO in the transaction."[20] Second, the terms offered by GSO contemplated the issuance of new long-term, low-yield 5% notes "to create a bond trading well below par so as to maximize monetary recovery for GSO under an [*sic*] CDS failure to pay Credit Event, by operation of the 'cheapest-to-deliver' rule."[21] Third, the Hovnanian non-payment did not result in a cross-default on all or any of Hovnanian's outstanding debt, and the

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19 *Solus Alt. Asset Mgmt. LP v. GSO Capital Partners L.P.*, No. 18 CV 232-LTS-BCM, at *2-3 (S.D.N.Y. Jan. 29, 2018).

20 *Id.* at *3.

21 *Id.* at *8.

record reflected that GSO was focused on "determin[ing] whether a default sufficient to constitute a 'failure to pay' event, but not of such magnitude as to trigger a cross-default…, could be engineered."[22] Fourth, Hovnanian had sufficient resources to make the payment, albeit Hovnanian faced an imminent need to refinance certain notes before their maturity.[23]

Taken together, these indicators likely would have led to a finding by the Determinations Committee that the Hovnanian non-payment would not have satisfied the CDR and, therefore, would not have triggered a "Credit Event" had the NTCE Supplement been effective with respect to the CDS transaction at the time of the non-payment.

Of further note, the Court found "that any proliferation of engineered defaults that did occur could likely be mitigated by actions on the part of ISDA."[24] The Court explained that,

> ISDA…has a process in place to study and approve modifications to its standard documentation, definitions, and Master Agreement that could change the definition of a failure to pay event…The Court is not… persuaded that ISDA is so powerless to act in an effective way with respect to the effect of intentional defaults on the CDS market, given the numerous proposals to prohibit such engineered defaults, as to require an injunction by this Court to prevent irreparable damage to the CDS marketplace.[25]

The Court went to length to foreshadow the development of the NTCE Supplement which likely would have, in the Court's opinion, resolved the present matter. Although the Court rejected Solus's request for injunctive relief, the Court noted that such relief would "not [be] necessary to remedy any harm if [Solus] succeed[ed] on its claims,"[26] that is, market manipulation violative of Section 10(b) of the Exchange Act and related Rule 10b-5,[27] and material misstatements with respect to exchange offer and consent solicitation disclosures violative of Section 14(e) of the Exchange Act.[28] The parties ultimately settled the action.

B. Anti-Net Short Provisions/Net Short Restrictions

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22 *Id.* at *7.

23 "In connection with a different refinancing, Hovnanian issued two series of secured notes…subject to a covenant preventing Hovnanian from using any cash on hand to redeem the bulk of the outstanding 7% or 8% Notes. Because of this covenant, Hovnanian must refinance the 8% Notes before their maturity date." *Id.* at *5-6 (internal citation omitted).

24 *Id.* at *9.

25 *Id.* at *10.

26 *Id.* at *13.

27 15 U.S.C. § 78j(b).

28 15 U.S.C. § 78n(e).

Borrower concern about the identity and motivations of potential creditors is regularly an issue in the negotiation of credit agreements, and the practice of explicitly disqualifying certain entities from becoming lenders under the credit agreement is commonplace. In Spring 2019, following the default involving Windstream Services, LLC. (“**Windstream**”) discussed in further detail below, new credit agreement and non-disclosure agreement terms began evolving in the credit market. These “Net Short Restrictions” generally limit the rights of any lender or participant in a syndicated loan that would stand to benefit economically from a deterioration in the creditworthiness or financial condition of a borrower, for example, because the lender or participant holds a “net short” position in the borrower through CDS. The lender or participant is determined to be “net short” to the extent its aggregate “short” exposure to the borrower and its indebtedness exceeds its aggregate “long” exposure to the credit risk of the borrower. The limitation of rights to which net short lenders or participants may be subject include limitations on access to information regarding the borrower, transfer restrictions, voting restrictions, forced divestment, and/or prepayment on a non-pro rata basis.

I. Windstream Services, LLC

In January 2013, Windstream issued senior unsecured notes in an aggregate amount of roughly $700 million, governed by an indenture which prohibited Windstream from engaging in a sale-and-leaseback transaction. In March 2015, Windstream’s and its parent holding company’s Boards approved the formation and spin-off of a real estate investment trust (“**REIT**”) to hold and lease certain of Windstream’s (and its subsidiaries’) critical telecommunications assets purportedly to improve the company’s financial flexibility, attract investment, and improve tax and cash flow efficiency. In return for the transferred assets, Windstream received all the REIT’s common stock, cash, and debt comprised of term loans and unsecured notes. The REIT then leased back the assets to the parent holding company,[29] and the transferor subsidiaries continued to use and occupy the assets as before and fulfill all obligations toward the assets, including maintenance, tax payments, and capital improvements.

In September 2017, a noteholder gave notice to Windstream that it believed that the March 2015 transaction breached the indenture as a sale-and-leaseback transaction and that, as a result, Windstream was in default. Windstream publicly disclosed its receipt of the notice in

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[29] Although the parent holding company’s counterparties were the REIT’s subsidiaries, the lease was not negotiated at arm’s length; the lease was designed and drafted within and by Windstream. The parent holding company alone signed the lease, and none of the transferor subsidiaries were party to the agreement.

> At trial, [Windstream’s] former General Counsel, John Fletcher, admitted that one reason that [the parent holding company] was the only Windstream entity to sign the Master Lease was to avoid ‘a clear violation’ of the Indenture. That is, [Windstream] understood and believe at the time that if the Transferor Subsidiaries signed the Master Lease and thus leased back the property they had transferred to [the REIT], the 2015 Transaction would have indisputably constituted a Sale and Leaseback Transaction prohibited by…the Indenture.

Windstream Services, LLC v. Aurelius Capital Master, LTD., No. 17-CV-7857 (JMF), at *11 (S.D.N.Y. Feb. 15, 2019) (internal citation omitted).

a filing with the Commission and represented that the noteholder's allegations were intended to manipulate the price of the notes and other securities. The universal assumption was that the noteholder held a significant short position in Windstream through CDS. The noteholder directed the Trustee in Delaware Chancery Court to file suit against Windstream on the ground that the transaction had violated the indenture, and Windstream brought the noteholder into the action by asserting counterclaims against the noteholder and the Trustee, seeking injunctive relief to prevent a declaration of default under the indenture. The action was ultimately removed to federal court. That Court concluded that the transferor subsidiaries leased the assets and, therefore, Windstream breached the terms of the indenture. The noteholder was entitled to a money judgment in the amount of the notes it held plus interest, in excess of $300 million. Windstream suffered the default, presumably triggering a payout under the noteholder's CDS, and subsequently filed for bankruptcy protection.

Separate and apart from Windstream's understanding and belief that the March 2015 transaction ran the risk of a breach of the indenture,[30] the actions taken by the noteholder likely would have been precluded by a Net Short Restriction had such provision been effective with respect to the notes at any time the noteholder was determined to hold a net short position in Windstream through CDS. Indeed, these provisions have become known as "Windstream Provisions," and effectively remove the financial incentive of net short debt activist strategies.

III. Conclusion

We support the Commission's goal of reducing the risk of fraud and manipulation in security-based swap markets. However, we submit that market participants share these goals and have reacted swiftly and effectively to the few isolated incidents which the Proposal was intended to address. We firmly believe that these industry efforts, including the NTCE Supplement and Net Short Restrictions, mitigate the risk of manufactured credit events and net short debt activist strategies, respectively. Additionally, in many cases where the threat of a manufactured credit event or other opportunistic strategy was present, the risk never materialized because of the reputational consequences and the availability of other legal recourse to market participants. As such, market pricing is not reflective of the perception that these risks are prevalent.

We strongly encourage the Commission to revisit Rule 9j-1(b) and appropriately tailor it to address the Commission's core concerns, without implicating other non-manipulative actions taken by market participants. The Commission should further consider the data presented herein and include in the text of the rule a specific description of what constitutes manipulative conduct. In doing so, the Commission should re-release Rule 9j-1(b) for public comment so as to provide market participants with the ability to adequately assess the potential impact of the Proposal on the security-based swap markets and, indeed, on the broader market for corporate debt.

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[30] *See* text accompanying n.29.

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We appreciate the opportunity to provide additional comments to the Commission regarding Rule 9j-1, and we would be pleased to meet with the Commission or its staff to discuss our comments. If the staff has questions or comments, please do not hesitate to call Joseph Schwartz, Director and Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Regulatory Affairs
Managed Funds 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
Mr. Haoxiang Zhu, Director, Division of Trading and Markets