Gina-Gail S. Fletcher
Professor of Law
Duke University School of Law
210 Science Drive
Box 90300 • Durham, NC 27708-0300

March 21, 2022

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: File No. S7-32-10; Proposed 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; Release No. 34-93784

Dear Ms. Countryman,

I am a Professor of Law at Duke University School of Law. I have written extensively on complex financial instruments and market regulation, focusing on the interplay of public regulation and private ordering in enhancing market stability and integrity, and much of my academic work focuses market manipulation.[1] Before becoming an academic, I practiced law at Gibson, Dunn, & Crutcher LLP, in the areas of securities regulation, banking, and mergers and acquisitions.

I write now to comment on the proposed rules relating to the prohibition against fraud, manipulation, or deception in connection with security-based swaps; prohibition against undue influence over chief compliance officers; and position reporting of large security-based swap positions presented in Release No. 34-93784 (the "Proposed Swaps Rules" or the "Release).[2]

Commission Approach to the Rules

At the outset, I want to applaud the Commission for turning its attention to upholding the integrity of the Security-Based Swaps (SBS) market. These complex financial instruments play an important role in our markets, but their complexity and technical nature may give rise to unique risks

---

[1] *See Deterring Algorithmic Manipulation*, 74 Vanderbilt Law Review 259-325 (2021); *Foreign Corruption as Market Manipulation*, 2020 University of Chicago Law Review Online 15-25 (2020); *Macroeconomic Consequences of Market Manipulation*, 83 Law and Contemporary Problems 123-140 (2020); *Engineered Credit Default Swaps: Innovative or Manipulative?*, 94 New York University Law Review 1073-1145 (2019); *Legitimate Yet Manipulative: The Conundrum of Open-Market Manipulation*, 68 Duke Law Journal 479-554 (2018).
[2] This comment letter was drafted by staff of the International Institute of Law and Finance, a non-profit, non-partisan corporation.

or misconduct, which regulations must prevent. I hope that my comments in this letter will help the Commission move towards the goals articulated in the Release.

As the title of the Release makes clear, the Proposed Swaps Rules take aim against "Fraud, Manipulation, [and] Deception in Connection with Security-Based Swaps," and rightfully so. These behaviors should not be tolerated in any parts of our markets, and particularly not in those sectors where greater complexities might conceal more inappropriate risk-taking. The Commission was particularly wise by emphasizing fraud, deception, and manipulation "in connection with <u>effecting</u> [SBS] transactions," as opposed to simply in connection with the purchase or sale of such securities.[3] Many SBS instruments carry unique risks and long duration, with a potentially complex stream of payments and obligations throughout the term of the swap.

Further, the scope of the Release includes not just actions taken in actually effecting an SBS transaction, but also those "inducing or attempting to induce the purchase or sale . . . of a security-based swap."[4] A fraudulent, manipulative, or deceptive attempt engage in an SBS transaction still carries negative consequences for the market, and must rightly be prohibited. To do otherwise would be to encourage perverse incentives for credit default swap (CDS) counterparties and issuers in the market.

More broadly, the Proposed Swaps Rules would construct a facts-and-circumstances approach to determining whether a specific SBS strategy is opportunistic and possibly manipulative. This approach avoids bright-line rules that potentially create opportunities to engage in manipulative behavior within the letter but not the spirit of the law, and provides the staff of the Commission with the flexibility it needs to evaluate transactions in an ever-evolving marketplace.

Certain Technical Concerns

While the Commission should be praised for the points raised above, I have concerns regarding certain technical aspects of the rule that I believe can and should be addressed before finalization.

The Release would make it "unlawful for any person . . . to terminate (other than on its scheduled maturity date) or settle any security-based swap in connection with which such person: (1) Employs or attempts to employ any device, scheme, or artifice to defraud or manipulate; or (2) Makes or attempts to make any untrue statement of a material fact, or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (3) Obtains or attempts to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (4) Engages or attempts to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[5] This language is simultaneously too broad and too narrow. This term would appear to exempt terminations at maturity from the scope of the rule. Yet there are scenarios in which an opportunistic scheme could be executed in line with the scheduled maturity date. This overly broad language would miss—and encourage—such situations. At the same time, this term would only exempt terminations at maturity, and would exclude contractually permitted terminations not conducted to intentionally distort the swap transaction. The Commission's rules

[3] Proposed Swaps Rules, at 1.
[4] *Id.*

should prohibit manipulative schemes, but should not in so doing prevent sophisticated parties from contractually agreeing to otherwise acceptable behaviors.

Credit Default Swaps

I have several comments regarding the Release's treatment of CDS, a subject which I have studied extensively.[6] Counterparties to CDS contracts are typically large, sophisticated players in the financial markets, who agree to transfer the default risk of an asset. These agreements are zero-sum (after transaction costs), giving rise to perverse incentives for actors to engage in engineered transactions to bring about a party's preferred outcome. Such actions, which have become increasingly common over the past decade, involve a counterparty to a CDS engaging in an engineered transaction to either create or avoid a credit event, either temporarily or permanently.

While the immediate effects of engineered CDS transactions often fall on the kinds of large investments firms that engage in such behavior, the broader impacts of such behavior may negatively impact the real economy and the market as a whole. First, engineered CDS transactions impede price efficiency in the CDS market. The proper price of a CDS incorporates numerous pieces of information, including the financial status of the issuer, the financial status of the issuer's industry, and macroeconomic factors. CDS prices, in turn, provide valuable information to the broader market about the health of an issuer, the industry, and the macroeconomy.[7] When a counterparty engineers an action with regards to CDS, however, the market's ability to accurately price credit risk is harmed, as the status of the CDS separates from the state of the underlying issuer, industry, and macroeconomic factors, and is driven instead by the manufactured event. Moreover, such manufactured transactions can be more profitable with distressed issuers, further incentivizing behavior that makes CDS prices less accurately reflect issuer health at a time when accuracy and information are most important for the broader market.

Second, engineered CDS transactions may impair the liquidity of the CDS markets. The fact that a counterparty might manufacture a credit event in the future can deter others from entering into such contracts. If fewer parties enter into CDS contracts, the overall value of CDS as a risk-transferring instrument for the market will be reduced.

Finally, engineered CDS transactions impact the real economy. Defaulting or not defaulting as a result of an engineered transaction has significant, real consequences for the employees, customers, and creditors of the issuer. And lenders may raise the cost of capital in the future for the issuer, fearing a reoccurrence of a manufactured event in the future. While the CDS counterparty receives the gain from an engineered CDS transaction, the costs are born by others in the public.

For these reasons, it is vital that the Proposed Swaps Rules properly address engineered CDS transactions. Any new rules should work to encourage the pricing efficiency and liquidity of the CDS markets while reducing the negative externalities that opportunistic manufactured transactions strategies have on third parties.

---

[5] *Id.* at 27.
[6] *See* Gina-Gail Fletcher, *Engineered Credit Default Swaps: Innovative or Manipulative?*, 84 New York Law Review 1073 (2019).
[7] For example, during the 2008 crisis, CDS were often a more accurate reflection of credit risk than were credit ratings.

That said, I am concerned that the Proposed Swaps Rules group CDS and SBS together under the same set of regulations. Opportunistic strategies work best with CDS because of the structure and nature of the CDS instruments. Similar concerns are far less pressing with equity-based SBS, which are less risky and less subject to the opportunistic strategies that have become popular in the market in recent years. The Commission should properly distinguish CDS from equity-based SBS and disseminate separate rules for each type of instrument. The Release does not describe any sound basis for copying the disclosure thresholds for CDS to the thresholds for SBS.

Finally, the Proposed Swaps Rules do not contemplate legitimate restructuring transactions that may implicate CDS transactions. Indeed, the International Swaps and Derivatives Association (ISDA) now recognizes that a "narrowly tailored credit event" may be part of a legitimate restructuring transaction for certain issuers.[8] The Proposed Swaps Rules fail, for instance, to offer a safe harbor or exception for legitimate restructurings, which may limit funds available to issuers during a restructuring.

I appreciate your consideration.

Respectfully,

Gina-Gail S. Fletcher
Professor of Law
Duke University School of Law

[8] *ISDA* 2019 *Narrowly Tailored Credit Event Protocol.*