March 21, 2022

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

VIA ELECTRONIC MAIL: rule-comments@sec.gov

Re: File Number S7–32–10: Notice of Proposed Rule Making on the Position Reporting of Large Security-Based Swap Positions

Dear Ms. Countryman:

The Committee on Capital Markets Regulation (the "**Committee**") appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "**SEC**") on the security-based swap ("**SBS**") position reporting requirements set forth in proposed Rule 10B-1 under the Securities Exchange Act of 1934 (the "**Exchange Act**") and proposed Schedule 10B, as reflected in the above-captioned proposed rulemaking (the "**Proposed Rule**").[1] Our comments relate only to proposed Rule 10B-1, and not to proposed Rule 9j-1 that would prohibit fraud, manipulation, or deception in connection with security-based swap positions.

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-eight leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Emeritus Dean, Columbia Business School) and John L. Thornton (Former Chairman, The Brookings Institution) and is led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

Our letter proceeds in three parts. First, we describe the Proposed Rule's reporting requirements, including a description of credit default swaps and total return swaps covered by the proposal. Second, we review the policy rationale for the Proposed Rule. Third, we assess the Proposed Rule's cost benefit analysis finding that it has several key shortcomings, including a failure to sufficiently analyze or quantify several of the principal benefits and costs of the proposal. While we generally support transparency and properly calibrated reforms to make markets more efficient and competitive, we find that the Proposed Rule's cost-benefit analysis ("**CBA**") fails to provide a sufficient basis for the proposed disclosure requirements, and we therefore cannot support the proposed security-based swap disclosures. If the SEC nonetheless chooses to impose such a requirement, then we recommend that the SEC revise the Proposed Rule such that reporting thresholds should only apply on a net basis, because the goal of the proposal is to identify directional positions. We also recommend increasing the threshold for reporting security-based swaps positions for all market participants to focus more narrowly on large positions.

[1] 87 Fed. Reg. 6652 (Feb. 4, 2022).

1. THE PROPOSED RULE'S POSITION REPORTING REQUIREMENTS

The Proposed Rule would implement a public disclosure requirement for positions in credit default swaps ("**CDS**"), total return swaps ("**TRS**"),[2] security-based swaps based on equities securities and other types of security-based swaps where positions exceed specified thresholds.

A CDS is a derivative, where one party (the "**protection seller**") agrees to pay the other party (the "**protection buyer**") if a designated debt issuer (the "**reference entity**") experiences a contractually defined "credit event," such as a default by failure to pay, during the covered period. In exchange, the protection buyer typically pays periodic fees to the protection seller, usually some percentage of the CDS notional amount based on the probability of default. The protection seller typically posts initial margin as collateral with the protection buyer at the initiation of the CDS contract. During the term of the CDS variation margin is then adjusted daily depending on whether the likelihood of a credit event has increased (in which case protection seller posts additional margin) or decreased (in which case the protection buyer returns margin to the protection seller). A CDS can cover a single reference entity, such as a corporate issuer ("**single-name**" CDS), or a basket of reference entities, such as an index. The CDS protection buyer need not actually own debt instruments of the reference entity.

A total return swap or TRS is a swap agreement in which one party, typically an institutional investor such as a hedge fund, mutual fund, pension fund or insurance company (the "**investor**"), makes payments based on a set rate, either fixed or variable, while the other party—typically a dealer—makes payments based on the return of an underlying asset, which includes both the income it generates and any capital gains. The investor also pays the dealer for any decline in the asset's value. In total return swaps, the underlying asset, referred to as the reference asset, is typically a stock, equity index, a basket of loans, or bonds, and the asset is typically owned by the dealer receiving the set rate payment but that is not always the case as the dealer may have an offsetting TRS with another customer or dealer.

For example, assume Institutional Fund A is seeking to gain long exposure to $100 million in Apple stock for the next six months, but does not want to spend $100 million to acquire the stock. Institutional Fund A could do so by entering into a TRS with Dealer 1 where Institutional Fund A would pay Dealer 1 a set rate for Dealer 1 to provide Institutional Fund A with this exposure. To hedge its exposure to the Apple stock, Dealer 1 could then purchase $100 million of shares in Apple and pass through any appreciation or depreciation in the Apple stock for the next six months.[3] Dealer 1's Apple position is market neutral because gains are passed onto Institutional Fund A and price decreases in Apple stock are covered by Institutional Fund A.

In addition to initial margin, TRSs also often require the two-way exchange of payments and variation margin. So, if the value of the Apple stock underlying the TRS appreciates to $110 million in month 2 of the TRS then Dealer 1 would have an obligation to pay Institutional Fund A $10 million in variation margin. However, if the value of the Apple stock depreciates by $15 million to $95 million in month 3 of the TRS, then Institutional Fund A has to pay Dealer 1 $15 million in variation margin at the end of month 3. At the

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[2] CORPORATE FINANCE INSTITUTE, *Total Return Swap* (last accessed Jan. 24. 2022), https://corporatefinanceinstitute.com/resources/knowledge/finance/total-return-swap-trs/; PRICEWATERHOUSECOOPERS, *The PricewaterhouseCoopers Credit Derivatives Primer*, 6 (accessed Jan. 24. 2022), https://www.pwc.com.tr/en/assets/about/svcs/abas/frm/creditrisk/surveys/pwc_credderi.pdf.

[3] Dealers may use other techniques to hedge TRS exposures that may not involve purchasing physical shares in the underlying company at a 1-to-1 ratio, including by establishing positions in other derivatives contracts, or by using techniques designed to hedge their net exposures across all their clients.

end of the six-month period, Institutional Fund A would receive the benefit (or pay the cost) of actually owning $100 million in Apple stock without actually having acquired the shares. Dealer 1 would be exposed to losses on the TRS only if the price of Apple's stock declines to an extent that exceeds the combined value of the initial and variation margin, if any, that Institutional Fund A has previously provided to Dealer 1, and Institutional Fund A defaults on its obligation to pay Dealer 1 the difference between the value of the Apple stock and the previously provided margin.

The anti-fraud and manipulation rule proposal describes manufactured credit events as "generally involv[ing] CDS buyers or sellers taking steps … to avoid, trigger, delay, accelerate, decrease, and/or increase payouts on CDS."[4] For example, a CDS buyer or seller may, through ownership of a reference entity's securities or otherwise, seek to influence the timing of a credit event to ensure that the CDS seller's payment obligation is triggered before or after the CDS contract's expiration.[5] This letter will focus on the Proposed Rule, which also relates to manufactured credit events as explained later.

If adopted, the Proposed Rule would impose a new obligation on all market participants with a security-based swap position to publicly disclose any positions exceeding one or more specified thresholds. The proposed reporting thresholds vary by type of security-based swap, as described in **Table 1**. The thresholds apply to long and short CDS positions. The protection buyer is considered to be "long" CDS and the protection seller is considered to be "short" CDS. However, the proposal does not distinguish between long and short TRSs for purposes of the disclosure threshold for TRSs. The proposal does not explain why the disclosure thresholds for CDS are different in this respect from the disclosure thresholds for TRSs.

Table 1

Type of Security-Based Swap	Reporting Threshold(s)
CDS	The **lesser** of: (i) a long notional amount of **$150 million**, calculated as: long notional amount of security-based swap position + notional amount of any long positions in a deliverable debt security underlying a security-based swap included in the security-based swap position ——— = long notional amount (ii) a short notional amount of **$150 million**; or (iii) a gross notional amount of **$300 million**.
Equity security-based swaps (including equity TRS)	The **lesser** of: (i) a gross notional amount of **$300 million**, *provided that* once an equity security-based swap position exceeds a gross notional amount of $150 million, the calculation of the security-based

[4] 87 Fed. Reg. at 6655.

[5] *Id*.

	swap position must also include the value of all of the holder's underlying equity securities and the notional amount of any other derivative instruments based on the same class of equity securities; or (ii) a "security-based swap equivalent position" representing more than **5%** of a class of equity securities, *provided that* once a security-based swap equivalent position represents more than 2.5% of a class of equity securities, the calculation of the security-based swap equivalent position must also include in the numerator all of the holder's underlying equity securities, as well as the number of shares attributable to any other derivative instruments based on the same class of equity securities.

Once one or more of the applicable thresholds is breached, the market participant must report via a newly created form, Schedule 10B, the following key information:

(1) Its identity (i.e., name, residence or place of organization, and Legal Entity Identifier if any).

(2) The notional amount of its applicable security-based swap position(s), along with the direction (long or short), the tenor/expiration of the underlying security-based swap transaction, and the product ID (such as the Unique Product Identifier, or "UPI") of the security-based swap(s) included in the security-based swap position, if applicable.

(3) For a security-based swap position based on debt securities (including CDS), ownership of: (i) all debt securities underlying a security-based swap included in the security-based swap position; and (ii) all security-based swaps based on equity securities issued by the same reference entity.

(4) In the case of a security-based swap position based on equity securities, ownership of: (i) all equity securities underlying a security-based swap included in the security-based swap position; and (ii) all security-based swaps based on debt securities issued by the same reference entity (including CDS).

The form must be submitted through the SEC's Electronic Data Gathering, Analysis, and Retrieval system ("**EDGAR**") promptly after the relevant threshold is breached, but no later than the end of the first business day after execution of the security-based swap transaction that causes the security-based swap position to exceed the relevant threshold. The report would be made publicly available immediately upon filing.

The Proposed Rule would require the reporting market participant to update the report in the event of any "material" change in the information reported, defined to include an acquisition or disposition in an amount equal to 10% or more of the position previously disclosed in Schedule 10B.

2. POLICY RATIONALE FOR THE PROPOSED RULE'S REPORTING REQUIREMENTS

The Proposed Rule sets out the following principal rationales for the proposed position reporting requirements:

(1) *Disclosure requirements will help prevent manufactured credit events for CDS.* The proposal suggests that market participants with large security-based swap positions stand to benefit the most from manufactured credit events and are therefore more likely to engage in such behavior than other market

participants.[6] The Proposed Rule predicts that public disclosure of the identity of market participants with large positions (and the size of those positions) will help reduce manufactured credit events because the market and regulators will be better able to monitor these market participants and identify and prevent manufactured credit events.[7]

(2) *Disclosure requirements will support risk-management efforts.* According to the proposal, the position reporting requirements would provide dealers and counterparties with access to information about other large positions held by their counterparties, allowing them to better manage their risk exposures. This would purportedly help prevent Archegos-type events where a market participant's default on large, concentrated positions in security-based swaps across multiple dealers can cause large losses for dealers and other market participants with positions linked to the same or a similar reference entity.[8] However, as described in further detail later, this assumption is not correct: Credit Suisse, which suffered the largest losses from the Archegos incident, acknowledged in its internal report that the relevant parties "had *all the information necessary* to appreciate the magnitude and urgency of the Archegos risks."[9] In **Box A** we further describe the Archegos event.

Box A

Archegos Capital Management ("**Archegos**") was a large $20 billion family office for the personal assets of fund manager Sung Kook "Bill" Hwang that failed in March 2021 after defaulting on large TRS positions on technology and media stocks, including Viacom, Tencent and Discovery.[10] Archegos' TRS exposures were very large, equivalent to owning approximately 6-8% of Viacom and Discovery, for example, and many of Archegos' dealer counterparties owned the underlying stock.

On the week of March 22nd, Viacom, Tencent and Discovery's stock each suffered significant price declines. Archegos' TRS positions therefore required that Archegos post variation margin to its dealers in response to the decline in the stock price of Viacom, Tencent and Discovery. However, on March 25th, Archegos notified its dealers that it would not be able to satisfy margin calls for its TRS positions on these stocks and requested additional time to post margin. Certain of the dealers holding the underlying stocks then liquidated their holdings of Viacom, Tencent and Discovery causing further

6 *See* 87 Fed. Reg. at 6656-57.

7 *See* 87 Fed. Reg. at 6656 ("In . . . instances [of manufactured credit events], both the Commission and relevant market participants – particularly issuers of the underlying debt securities – could benefit from having access to information that may indicate that one or more market participants has a financial incentive to take an action that would be harmful to the issuer, which in turn could impact the issuer's other security holders. In particular, such notice would provide the relevant parties with the ability to take appropriate action to limit any potential harmful consequences.").

8 *See id.* ("Additional transparency regarding large security-based swap positions also could alert market participants, including counterparties, as well as issuers of securities and their security holders, to the risk posed by the concentrated exposure of a counterparty. Such transparency also could enhance risk management by security-based swap counterparties and inform pricing of the security-based swaps.").

9 PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP, *Credit Suisse Group Special Committee of the Board of Directors Report on Archegos Capital Management* (Jul. 29, 2021), https://www.credit-suisse.com/about-us/en/reports-research/archegos-info-kit html.

10 Juliet Chung and Margot Patrick, *What Is Archegos and How Did It Rattle the Stock Market?*, THE WALL STREET JOURNAL (April 6, 2021), https://www.wsj.com/articles/what-is-archegos-and-how-did-it-rattle-the-stock-market-11617044982.

declines in the price of these stocks and additional losses on Archegos' TRS positions requiring Archegos to post even more variation margin.

On March 26th, several of Archegos' dealers delivered a notice of default to Archegos. Archegos' dealer counterparties suffered approximately $10 billion in losses on Archegos-related positions. Losses varied widely by dealer because certain dealers, were faster than others at increasing Archegos' margin requirements (when Archegos could still satisfy them) and faster at selling the underlying assets.[11] Credit Suisse and Nomura Securities suffered the largest losses from Archegos-related positions at $5.5 billion and $2.9 billion, respectively.

3. ANALYSIS

In this section, we review certain shortcomings of the Proposed Rule's CBA. The Proposed Rule's CBA fails to provide sufficient quantitative or qualitative support that the benefits of the proposed disclosure requirements outweigh the costs, and we therefore do not support the proposed mandatory security-based swap disclosures. If the SEC nonetheless determines to proceed with such a requirement, we recommend that the SEC recalibrate the reporting requirements such that they operate on a net basis and increase the disclosure thresholds for security-based swaps positions.

Insufficient cost-benefit analysis

Under the National Securities Markets Improvement Act of 1996, Congress amended federal securities law "to promote efficiency and capital formation in the financial markets," requiring that "[w]henever . . . the [SEC] is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the [SEC] shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[12] The U.S. Court of Appeals for the District of Columbia Circuit (the "D.C. Circuit") has held that the statutory language imposes an obligation on the SEC to weigh the costs and benefits of proposed regulation.[13] In *Business Roundtable v. SEC,* the D.C. Circuit remanded an SEC rulemaking on shareholder proxy access due to inadequate economic analysis, including a failure to quantify the costs of the rulemaking.[14]

The Committee is concerned that the Proposed Rule's CBA does not engage in a qualitative or quantitative assessment of certain principal costs and benefits of the proposed reporting requirements.

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[11] Margot Patrick, *Credit Suisse Failed to Act on Archegos Risks, Report Says*, THE WALL STREET JOURNAL (July 29, 2021), https://www.wsj.com/articles/credit-suisse-report-pins-archegos-disaster-on-fundamental-failure-of-management-and-controls-11627537722;

[12] National Securities Markets Improvement Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

[13] *See generally* Paul Rose & Christopher Walker, *The Importance of Cost-Benefit Analysis in Financial Regulation*, CTR. FOR CAPITAL MKTS. COMPETITIVENESS 24–33 (2013), *available at* http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/CBA-Report-3.10.13.pdf

[14] Bus. Roundtable v. SEC, 647 F.3d at 1149 (D.C. Cir. 2011).

Costs

The CBA fails to consider various types of costs that are likely to arise from the Proposed Rule's public disclosure requirement, and where it does consider certain such costs, it fails to quantify them. Empirical evidence indicates that the public disclosure requirement would likely impose significant costs on financial markets particularly in the form of (i) reduced liquidity and price efficiency in the underlying securities, (ii) reduced incentives for fundamental research, and (iii) distorted economic incentives.

i) Reduced liquidity and price efficiency in underlying securities

Liquidity in security-based swaps, including CDS and TRS, contributes to liquidity and pricing efficiency in the underlying securities. For example, increased liquidity in TRS leads to trading and price discovery in the underlying security, as dealers often purchase the underlying security to hedge the swap. Similarly, increased CDS volume can enhance liquidity in bond markets by hedging bond purchasers against credit risk that may otherwise deter them from buying a given bond.[15] High volumes of CDS trading can also enhance pricing efficiency in the reference entity's securities by contributing to price discovery in terms of views on the creditworthiness of the reference entity.

A regulatory requirement that causes market participants to reduce their use of security-based swaps is thus likely to reduce liquidity in the securities underlying those swaps. The Proposal's CBA fails to consider or quantify the extent to which market participants will reduce participation in the security-based swap market in order to avoid disclosure requirements, and the costs to the market as a whole as a result of such reductions, including in the form of decreased liquidity in the underlying instruments. Market participants have been demonstrated to prefer to avoid public disclosure, out of the economically rational desire to protect one's "valuable proprietary information."[16] For example, and as discussed further below, increased transparency may require a fund manager to reveal proprietary information that allows competitors to free ride on the manager's efforts to identify profitable investments and trading strategies. Increased transparency can also be costly to a party that is in the process of accumulating or disposing of a position when the disclosure allows front-runners to trade against the disclosing party.[17]

The Proposed Rule's requirement that positions be disclosed no later than the end of the first business day after execution of a transaction ("**T+1**") is likely to exacerbate these negative effects, by increasing the likelihood that a market participant will be required to disclose proprietary information in a manner that will create opportunities for front running and other opportunistic behavior that the rule is intended to address. The CBA does not empirically weigh the marginal costs associated with a T+1 timeframe compared to more lenient timeframes against any benefits associated therewith.

In view of such costs, the economically rational response of those who seek economic exposure to securities without obtaining ownership or control of the issuer would be to reduce or eliminate their use of security-based swaps. Such a development carries the potential for severe declines in market liquidity and distortions

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[15] *See, e.g.*, Robert Czech, Bank of England Staff Working Paper No. 810, *Credit default swaps and corporate bond trading* (July 2019), https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2019/credit-default-swaps-and-corporate-bond-trading.pdf?la=en&hash=66BA0BEF5C7A5588A7C14BFEB3AFECB9469CB90F.

[16] George O. Aragon et al., *Why Do Hedge Funds Avoid Disclosure? Evidence from Confidential 13F Filings*, 48(5) THE JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS 5, 1499 (2013); *see also* Vikas Agarwal et al., *Perils of Fame and Fortune: Are Hedge Fund Stars Front-Run by Institutional Investors?* (2021), *available at* https://intranet.weatherhead.case.edu/document-upload/docs/1850.pdf.

[17] *See* Aragon, *supra* note 17.

in optimal capital formation and risk allocation, which are risks that, as noted above, the CBA does not consider or quantify.

As a further example of potential costs that the CBA fails to consider, we note that mandatory public disclosure may reduce the incentive for certain market participants to engage in beneficial activist investing. Activist investors generally seek to purchase shares at prices that do not yet fully reflect the value that the investor expects to achieve as a result of its activities. Such investors commonly seek to multiply the returns from physical positions in shares of the issuers in which they invest by obtaining additional exposure through security-based swaps.[18] The empirical evidence shows that hedge-fund activists create value for the target firms' shareholders and their own investors as evidenced by the positive short- and long-term returns around and after the announcement of efforts by activist shareholders to redirect management's efforts.[19]

Confidentiality usually becomes a higher priority for investors with larger, riskier portfolios and nonconventional strategies, such as activist investors.[20] Confidential holdings exhibit superior performance and take longer to build.[21]

The imposition or strengthening of public disclosure requirements for security-based swaps would thus erode the confidentiality activist investors require to capitalize on their strategies as they accumulate combined physical and synthetic holdings in the issuers they seek to influence. Activist investors might well therefore curtail their activities, resulting in suboptimal levels of activist shareholder activity, the benefits of which are noted above. Indeed, empirical evidence from markets with similar characteristics to that of security-based swaps shows that the imposition of mandatory disclosure regulations causes investors to restrict their market activities, which in turn leads to deterioration in the informational efficiency and decreased liquidity.[22]

The CBA also fails to consider or quantify the potential detriments of the Proposed Rule to the price quality of underlying securities. The marketplace for security-based swaps is characterized by the participation of sophisticated and informed participants. As a general matter, empirical research indicates that the imposition of mandatory disclosure requirements does not necessarily improve price efficiency. On the contrary, in the case of markets where sophisticated parties are effective at aggregating private information, requiring the disclosure of information that is relevant to price has been shown to affect price efficiency negatively, because it interferes with the ability of the market to reveal this information on its own.[23] The

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[18] See Ronald J. Gilson, Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 COLUM. L. REV. 863 (2013).

[19] *See, e.g.,* Alon Brav et al., Hedge Fund Activism, Corporate Governance, and Firm Performance, 63 J. FIN. 1729, 1760; COMMITTEE ON CAPITAL MARKET REGULATION, *Short-Termism, Shareholder Activism and Stock Buybacks*, (Apr. 8, 2020), https://www.capmktsreg.org/2020/04/08/short-termism-shareholder-activism-and-stock-buybacks/.

[20] *See* Vikas Agarwal et al., *Uncovering Hedge Fund Skill from the Portfolio Holdings They Hide*, 68 J. FIN. 739 (2013).

[21] *Id*.

[22] Truong X. Duong et al., *The costs and benefits of short sale disclosure*, 53 JOURNAL OF BANKING AND FINANCE124 (2015), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2297680.

[23] *See* Itay Goldstein, Liyan Yang, *Good Disclosure, Bad Disclosure*, 131(1) JOURNAL OF FINANCIAL ECONOMICS 118 (2019).

empirical evidence developed in the economic literature also supports the idea that, in the context of a marketplace similar to that of the marketplace for security-based swaps, the imposition of mandatory disclosure requirements tends to result in "herding behavior"[24] and "trend-chasing"[25] and lead to investment decisions – and, thus, price formation – being made on the basis of the balance of market participants' investment actions and perceived staying power rather than on market fundamentals. As a result, prices are driven away from their true values (creating the potential for massive price distortions of the kinds recently observed in so-called meme stocks) and the marketplace can no longer serve its role as a price discovery mechanism.[26]

Mandatory disclosure can thus cause stock prices to deviate from firm fundamentals, make prices less informative, increase price volatility, and reduce pricing efficiency.[27] The erosion of market efficiency and the market's ability to serve as a price discovery mechanism as a result of the imposition of mandatory disclosure requirements in marketplaces similar to that of security-based swaps, is amply documented in the economic literature.[28] These potential costs are not considered or offset against the benefits of the Proposed Rule asserted in the CBA.

The Proposed Rule briefly acknowledges links between security-based swap and underlying securities markets and that the disclosure requirements could make trading strategies public by disclosing the identity of market participants and the size of their position, reducing such strategies' future profitability.[29] However, the Proposed Rule does not further assess the possibility that the proposal would reduce market liquidity due to decreased strategy profitability.

ii) Reduced fundamental research

The Proposed Rule's CBA also does not acknowledge that it would result in reduced fundamental research or consider the effects on pricing efficiency. For example, assume an institutional investor with a history of strong investment performance sought to take a long position of $1 billion in a stock by entering into a TRS. The proposal would require the institutional investor to "promptly" disclose its position and identity once the position reached a gross notional value of $300 million. This would very likely result in other market participants engaging in copycat trading and driving up the price of the security-based swap and underlying stock.[30] The cost of continuing to build the position for the institutional investor would go up, and so the return from the fundamental research conducted by the institutional investor would go down. Institutional investors would therefore be less incentivized to conduct such research, and there would be less informed trading as a result. This would reduce market liquidity (increasing transaction costs for investors) *and* pricing efficiency.

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[24] Such "herding behavior" is a well-documented unintended consequence of mandatory regulatory disclosures. For example, "by forcing disclosures to be widely disseminated, Regulation FD may heighten herding among analysts and leave investors worse off." *See* Anil Aryaa et al., *Unintended consequences of regulating disclosures: The case of Regulation Fair Disclosure*, 24 JOURNAL OF ACCOUNTING AND PUBLIC POLICY 243 (2005).

[25] *See* Duong, *supra* note 23.

[26] Id.

[27] *Id.*; *see also* John C. Heater et al., *Does Mandatory Short Selling Disclosure Lead to Investor Herding Behavior?* (2021) *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3923046.

[28] *See*, *e.g.*, *id*.

[29] 87 Fed. Reg. at 6689.

[30] See id.

The existence of such risks is supported by substantial empirical research demonstrating the negative impact of public disclosure requirements on fund performance as well as incentives to engage in fundamental research.[31] One such recent study that examines the impact of mandatory disclosure requirements found that market participants' "strategies changed significantly in response to the disclosure" requirements and found indications of a shift in market activity away from large sophisticated market participants and towards retail investors."[32]

iii) Distorted Incentives

The CBA does not consider the extensive empirical evidence showing that, in a derivatives marketplace, mandatory disclosures impose potentially substantial costs and distort economic agents' incentives. As a result, the CBA cannot quantify the potential costs associated with these dynamics. For example, one study concluded that "greater transparency about a firm's derivative activities [] induces the firm to take excessive speculative positions in the derivative market."[33] Another recent economic study of the impact of disclosure on short selling finds "strong evidence that short sellers increase security selection intensity when their short positions approach the reporting threshold." Put simply, mandatory disclosure requirements have the effect of "disincentivizing" optimal short-selling behavior, and, thus, reduce market efficiency and distort price formation.[34]

Benefits

The proposal also does not attempt to quantify certain of the principal benefits of its disclosure requirements. The CBA identifies one benefit of the Proposed Rule as the possibility of reducing manufactured credit events, thereby increasing liquidity in CDS markets because market participants will have more confidence that such behavior is effectively prohibited.[35] However, the proposal does not qualitatively or quantitatively assess the magnitude of this purported benefit. It does not estimate how frequent "manufactured credit events" are or the costs of such events. Examples of such events, while undesirable, appear to be quite rare. The academic papers cited by the Proposed Rule identified six examples of potential manufactured credit events: RadioShack (2014-2015), Norske Skog (2016), Hovnanian (2017-2018), Windstream Services (2015-2018),[36] Codere (2013), and Mcclatchy (2018).[37] Research by

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[31] *See, e.g.*, Zhen Shi, *The Impact of Portfolio Disclosure on Hedge Fund Performance* (2016), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573151; Sitikantha Parida and Terence Teo, *The Impact of More Frequent Portfolio Disclosure on Mutual Fund Performance*, 87(C) JOURNAL OF BANKING & FINANCE 427 London School of Economics (2018); Verbeek, M., Wang, Y., Better than the original? The relative success of copycat funds, Journal of Banking and Finance 37, 3454–3471 (2013).

[32] *See* Duong, *supra* note 23.

[33] Haresh Sapra, *Do Mandatory Hedge Disclosures Discourage or Encourage Excessive Speculation?* 40 JOURNAL OF ACCOUNTING RESEARCH 933 (2002).

[34] Sheran Deng, *Does Disclosure Deter Short Selling with Noisy Information* (2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3720206.

[35] 87 Fed. Reg. at 6685-86.

[36] Henry T.C. Hu, *Corporate Distress, Credit Default Swaps, and Defaults: Information and Traditional, Contingent, and Empty Creditors*, 13 BROOKLYN JOURNAL OF CORPORATE, FINANCIAL, & COMMERCIAL LAW 5, 22 (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3302816.

[37] Gina-Gail S. Fletcher, *Engineered Credit Default Swaps: Innovative or Manipulative?*, 94(5) N.Y.U. L. REV. 1073 (Nov. 2019), https://www.nyulawreview.org/issues/volume-94-number-5/engineered-credit-default-swaps-innovative-or-manipulative/.

Committee staff can find no reporting on any such events since July 2019, when the International Swaps and Derivatives Association ("**ISDA**") introduced amendments to its Credit Derivatives Definitions designed to address certain manufactured credit events.[38]

The proposal's CBA further argues that the Proposed Rule will reduce the risk of losses from participating in security-based swaps markets by informing market participants when their counterparties have built up large security-based swap exposures with other counterparties, and as a result participation in such markets will increase, enhancing the liquidity of security-based swaps and the underlying securities.[39] Again, the proposal does not quantify the probability or magnitude of any of these anticipated benefits to liquidity.

Moreover, the Proposed Rule is based on the inaccurate assumption that market participants are not aware, or at least insufficiently aware, of the fact that their counterparties may hold large security-based swap positions in various reference entities. The CBA ignores that many dealers already require such exposure information from their counterparties. It is therefore not clear that public position disclosures would have prevented Archegos or prevent similar events in the future. Internal reports found that Credit Suisse—the dealer that suffered by far the greatest losses from the failure of Archegos—was aware of certain of Archegos' counterparty's exposures but simply did not call for collateral when its own internal risk models required it to do so.[40] The report acknowledges that the relevant parties "had *all the information necessary* to appreciate the magnitude and urgency of the Archegos risks" and "Archegos's voracious risk-taking" through "concentrated, volatile, and severely under-margined swap positions."[41]

Even if the Archegos incident were the result of inadequate information disclosure, this would only support a requirement that security-based swap positions be disclosed to one's direct counterparties only, not the entire market. Indeed, the statutory language on which the proposal for public disclosure is based, Section 10(B)(d) of the Exchange Act, refers only to requirements to "report" and does not refer to public disclosure. Other sections of the Exchange Act that contemplate a public disclosure requirement specify that the contemplated disclosure is to be "public."

In addition, both policy rationales for the proposal—i.e., prevention of manufactured credit events and enhanced risk management—will already be served by the existing regime of *anonymized* regulatory and real-time public reporting for security-based swaps via security-based swap data repositories ("**SBSDR**"), just coming online now.[42] These existing reporting requirements will allow regulators and the market to identify elevated activity in certain security-based swaps that is informative as to whether there could be large positions in specific security-based swaps, without threatening liquidity in such swaps in the way public disclosure of a position holder's *identity* would. The CBA does not quantify the marginal benefits that a new public identification requirement would provide over and above the existing anonymized framework established by Congress and only now coming into force under the SEC's security-based swaps

[38] International Swaps and Derivatives Association, *2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions* (July 15, 2019), https://www.isda.org/book/2019-narrowly-tailored-credit-event-supplement-to-the-2014-isda-credit-derivatives-definitions/.

[39] *See* 87 Fed. Reg. at 6687.

[40] PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP, *Credit Suisse Group Special Committee of the Board of Directors Report on Archegos Capital Management* 1-2 (Jul. 29, 2021), https://www.credit-suisse.com/about-us/en/reports-research/archegos-info-kit html.

[41] *Id*.

[42] *See* 87 Fed. Reg. at Note 4.

rules. The SEC should allow SBSDR reporting to take full effect and study the related data before imposing extensive reporting requirements that present a clear risk of negative impacts to security-based swap markets and to capital formation that depends on such markets to hedge risk.

Use net rather than gross positions

The Proposed Rule is intended to address circumstances where large positions in security-based swaps may give rise to financial incentives that could lead to actions harmful to the markets or certain market participants. Those incentives can only be driven by directional positions. In contrast, where a party has a market-neutral position, either with offsetting security-based swap positions or a security-based swap position offset by a position in the referenced security then the incentives for harmful conduct do not exist. Dealers, by way of illustration, generally do not take directional positions with security-based swaps, as they seek to maintain a balanced book and minimize their net exposures, including where appropriate through hedging and portfolio compression exercises as noted in the proposal.[43] However, the proposal does not apply a net exposure threshold. Instead, any market participant exceeding $300 million in gross exposures for a security-based swap must disclose their position (even if their net exposure is zero). The proposal goes further and requires that all market participants update their public disclosures when their gross exposures change by 10% or more. These requirements would be burdensome for security-based swap dealers and unnecessary, as such dealers' reports would not expose large directional positions, which is the primary purpose of the proposal. More importantly, large nondirectional position reporting could obscure directional positions reported by others. The value and transparency of the reporting is diminished if a gross notional threshold is utilized.

Although we recommend that the public disclosure requirement be removed from the Proposed Rule entirely, if the SEC determines to proceed with such a requirement, then we recommend that the Proposed Rule utilize net rather than gross exposure thresholds.

Reporting thresholds for all market participants are too low

Although we do not support the mandatory disclosure of security-based swap positions, we are further concerned that the proposal's thresholds for disclosure are too low and would result in the mandatory disclosure of positions that are too small to achieve the dubious goal of publicly identifying large positions relevant to manufactured credit events or risk management concerns.[44] For example, the proposal would require the public disclosure of a long equity TRS (or other equity security-based swap) position when it exceeds the $300 million gross notional threshold, even if the shares attributable to this position are only a minuscule fraction of the issuer's outstanding securities. A gross long position of $300 million equates to only 0.01% ownership of AAPL shares. Similarly, the median S&P 500 company has a market capitalization of $30 billion, meaning that the proposal would require the public disclosure of a TRS position when it is equivalent to only 1% ownership in the median S&P 500 company. On the other hand, the SEC's reporting threshold for equities set forth by Rule 13d-1 is 5% ownership.[45]

The CBA does not otherwise justify or support the reasonableness of the reporting threshold levels it seeks to adopt, including in the context of the various market-based concepts relevant to risk management (e.g., price volatility and liquidity) or acknowledge the idiosyncratic differences associated with trading in different market segments and in different underlying securities. The proposed $300 million reporting

[43] *See* 87 Fed. Reg. at 6682.

[44] *See* 87 Fed. Reg. at 6691.

[45] 17 CFR 240.13d–1.

threshold for TRS swaps in particular appears to be based purely on the equivalent threshold for CDS, and is not, supported by data specific to the equity-based swap market.

The Proposed Rule also estimates the number of persons that will be subject to a reporting obligation based on TRS positions disclosed in Form N-PORT filings by registered investment funds. As the Proposed Rule acknowledges however, such funds are limited by regulation in the extent to which they may invest in TRS and are therefore unlikely to represent the typical users of TRS instruments. The Proposed Rule may well therefore underestimate the number of market participants that will be subject to a reporting obligation under the proposed thresholds.

Moreover, the purported purpose of the Proposed Rule - to assist market participants in assessing, evaluating, and managing risk - is not served by the choice of "notional" amount as the threshold levels metric. Notional amounts are not a measure of the actual amount of market risk exposure. Among other weaknesses, a notional value-based threshold fails to distinguish between highly speculative positions built around risky assets and relatively low-risk strategies using conservative investments. This view is widely and unanimously supported by market participants and regulators alike.[46] Therefore, the use of notional amounts for the purposes of assessing, evaluating, and managing risks in the marketplace, particularly that of securities-based swaps, is inappropriate, ill-advised, and could potentially result in market disruptions.

If the SEC determines to proceed with the proposed mandatory disclosure requirements for security-based swaps, then we recommend that the SEC revise the disclosure thresholds to focus solely on large positions.

Failure to assess cumulative effects or consider potential alternatives

The CBA fails to consider the cumulative costs of the public disclosure requirement it seeks to adopt for securities-based swaps along with recent SEC proposals for additional public disclosure requirements with respect to securities lending[47], beneficial ownership[48], and short positions.[49] The combined regulatory burden and adverse market impacts of these proposals may further increase the costs imposed on market participants in a manner that is not contemplated by the CBA. Finally, the CBA fails to consider potential alternatives to the Proposed Rule that would reduce counterparty risk in the security-based swaps market,

[46] *See* The ISDA Market Survey: What the results show and what they don't," ISDA Research Notes, Number 1, Autumn, 2008, page 2, ("[N]otional amounts are only loosely related to risk."). The ISDA Market Survey specifically warns users not to misinterpret notional amounts as a measure of risk. *See also Uses of Notional Amount in Derivatives Regulation*, ISDA, May 25, 2018; David Reiffen and Bruce Tuckman, *Systemic Risk and Firm Size: Is Notional Amount a Good Metric?*, Office of the Chief Economist, US CFTC, 2020 ("[N]otional amount, the metric used to measure size in regulations of derivatives markets, does not appropriately measure an entity's contribution to systemic risk."); OCC Quarterly Report on Bank Trading and Derivatives Activities, 3Q 2021, *available at* https://www.occ.treas.gov/publications-and-resources/publications/quarterly-report-on-bank-trading-and-derivatives-activities/files/q3-2021-derivatives-quarterly html ("The notional amount of a derivative contract is a reference amount that determines contractual payments, but it is generally not an amount at risk."); *id*. ("Changes in notional amounts are generally reasonable reflections of business activity and can provide insight into potential revenue and operational issues. The notional amount of derivative contracts, however, does not provide a useful measure of market or credit risk.").

[47] 17 CFR 69802.

[48] Release Nos. 33-11030; 34-94211; File No. S7-06-22.

[49] Release No. 34-94313; File No. S7-08-22.

including strengthening the uncleared initial margin rules or strengthening counterparty risk management rules.

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Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott [redacted], or its Executive Director, John Gulliver [redacted], at your convenience.

Respectfully submitted,

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CO-CHAIR	PRESIDENT	CO-CHAIR