August 21, 2023

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

VIA ELECTRONIC PORTAL

Re.: File Number S7–32–10 – *Reopening of Comment Period for Position Reporting of Large Security-Based Swap Positions*

Dear Ms. Countryman:

The Committee on Capital Markets Regulation (the "Committee") offers these comments to the Securities and Exchange Commission (the "SEC") on the memorandum from the SEC's Division of Economic and Risk Analysis (the "DERA Memo"),[1] which seeks to supplement the SEC's economic analysis of its proposed rule on position reporting of security-based swaps (the "Proposal").[2]

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-seven 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.

On June 26, 2023, the SEC reopened the comment file for the Proposal to allow commenters to respond to the DERA Memo, which draws on newly available security-based swap data to estimate the number of market participants that would be required to report equity security-based swap positions under the Proposal.

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[1] Staff of Division of Economic and Risk Analysis, SEC, *Memorandum re: Supplemental data and analysis regarding the proposed reporting thresholds in the equity security-based swap market* (June 20, 2023), https://www.sec.gov/comments/s7-32-10/s73210-207819-419422.pdf [the "DERA Memo"].

[2] SECURITIES & EXCHANGE COMMISSION ["SEC"], *Reopening of Comment Period for Position Reporting of Large Security-Based Swap Positions*, 88 F.R. 41,338 (June 26, 2023) https://www.federalregister.gov/documents/2023/06/26/2023-13447/reopening-of-comment-period-for-position-reporting-of-large-security-based-swap-positions. SEC, *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*, 87 F.R. 6,652 (Feb. 4, 2022) https://www.federalregister.gov/documents/2022/02/04/2021-27531/prohibition-against-fraud-manipulation-or-deception-in-connection-with-security-based-swaps. [the "Proposal"].

Despite its assertion that these estimates constitute "supplemental analysis related to the economic effects" of the Proposal, the DERA Memo does not remedy any of the flaws in the Proposal's cost-benefit analysis. Instead, the DERA Memo only provides further confirmation that the Proposal will result in costs but provides no evidence of their extent. And because the DERA Memo does not evidence any of the Proposal's purported benefits – or indeed present any conclusions about the Proposal's economic effects – it does not support the conclusion that the Proposal will provide net benefits for U.S. investors, which should be an essential precondition for SEC rulemaking. The Committee therefore continues to urge the SEC to withdraw the Proposal.

Section I briefly summarizes the Proposal. Section II analyzes in greater detail whether the DERA Memo addresses any of the flaws in the Proposal's economic analysis and finds that it does not. Section III concludes.

I. Summary of the Proposal

The Proposal would require market participants to publicly disclose their positions in certain security-based swaps ("SBS"), including equity-based SBS, credit default swaps ("CDS"), and other debt-based SBS, that exceed specified size thresholds.

In the case of an equity-based SBS, the reporting threshold would be a gross notional position that exceeds either $300 million or 5% of any class of equity securities. The thresholds would combine a market participant's SBS positions with direct exposure the market participant has to the equity security underlying the SBS as well as exposure through any other derivative instruments. The thresholds would also consider a market participant's *gross* exposure by adding together rather than offsetting the market participant's long and short positions.

The SEC claimed that requiring public disclosure of large SBS positions would be beneficial for U.S. markets because it would allow dealers and other market participants to better manage their risk exposures by identifying counterparties that have concentrated economic exposure to individual companies through SBS and other instruments and make it more difficult for market participants with CDS positions to create manufactured credit events (where a holder of CDS seeks to cause the underlying issuer to default on its payment obligations).[3]

II. Analysis of the DERA Memo

The DERA Memo is presented as a supplement to the SEC's economic analysis of the Proposal. We therefore review in subsection 1 below the flaws in the SEC's economic analysis, specifically the cost-benefit analysis ("CBA"), before addressing in subsection 2 whether the DERA Memo addresses these flaws. We find that the DERA Memo provides nothing of value for the purpose of analyzing the economic effects of, or establishing a rational basis for, the Proposal. The DERA Memo thus fails to remedy any of the flaws in the SEC's CBA.

[3] Proposal at 6656-57.

1. Flaws in the Proposal's CBA

As explained in greater detail in the Committee's original comment letter, the Proposal's CBA failed to consider or quantify several significant costs of the Proposal and to substantiate or quantify any of its purported benefits.[4]

In the case of costs, the CBA failed to consider or quantify that the Proposal's additional disclosure requirements could reduce participation in SBS markets and the resulting reductions in liquidity, price efficiency, and fundamental research. It also failed to consider the costs of preventing investors from pursuing strategies that rely on keeping SBS positions confidential, including strategies pursued by activist investors and investors who use SBS to obtain uniquely valuable economic exposures to underlying issuers (e.g., long/short strategies). The CBA also failed to consider the extensive empirical evidence showing that disclosure requirements in derivatives markets create distorted incentives that make markets less efficient, such as one study that found that greater transparency about firms' derivatives activities induced firms to take excessively speculative positions in the derivatives market.[5]

In the case of benefits, the CBA presented the two main policy rationales advanced in favor of the Proposal generally – i.e., reducing manufactured credit events and improved risk management – as the principal economic benefits of the Proposal. However, the CBA failed to quantify or substantiate these purported benefits. It also failed to consider how these goals are already served by the newly introduced requirement for SBS dealers and major market participants to submit transaction data to SBS data repositories ("SBSDRs"), which data are disseminated to the public in anonymized form. As the Committee pointed out, SBSDR data will already 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. Furthermore, as other commenters noted, market pricing data does not show any significant risk of fraud or manipulation in the CDS market. [6] And market participants have already amended industry standard swap terms to prevent CDS payments attributable to manufactured credit events, thus removing the incentive for market participants to bring about such events.[7]

The CBA also failed to reasonably estimate the number of market participants that would be subject to a reporting obligation.[8] In particular, the Proposal based its estimate of the number of persons that would be subject to a reporting obligation with respect to equity-based SBS positions on Form N-PORT filings by registered investment funds. As the Proposal itself acknowledged,

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[4] Committee on Capital Markets Regulation, Comment Letter Re. File Number S7–32–10: Notice of Proposed Rule Making on the Position Reporting of Large Security-Based Swap Positions (Mar. 21, 2022), https://capmktsreg.org/wp-content/uploads/2022/03/CCMR-Comment-Letter-SEC-SBS-Proposal-03-21-22-2.pdf ["CCMR Comment Letter"].

[5] *Id*. at 9.

[6] *See, e.g.*, 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. S7-32-10 (Jul. 8, 2022), https://www.sec.gov/comments/s7-32-10/s73210-20133907-303833.pdf.

[7] 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-eventsupplement-to-the-2014-isda-credit-derivatives-definitions/.

[8] CCMR Comment Letter at 12-13.

however, such funds are limited by regulation in the extent to which they may invest in such SBS, such that the Proposal's economic analysis failed to accurately estimate the number of market participants that would be subject to a reporting obligation, which is a prerequisite for any meaningful quantification of the costs and benefits that could be expected to flow from the Proposal.

2. The DERA Memo Fails to Address the Flaws in the Proposal's CBA

The DERA Memo attempts to "supplement" the Proposal's economic analysis by presenting new estimates of the number of market participants that would incur a reporting obligation with respect to equity-based SBS. These estimates, however, fail to improve the economic analysis or CBA in any respect. First, the new estimates are, like those in the Proposal, based on flawed methodologies and thus continue to grossly underestimate the number of market participants that would be affected by the Proposal. Second, the DERA Memo does not present any new analysis or conclusions as to the quantifiable costs and benefits of the Proposal as it relates to equity-based SBS. Indeed, the memo does not even attempt to analyze the appropriateness of the Proposal's reporting thresholds in light of its own estimates. Third, the DERA Memo relates only to equity-based SBS and thus does not address any of the effects of the Proposal on CDS or other debt-linked SBS markets.

i) The DERA Memo's estimates are based on flawed methodologies.

The DERA Memo seeks to improve the Proposal's estimate of the number of market participants, including activist investors, that would be subject to a reporting obligation with respect to an equity-based SBS position by drawing on SBSDR data instead of the Form N-PORT filings that informed the equivalent estimate in the Proposal. However, basic shortcomings in the DERA Memo's methodologies mean that the estimates are unreliable indicators of the number of market participants that would actually be affected.

First, the DERA Memo uses a sample of only one year (November 1, 2021, through November 25, 2022) to estimate the number of market participants that would be affected by the Proposal in every future year. The significant volatility in the data presented should make it obvious that the number of market participants affected in one year is not a reliable indication of the number that would be affected in each year thereafter. For example, Figure 3B shows that the number of positions meeting one threshold (gross positions over $300 million) shrank by a factor of 3 between June and September. Figure 4B by contrast shows the number of positions meeting the other threshold (gross positions exceeding 5% of a referenced security's market capitalization) increased by a similar factor during the same period. Would similar trends be observed in future years? And more generally, how would changing economic conditions and other exogenous factors affect the number of positions meeting the thresholds in future years? These are questions that have a fundamental impact on the accuracy of the estimates but that the DERA Memo does not attempt to answer.

Second, the data on which the DERA Memo relies are, as the memo itself acknowledges, affected by "significant limitations" and "several data issues."[9] These limitations make inaccurate estimates

[9] DERA Memo at 12; 3 at note 10.

a certainty. For example, the sample swap data are drawn solely from the year *before* the CFTC made structural changes to correct reporting instructions that were resulting in a "significant number of existing swap data errors."[10] In other words, the DERA Memo's data likely contain errors, particularly the reporting of open positions that were in fact closed.

Furthermore, the memo's estimates "do not account for direct equity holdings"[11] even though direct equity holdings are considered under the Proposal's thresholds. The sample also omits positions held through multiple affiliated entities that are not in direct ownership chains, even though the Proposal's thresholds would aggregate such positions and the authors "are aware of many cases" of investors holding such positions.[12]

ii) The DERA Memo does not analyze any of the economic effects of the Proposal.

The DERA Memo does not present any evidence or analysis as to the many costs of the Proposal that the Committee and other commenters identified, and which are ignored in the original Proposal. For example, there is no consideration of whether the Proposal would cause the market participants identified to reduce their participation in the SBS markets, curtail their fundamental research activities, or adopt inefficient modifications to their investment strategies. Market participants may also be forced to forgo valuable investment strategies entirely due to the risk of copycatting that arises from being required to publicly disclose their positions. These costs are well documented in the relevant academic literature and the SEC has explicitly recognized them in other proposals.[13] And the DERA Memo presents no analysis or conclusion about the costs implied by the estimates it presents or the Proposal more generally or whether they are justifiable relative to the Proposal's purported benefits.

Furthermore, although most of the DERA Memo's discussion is devoted to those investors it deems to be "activist" investors, its estimates of the number of other market participants that would have a reporting obligation show that the Proposal would, *at a minimum*, require public disclosure of thousands of positions pursued by hundreds of additional market participants that are not activist investors. The Proposal would thereby undermine the economic viability of those positions and the investment strategies they support (e.g., long/short strategies). The DERA Memo thus in fact provides further evidence that the Proposal's costs will be far beyond those considered in the CBA. The DERA Memo, however, does not address this evidence.

Similarly, the DERA Memo presents no evidence or analysis substantiating the purported benefits of the Proposal. And though the DERA Memo relies on SBSDR data to perform its estimates, like the Proposal, it fails to consider how the availability of this data obviates the principal policy rationales advanced in favor of the Proposal. More specifically, SBSDR data already allows regulators and the market to identify elevated activity in certain security-based swaps that is

[10] CFTC Letter No. 22-06, at 2 (June 10, 2022), https://www.cftc.gov/csl/22-06/download.
[11] DERA Memo at 12, 14 ("The analysis . . . is subject to the same limitations we previously identified in our analysis of equity security-based swap positions associated with activist investors.").
[12] *Id*. at 12, 14.
[13] *See, e.g.*, SEC, *Short Position and Short Activity Reporting by Institutional Investment Managers*, 87 F.R. 14,950 at 14,952 (Mar. 16, 2022) (acknowledging that "requiring disclosure of short positions could facilitate copycat trading that, in turn, could limit the profit of an investor may earn using strategies developed in connection with its marketplace information gathering efforts").

informative as to whether there could be large positions in specific SBS, without threatening liquidity in the way public disclosure of a position holder's identity would. In fact, the ability of DERA to use the SBSDR data to generate its estimates underlines the questionable necessity of creating additional public disclosure requirements for SBS positions.

Indeed, the DERA Memo does not even attempt to analyze the implications of its estimates for the appropriateness of the Proposal's thresholds. Is the estimated number of market participants affected sufficient to realize the purported benefits? Will the Proposal's costs be greater or lesser than expected? Does it make sense for the Proposal to apply the same $300 million threshold to equity-based SBS as it does to CDS and other debt-linked SBS, despite these being three distinct asset classes? The DERA Memo does not attempt to address these questions.

iii) The DERA Memo does not address the effects of the Proposal on CDS or other debt-linked SBS markets.

Finally, because the DERA Memo relates only to equity-based SBS, it does not address any of the costs and benefits of the Proposal as they relate to CDS or other debt-linked SBS markets. For example, the DERA Memo does nothing to address the market pricing evidence, noted above, that fraud and manipulation in CDS markets is in fact quite rare and the evidence that even these rare events have been mitigated by industry efforts. Thus, even if the DERA Memo had addressed any of the flaws of the CBA as it relates to equity-linked SBS markets, it would still leave unaddressed the same flaws as they relate to these two other distinct asset classes.

III. Conclusion

For the reasons noted above the DERA Memo fails to address any of the flaws in the Proposal's CBA. And because it makes no changes to the Proposal, it fails to address any of the flaws in the Proposal itself. The Committee therefore continues to call on the SEC to withdraw the Proposal and repeats its recommendation that if the SEC nonetheless chooses to adopt the Proposal, the final rule increase the proposed disclosure thresholds and base the thresholds solely on net exposure, not gross exposure.

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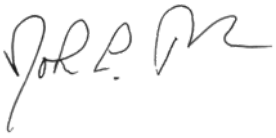
Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott (hscott@law.harvard.edu), or its Executive Director, John Gulliver (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,



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