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In A Trinity of Releases, the SEC Proposes To Make Hedging Transactions More Transparent

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If adopted, the proposals will likely impact market practices

In a trinity of proposing releases rolled out in less than three months, the SEC has comprehensively proposed to regulate the use of derivatives and short sales by private investors, including private funds, hedge funds and family offices. The proposed new regulations reflect a decision by the SEC to promote transparency as its cure for perceived misuse of derivatives. Market participants are concerned that increased transparency will enable those who might manipulate markets by letting them know the positions and strategies of market participants. Market participants also fear that the proposals will discourage market activity that promotes economic efficiency, including hedging.

Between last December and February, the SEC proposed:

- Adding new Rule 10B-1 under the Securities Exchange Act of 1934 (1934 Act) [1], which would require prompt disclosure and public dissemination of large security-based swap positions, including credit default swaps and total return swaps which exceed specified thresholds;
- Amending Rule 13d-3 under the 1934 Act[2] to significantly expand both the definition of "beneficial ownership" for purposes of reporting on Schedules 13D and 13G to include cash-settled derivatives for non-passive investors, and the definition of "group" whose holdings must be aggregated for purposes of the reporting thresholds; and
- Adding new Rule 13f-2 and amending Regulation SHO under the 1934 Act[3] to incorporate new requirements that: (a) investment managers report short sale information on a monthly basis if such activity exceeds certain thresholds and (b) broker dealers mark "buy to cover" trades under Regulation SHO in addition to marking trading activity as "long," "short" and "short exempt."

A handful of controversial and widely-reported events involving derivatives and short-selling over the last few years apparently prompted the SEC's proposals. One is significant volatility involving shares of GameStop and other securities – so-called "meme stocks" – which reportedly involved "short squeezes," short sales in excess of shares available to cover those sales[4]. Another is the collapse of Archegos Capital Management, a family office, which involved billions in swaps that ended up being bad bets, resulting in significant losses for market participants[5]. Finally, certain public companies and other market participants have expressed concern about the use of derivatives including cash-settled swaps, credit default swaps and manufactured credit events in contests for corporate control without, in their view, adequate or timely disclosure and warning to the market.

The SEC public comment periods on these proposals are short (as it has been for most recent proposals). Although the SEC has a challenging number of demands on its time, including multiple significant rule proposals currently pending, it is possible that one or two, or even all three, rule proposals regulating derivatives and short sales will be adopted before the end of this year.

The proposals are summarized in more detail below:

Proposed New Rule 10B-1: Disclosure of Large Security-Based Swaps Positions

The SEC has proposed that any person or "group" of persons with a security-based swap position that exceeds certain thresholds report such position no later than the day following execution on proposed Form 10B. The proposed thresholds are:

- A credit default swap that amounts to the lower of a short notional amount of $150 million, a long notional amount of $150 million or a gross notional amount of $300 million;
- Debt securities with a gross notional amount of $300 million underlying the swap position; and
- Equity securities if the lower of two alternative tests is met: (a) a gross notional amount of $300 million, but if the gross notional amount exceeds $150 million then the calculation also encompasses other equity securities of the same issuer held by the person as well as equity securities of the same class underlying derivatives, or (b) the swap position represents more than 5% of the outstanding equities, but if it represents more than 2.5% then the calculation includes the number of equity securities of the same issuer held by the person as well as derivative securities

based on the same class of equity securities.

The proposed report would be required to include the person's identity, the nature of the position and underlying and related loans and securities; and certain information from the report will be publicly disseminated.

The proposals also include a new anti-fraud rule applicable to swap transactions, as well as a rule that prohibits any officer, director, supervised person or employee of a security-based swap dealer or major security-based swap participant, or any person acting under such person's direction, to take any action to coerce, manipulate, mislead or "fraudulently influence" the chief compliance officer of the swap dealer or participant.

Our client alert on this proposal is available at the following link.

Proposed Expansion of Definitions of "Beneficial Ownership" and "Group" for 13D and 13G Reporting

The SEC's proposals would require cash-settled derivatives (other than security-based swaps) to be included in calculating beneficial ownership for non-passive investors. Under current rules, market participants may acquire long positions using cash-settled derivatives instead of physically-settled derivatives or purchasing the stock directly to avoid crossing the 5% beneficial ownership threshold for 13D/G filings, or the 10% threshold for Section 16 reporting and liability. Under the proposed rules, such cash-settled derivatives (other than security-based swaps) would be added to the beneficial ownership calculation. The SEC believes that its proposed rule requiring reporting of large security-based swap positions described above will be sufficient to ensure transparency of those positions.

The SEC has also proposed to expand the definition of a "group" whose members' holdings are required to be aggregated in determining whether the 5% or 10% beneficial ownership thresholds have been crossed. Among other things, the revised rule would reflect that a "group" may be formed without an agreement among the members of the group.

Proposed Shortening of Time Period to File Schedules 13D/G.

The SEC has also proposed to expedite filings of initial Schedules 13D and 13G as well as amendments. For example, a Schedule 13D would have to be filed within five calendar days rather than 10 calendar days, and an amendment would be required in one business day instead of "promptly" under current rules, which generally has been understood to mean two business days in the most urgent circumstances (e.g., a proxy contest) but a longer period in less urgent circumstances. For Schedule 13G filers filing under Rule 13d-1(c) (i.e., passive investors), the proposed amendments would also shorten the initial filing deadline from 10 days to five days. For all Schedule 13G filers, the proposed amendments would require that an amendment be filed five business days after the month in which a material change occurred rather than 45 days after the year in which any change occurred. The proposed amendments would accelerate the amendment obligations for certain Schedule 13G filers upon exceeding 10 percent beneficial ownership or a 5 percent increase or decrease in beneficial ownership of a covered class, requiring that qualified institutional investors and passive investors file an amendment within five days and one business day, respectively.

Proposed Monthly Disclosure of Short Sales

Under the proposal, investment managers that have investment discretion over accounts that exceed certain thresholds on short sale activity would have to comply with proposed Rule 13f-2 and new Form SHO to report short sale activity on a monthly basis. This information would be submitted confidentially to the SEC. The thresholds that trigger a monthly filing are as follows:

- For any "equity security" of an issuer registered pursuant to Section 12 of the 1934 Act or for which the issuer is under a reporting obligation under section 15(d) of the 1934 Act, where the investment manager's short sale activity meets or exceeds either (a) a gross short position in the equity security with a U.S. dollar value of $10 million at the close of any settlement date or (b) a monthly average gross short position as a percentage of shares outstanding in the equity security of 2.5% or more; or
- For any "equity security" of any other issuer where the investment manager's gross short sale position meets or exceeds a gross short position with a U.S. dollar value of $500,000 or more at the close of any settlement date.

“Equity security” includes securities convertible into equity securities but would not include short positions established through derivatives, and “gross short position” is calculated without regard to any offsetting long position.

The SEC further proposed to amend Regulation SHO to add Rule 205 requiring broker dealers to mark trades as “buy to cover” a short position in addition to the current order marking requirements. The SEC also proposed amendments to the consolidated audit trail plan created pursuant to the requirements of Rule 613 of the Exchange Act to provide additional data on purchases to cover short sales as well as assertion of Regulation SHO’s bona fide market making exceptions.

Our client alert on this proposal is available at the following link.

Considerations

While we expect these proposals to be revised prior to adoption, we do expect that the Commission will adopt new rules in due course. A majority of the Commission already supported issuance of the proposed rules on swaps and Section 13(d), and the Commission previously voted unanimously when proposing the rules on short sale disclosure. While we do expect that the Commission will delay the effectiveness of new rules following adoption to allow firms to make any necessary updates to their compliance systems, it is unclear at this point how lengthy a transition period the agency will offer, and firms might begin to consider the scope of any modifications.

Perhaps most important at this point, we expect that the Commission will be responsive to practical input on real world market impacts, and strongly recommend that market participants provide input through comment letters to the Commission either directly or through an appropriate trade association. The SEC has already received comment letters from many industry participants and their trade groups, which are publicly available on the agency's website so that it is possible to assess the level and scope of input on specific issues. In some cases additional comment letters supporting views that have been expressed by others, or responding to points raised by others, can be effective and helpful to the SEC. The comment period ended March 21st for the security-based swaps proposals, and April 11th for the 13(d) proposals. The SEC will consider comment letters submitted after the expiration of the comment period but before new rules are adopted, but we recommend submitting comments soon as the weight accorded to such letters diminishes over time as the SEC staff prepares comment summaries and briefs senior staff and Commissioners. The comment period ends on April 26th for the proposals on disclosure of short sales.

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[1] *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*, Exchange Act Rel. No 93784 (Dec. 15, 2021).

[2] *Modernization of Beneficial Ownership Reporting*, Securities Act Rel. No 11030, Exchange Act Rel. No 94211 (Feb. 10, 2022).

[3] *Short Position and Short Activity Reporting by Institutional Investment Managers*, Exchange Act Rel. No 94313 (Feb. 25, 2022).

[4] See, e.g., *'Short squeeze' spreads as day traders hunt next GameStop*, Financial Times (Jan. 27, 2021); *Are "meme stocks" harmless fun, or a threat to the financial old guard?*, Economist (July 6, 2021).

[5] See, e.g., Gensler, Gary, SEC Chair, *Statement on Exchange Act 10B and Rule 9j-1* (Dec. 15, 2021) ("In March, 13 years after the collapse of AIG, when Archegos Capital Management collapsed, we saw once again the risks that might arise from the use of another security-based swap – total return swaps. At the core of that story was Archegos' use of total return swaps based on underlying stocks, as well as significant exposure that the prime brokers had to the family office.")

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