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On June 24, 2019, the U.S. Securities and Exchange Commission, the U.S. Commodity Futures Trading Commission, and the U.K.'s Financial Conduct Authority issued a joint statement regarding the practice of "various opportunistic strategies in the credit derivatives markets, including but not limited to those that have been referred to as 'manufactured credit events.'" This extremely rare joint statement by the three regulators indicates close scrutiny of any apparently self-serving actions that market participants might take with respect to derivatives positions. No definitive case has yet been brought, jointly or independently, by the regulators in this area, suggesting they may be seeking the right set of facts upon which to take precedential action.

The regulators did not explicitly define in the joint statement what "various opportunistic strategies" means or what constitutes a "manufactured credit event," but the vagueness of their characterization suggests a broad interpretation. Market participants should expect increased scrutiny with respect to any "manufactured" event designed to favorably impact their credit derivatives positions.

This article describes the increased regulatory attention recently brought to this area, provides examples of the types of "manufactured" credit events that likely led to the joint statement, and concludes by outlining the relevant SEC, CFTC, and FCA law under which the regulators could potentially bring an action.

Heightened Regulatory Scrutiny

In the June 24, 2019 joint statement, the regulators noted that opportunistic strategies taken with a derivatives position raise "various issues under securities, derivatives, conduct and antifraud laws, as well as public policy concerns." The regulators stated that they intend to act collaboratively to explore avenues, including industry input, to address these concerns and "foster transparency, accountability, integrity, good conduct and investor protection." In a Sept. 19, 2019 update to the joint statement, the regulators noted, among other things, that the International Swaps and Derivatives Association had recently released a proposed protocol designed to address certain issues related to narrowly tailored credit events.

The June 24, 2019, and Sept. 19, 2019, statements follow a little more than a year after the CFTC noted that manufactured credit events "may constitute market manipulation and may severely damage the integrity of the [Credit Default Swap] markets," stating that the "CDS market functions based on the premise that firms referenced in CDS contracts seek to avoid defaults, and as a result, the instruments are priced based on the financial health of the reference entity."

Events Leading to the Joint Statements

Hovnanian

The joint statement and subsequent update follow a number of controversial instances in the credit derivatives markets which brought to the fore the concerns articulated by the regulators. For example, in 2017, a major hedge fund acquired approximately $333 million worth of credit derivatives on Hovnanian Enterprises Inc., a New Jersey-based construction company. The hedge fund then offered Hovnanian cheap financing on the condition that Hovnanian default on a small portion of its debt, which would trigger payments on the hedge fund's derivatives positions. Under pressure from regulators and the hedge fund's derivatives counterparties, the hedge fund eventually backed away from the plan.

Sears

Another instance of conduct in connection with credit derivatives positions that could trigger regulatory scrutiny arose in connection with the bankruptcy of Sears Holding Corp. In Oct. 2018, Sears owned certain notes that effectively allowed it to set the price of credit default swap contracts on Sears. Sears's bankruptcy estate auctioned off these notes, and the

winner was a hedge fund that is widely believed to have sold considerable CDS protection on Sears debt, which paid $82.5 million for the notes on the condition that Sears not sell any more of the notes.

At least one market participant objected to the note sale in court. The objecting market participant argued that it was not a fair and open auction and that Sears improperly provided the hedge fund with a more favorable deal than would have occurred in a fair auction by selling the hedge fund more notes than were supposed to be auctioned and agreeing not to sell any more. The hedge fund eventually settled with its swap counterparties who would have otherwise profited significantly on their CDS positions.

McClatchy

A third instance that has drawn public scrutiny involved McClatchy Co., a distressed newspaper publisher with substantial debts held by a large hedge fund that had also been selling CDS contracts insuring that debt. In April 2018, McClatchy announced a refinancing sponsored by the hedge fund in which the hedge fund would provide McClatchy with $418.5 million in new secured term loans on the condition that the new financing was incurred at a new entity, and the proceeds of the new term loans would be used to repurchase bonds held by the hedge fund. With the bonds held by the hedge fund paid down and the new debt incurred through the financing held through another entity, the hedge fund would be able to avoid paying out on CDS contracts tied to the bonds that McClatchy paid down. Following this refinancing, McClatchy entered into a new financing deal with certain other hedge funds that had bet against it, an action which would keep some of the original bonds around, in turn retaining some of the value of the CDS positions that the hedge fund sought to eliminate.

Potential Liability

Regulators are likely to scrutinize more egregious fact patterns of manufactured credit events that lend themselves to a manipulation or market abuse charge. Any such action could permit them to follow their public statements of warning with concrete enforcement actions, which they would expect to provide additional deterrence. Depending on the structure, parties, and/or products at issue, the CFTC, SEC, and/or FCA regulatory frameworks may apply. Below is a brief overview of the various authorities that may apply to a manufactured credit event involving a derivative or security-based derivative.

CFTC

The core elements of manipulation under the federal commodities laws under the test arising from the long-standing provision in the law are the ability to influence market prices, the intent to do so, and achieving that purpose by causing artificially high or low prices. Absent one or more of these elements, a market manipulation may not occur. However, Sections 6(c) and 9(b) of the Commodity Exchange Act prohibit manipulative attempts as well as successes under the traditional test. The two elements required to establish attempted manipulation under the traditional test are an intent to create an artificial price, and an overt act in furtherance of that intent. See, e.g., *CFTC v. Bradley*, 408 F. Supp. 2d 1214, 1220 (N.D. Okla. 2005). It is not necessary that there be an actual effect on price in an attempted violation.

Moreover, the Dodd-Frank Wall Street Reform and Consumer Protection Act granted the CFTC new, broader anti-manipulation authority. Pursuant to this authority, the CFTC adopted Rule 180.1 under the CEA, which parallels Rule 10b-5 under the Exchange Act, prohibiting any person from directly or indirectly "in connection with any swap, or contract of sale of any commodity, to "engage, or attempt to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person."

The CFTC also adopted Rule 180.2, which addresses non-fraud-based manipulation, prohibiting any person from, directly or indirectly, manipulating the price of any swap or commodity on or subject to the rules of any registered entity. These new provisions are essentially untested, but the CFTC is likely to argue that it is not necessary for the CFTC to find that an artificial price was created under the test for actual (rather than attempted) market manipulation.

SEC

The core of manipulation under the federal securities laws is proof that one has engaged in artificial transactions for the express purpose of changing the market price of a security. The anti-manipulation prohibitions are designed to preclude artificial interferences with the market process. See, e.g., *SEC v. First Jersey Securities*, 101 F.3d 1450, 1466 (2d Cir. 1996), cert. denied, 522 U.S. 812 (1997). The fact that the alleged manipulator believes a security is undervalued or overvalued and is merely trying to correct market inaccuracies neither excuses nor serves as a defense to manipulative activity. See,

e.g., *U.S. v. Hall*, 48 F. Supp. 2d 386 (S.D.N.Y. 1999). Regulators need only establish that a manipulator engaged in conduct calculated to artificially affect a security's price.

The primary mechanism under the securities laws to enforce manipulation is Section 10(b) of the Securities Exchange Act of 1934, which prohibits the use "in connection with the purchase or sale of any security" of "any manipulative or deceptive device." Under the authority granted by Section 10(b), the SEC promulgated Rule 10b-5, which provides "[i]t shall be unlawful for any person" to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

To state a claim for manipulation under Rule 10b-5, a plaintiff must allege all of the following: manipulative acts, damage, caused by reliance on an assumption of an efficient market free of manipulation, scienter, in connection with the purchase or sale of securities, furthered by the defendant's use of the mails or any facility of a national securities exchange. See, e.g., *Wilson v. Merrill Lynch & Co.*, 671 F.3d 120 (2d Cir. 2011).

FCA

FCA chief executive Andrew Bailey said in a Bloomberg interview in July 2018 that the FCA believes manufactured credit events are on "the wrong side of the line" and go against the intended purpose of CDS contracts. In the FCA's Dec. 2018 newsletter Market Watch, the FCA stated:

> Manufactured credit events may in certain circumstances constitute market abuse by the involved parties—both the CDS counterparty and the firm referenced in the CDS. We have been speaking with firms, the International Swaps and Derivatives Association (ISDA) and other regulators about this. We support the work undertaken by the industry and ISDA to address behaviour which undermines the functioning of CDS and the integrity of our financial markets, and we look forward to swift and effective action to avoid the spread of this unwanted activity into our markets. We will investigate and assess any suspected market abuse we find, and take any appropriate action.

The principal tool for any regulatory action would be the U.K.'s rules on market abuse. They are set out in the European Union's Market Abuse Regulation, which, as an EU regulation, is directly applicable in the U.K. and across the EU. MAR will be transposed into U.K. domestic law following Brexit.

MAR prohibits market manipulation with respect to financial instruments that either: are admitted to trading (or in the process of being admitted to trading), or otherwise traded, on an EU trading venue (i.e., EU listed); or have a price or value dependent on, or affected by, the price or value of another financial instrument as described in the former. This would include any debt or equity of a CDS reference entity that is admitted to trading on an EU trading venue, and would also include any CDS contracts affected by the value of such debt or equity (e.g., CDS on a reference entity whose debt is traded on EU venues would be in scope of the MAR prohibition, even if the CDS contract is traded over the counter).

Market manipulation under those standards includes entering into a transaction, placing an order to trade, or any other behavior which employs "a fictitious device or any other form of deception or contrivance." It is possible that a regulator may choose to interpret this particularly broad provision to include a market participant's or reference entity's involvement in the restructuring of the reference entity's debt to trigger a credit event, or to affect the payout of a CDS contract.

This could be the case where, for example, a debt restructuring is designed to result in a credit event that could otherwise have been avoided, and so paints a misleading picture of the reference entity's financial health to the market, and thereby could affect the price of a reference entity's bonds or shares. Market manipulation could also be viewed to arise with respect to the CDS contracts on that reference entity, as a perceived deterioration in the financial health of the reference entity could drive up the cost of buying protection.

As MAR is applicable across the EU, it seems likely that other EU national regulators would also be alert to potentially addressing these types of practices, particularly if the FCA were to take any action in this area.

Conclusion

In light of the joint statement and subsequent update, market participants are at serious risk if they take actions with the specific intent of manipulating or triggering a credit derivatives position. Even where a market participant does not specifically intend to influence a credit derivatives position it holds, it should carefully consider actions that might nonetheless favorably impact its credit derivatives positions, or risk potential extended regulatory scrutiny.