JONES DAY

COMMENTARY

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CFTC Scrutiny of Opportunistic CDS Strategies Extends Beyond Manufactured Credit Events

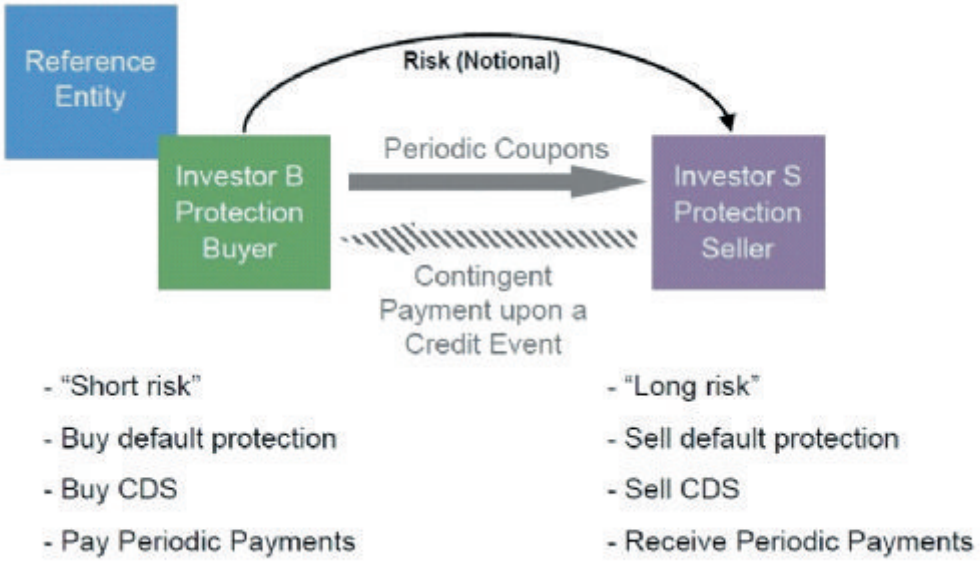
IN SHORT

The Situation: Following its recent joint statement on opportunistic strategies in the credit derivatives market with the U.S Securities and Exchange Commission ("SEC"), the United Kingdom's Financial Conduct Authority ("FCA"), and the U.S. Commodity Futures Trading Commission ("CFTC") published a podcast providing greater detail and insight into the strategies it regards as problematic.

The Developments: During the past two and half years, the CFTC has observed a total of 14 instances where opportunistic strategies have been employed in the credit default swap ("CDS") marketplace, raising regulatory and legal compliance, market conduct, anti-fraud, and broader public policy concerns. CFTC staff have undertaken an analysis that has identified multiple ways buyers and sellers of protection sought to artificially influence a CDS contract's value to their benefit.

Looking Ahead: Participants in the credit default swaps market and restructuring practitioners should be alert to those situations identified by the CFTC. Participants in the credit default swaps market should be prepared for document requests and other outreach by regulatory authorities and take steps to ensure that their trading strategies have not and do not run afoul of the situations described below.

A CDS is a credit derivative in which two counterparties agree to exchange a regular, fixed coupon for a one-off payment contingent on the occurrence of a credit event of a specified reference entity or obligation. The buyer of protection pays a premium to the seller of protection in order to receive protection against a credit event. As such, the trade comprises a premium leg (the fixed-coupon stream) and a protection leg (the one-off, contingent payment).



In the United States, the SEC regulates CDS on single names, loans, and narrow-based security indexes, and the CFTC regulates CDS based on broad-based security indexes. Because

of the interconnectedness of the narrow-based and broad-based CDS markets, close coordination between the staffs of the SEC and CFTC can be expected, particularly in enforcement investigations.

On June 24, 2019, SEC Chairman Jay Clayton, CFTC Chairman J. Christopher Giancarlo, and FCA Chief Executive Andrew Bailey issued a joint statement regarding the credit derivatives markets. In that statement, they announced that their respective agencies would make collaborative efforts to halt the continued pursuit of various opportunistic strategies in the credit derivatives markets, including manufactured credit events. According to the agency heads, opportunistic strategies raise various issues under securities, derivatives, conduct, and antifraud laws, as well as public policy concerns.

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The recent joint statement follows another statement issued a little over a year ago, on April 24, 2018, by the CFTC's Divisions of Clearing and Risk, Market Oversight, and Swap Dealer and Intermediary Oversight manufactured credit events in connection with CDS. That statement noted that manufactured credit events may constitute market manipulation and may severely damage the integrity of the CDS markets, including markets for CDS index products, and the financial industry's use of CDS valuations to assess the health of CDS reference entities.

Since the CFTC made that statement, the CDS industry has taken steps to curb manufactured credit events, culminating in the July 15 publication of the 2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions. While promising, the amendments themselves are fairly "narrow" as they address only a few specific strategies.

In a podcast released on July 10, 2019, CFTC staff detailed several additional opportunistic strategies deemed problematic. According to CFTC staff, the most straightforward of these strategies is where a default is induced or default timing is altered. In this situation, a protection buyer may attempt to establish an agreement with the reference entity that includes a requirement that a default is artificially made in the reference obligation. Alternatively, a protection seller might establish a private financial agreement designed to prevent the default by the reference entity until after the maturity date of CDS contracts they have sold.

Another strategy identified by staff involved actions undertaken to alter the amount of reference obligations at a particular reference entity. For instance, according to the staff, a protection buyer may seek to either add new debt to the reference entity as part of a private financial agreement, or to artificially increase the amount of debt in a reference entity. This increases the default risk of the reference entity, driving up the cost of credit protection on that reference entity. Buyers can profit on such strategy even if no default occurs by unwinding their original trade at the increased price. Similarly, protection sellers can profit from a strategy known as "orphaning" by coordinating with the reference entity for the repayment of its debt, typically through a loan made to an affiliate of the reference entity, solely to reduce or remove the sellers' risk obligations. If there are no further reference obligations related to the CDS, sellers can continue to collect premiums without the risk of the reference entity defaulting.

CFTC staff also observed that, after credit events have occurred, protection buyers or sellers will take steps to increase the value of their positions by affecting the cost of reference obligations that would be deliverable into the CDS auction process. Buyers could employ a strategy to lower the bond valuation at auction that occurs after a default, while sellers could engage in a classic corner or squeeze in the bond market to prevent deliverable obligations from being delivered into an auction.

Finally, CFTC staff identified instances combining aspects of the above examples to magnify the benefit to both buyers and sellers of protection. A protection buyer, for instance, may enter into a private financial arrangement with a reference entity that includes the default requirement, but also work with the reference entity to issue bonds that trade at subpar values. This particular strategy ensures that protection buyers will receive a payout from their CDS contracts while also increasing the supply of deliverable obligations into the CDS bond auction, lowering the recovery rate and increasing the guaranteed CDS payout.

Meanwhile, sellers may engage in a private financial arrangement with a reference entity that is designed to move a default beyond the CDS contract maturity date and also decide to purchase protection that covers the time period into which the default has been pushed. This would allow the seller to continue collecting premiums on contracts that are unlikely to pay out while simultaneously allowing them to receive a payout when the reference entity eventually defaults in the future.

FIVE KEY TAKEAWAYS

1. CDS market participants can expect further action—either in the form of rulemakings, statements, or enforcement proceedings—by regulators going forward.
2. CFTC manipulation authority is broad, particularly under new CFTC Rule 180.1, the CFTC is putting the marketplace on notice that opportunistic CDS strategies may result in CFTC action, including an enforcement action.
3. Participants in debt restructurings must pay close attention to the problematic scenarios outlined by the CFTC. What may seem like a strategy to keep a company alive may be viewed by CFTC staff as a problematic, opportunistic CDS strategy.
4. Many of the strategies outlined as problematic to the CFTC are illustrative of what the CFTC staff views as manipulative conduct outside the CDS marketplace. While courts may ultimately disagree with these views, derivative market participants will be well served to understand the staff's view, as enforcement investigation and proceedings are exceedingly costly and time-consuming.
5. Market participants should review their policies and procedures to ensure that the problematic strategies listed above are explicitly highlighted as conduct the CFTC staff views as problematic, and appropriate safeguards should be taken if any strategy is being employed that could potentially be viewed unfavorably or as opportunistic.

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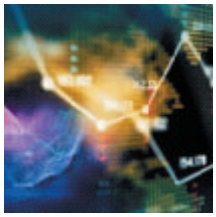

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