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Derivatives 2020

A practical cross-border insight into derivatives

First Edition

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Derivatives and Incentives for Opportunistic or Manipulative Behaviour: Related Issues and Responses

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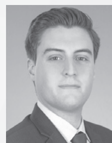

Matthew Howes

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Introduction

Over the past two decades, the market for derivatives products has expanded dramatically in both volume and scope. No longer limited to plain-vanilla swaps, options and futures, derivatives now enable parties to take long or short positions in or transfer exposures to a wide range of underlying assets. The ease of taking such positions synthetically via a derivatives contract instead of outright ownership of the asset has created incentives unanticipated by investors in the cash markets for the underlying assets, regulators or often even other derivatives market participants.

This article examines certain ways in which these unanticipated effects of derivatives on debt and equity holders' investment decisions can have a significant impact upon debt and equity markets, and some of the regulatory and market responses developed to address and potentially limit what some have perceived as manipulative activity or vulnerabilities in the derivatives markets.

Debt Market/Credit Default Swaps

In the ordinary course, a credit default swap ("CDS") on a specified debtor, or reference entity, is intended to provide credit protection against the risk of its default. Upon the occurrence of certain trigger events,[1] one party (the protection buyer) receives a payment corresponding to hypothetical losses that would be suffered by a holder of such reference entity's debt obligations.[2] In this way, a protection buyer is short (and a protection seller is long) the credit of the reference entity.

A buyer of CDS protection may hold a short position that is larger than its underlying long bond position (if any), in which case such a buyer (known as a "net short creditor") may be incentivised to prefer that the reference entity default so that it can collect payment on its CDS short position.

In recent years, certain instances of investor behaviour and flipped incentives motivated by CDS holdings have highlighted some limitations of, and to some extent have called into question the integrity and credibility of, CDS as a risk management tool.

Narrowly tailored/manufactured credit events

One example has been the strategic use of so-called "narrowly tailored credit events" (also referred to as "manufactured credit events") in which a debtor receives refinancing assistance from a CDS protection buyer while also triggering a default on the debtor's debt. Such default enables the CDS protection buyer to receive a payout under the CDS. Meanwhile, the debtor may be indifferent to the outcome under its CDS, but its need for the refinancing support may outweigh its interest in avoiding a technical default under some of its debt. In some cases, such defaults have been structured to take advantage of different thresholds in the CDS (where the payment requirement, or threshold, to trigger a failure to pay credit event is often set at a low amount) and the debtor's other debt agreements (where cross-default triggers may be set at substantially higher levels). It is therefore possible for a CDS buyer and a debtor to trigger a CDS payout while avoiding more significant impact to the debtor's other debt.

Because this type of strategic or engineered default has, in some cases,[3] been triggered by debtors that are not necessarily unable to make debt payments (and therefore might not have defaulted in the absence of a side agreement with a protection buyer), protection sellers and other observers have complained that such an outcome would frustrate the intent of the CDS and/or constitute manipulation or bad faith.[4]

Manufactured non-defaults

Another variation are strategies intended to prevent a debtor's default or credit event, or to delay it until after the expiration of a CDS or until a time that is otherwise more favourable to a CDS protection seller. A hedge fund that has taken a large position as a protection seller under CDS could be incentivised to assist the relevant debtor in refinancing its debt (which would make its default, and hence the protection seller's payout under CDS, less likely). For example, in 2014–15, RadioShack Corporation was able to stay in business and delay its eventual default due to additional financing that was reportedly arranged by parties that had sold credit protection on CDS referencing RadioShack debt.[5]

Other strategies involving CDS positions

Since protection sellers and protection buyers may have significant amounts at stake under CDS positions, yet are not prohibited from participating in a debtor's refinancing efforts, there may be inherent incentives to provide (or refrain from providing) an injection of capital or other financial assistance in order to influence the likelihood of a CDS credit event and payout thereunder. Such incentives have led parties to attempt several variations of strategies involving CDS (in some cases combining multiple approaches, or different approaches at different stages)[6] – some typical strategies observed include the following:

- Modifications to the terms of outstanding debt that would affect potential recoveries and hence CDS payments in case of a credit event (*e.g.*, modifications to expand the scope of which debt obligations qualify as "deliverable obligations").[7]

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- "Short squeeze"-type manipulations to restrict liquidity of deliverable obligations (which would impact CDS payouts due to the mechanics of the auction procedure for post-default valuation).[8]
- "Orphaned CDS": a debtor reference entity could arrange for its debts to be moved to an affiliate (without triggering a CDS succession event), such that the CDS would remain tied to the original reference entity, now holding no or few deliverable obligations, and potentially reducing the likelihood or amount of a payout to the protection buyer.[9]
- Delayed Exercise: opportunistic timing of a decision to trigger a debtor default when market conditions turn in a protection buyer's favour.
- Strategic use of ambiguities in bankruptcy triggers: because different investors may be using CDS with slightly different bankruptcy trigger definitions, proposed restructurings or other events may impact them differently, which could affect or cause a deadlock in negotiations.[10]

Equity Market/Total Return Swaps

Turning to the equity markets, an "equity payer" in a total return swap ("TRS") on equity shares pays its counterparty, the "equity receiver", the return on the shares. If the value of the shares has gone up, the equity payer will pay the equity receiver the difference between the initial market value and the market value at termination, multiplied by the notional amount. If the value has gone down, the equity receiver will pay such difference to the equity receiver.[11] In this way, the payer and receiver have replicated a position in a stock equivalent to that of a seller and a buyer without either party necessarily owning the underlying shares.[12]

One would generally expect a short party to believe the stock is overvalued and a long party to believe the stock has room to grow. However, as with the credit markets, parties to a TRS may not always be aligned with their assumed incentives. For example, a holder of a long position in the underlying equity may have a larger short position via a TRS, making the investor net short and incentivised to prefer a decline in the stock price due to its larger short TRS position.[13] As with the debt markets, such unanticipated (and sometimes invisible) alteration of incentives can have significant effects on interactions among companies, their investors and financing providers.

Empty votes[14]

An example of the effect of TRS on investors' incentives is the so-called "empty voting" scenario, in which a holder of shares – perhaps even with a significant long stake – also holds a short position via TRS in a notional amount at least as large as its long position. Such a holder would have voting rights on its long shares, but would be either economically indifferent to the outcome of the vote (if it has a net zero position), or even incentivised to take a position adverse to the company (if it is net short).

Mylan Laboratories' attempted a merger with King Pharmaceuticals illustrates how hedged shareholders' incentives can affect their behaviour. Mylan agreed to merge with King in a stock-for-stock transaction, causing Mylan's share value to drop and King's share value to rise. An activist hedge fund owned a large stake in King and stood to benefit greatly if the merger was approved by shareholders. Mylan shareholders, however, were reluctant to approve the deal. In an effort to get the transaction approved, the hedge fund purchased a nearly 10% stake in Mylan (but also hedged its economic exposure to Mylan via TRS, while retaining the vote on that stake).

Due to its long position in King and its larger, hedged, long position in Mylan, the hedge fund had the exact opposite motivation one would expect from a long holder of Mylan shares. Unlike other Mylan shareholders, the fund stood to benefit if Mylan shareholders approved the merger – even if Mylan overpaid. Despite its interests not being aligned with (and in fact being directly opposite to) those of Mylan and its other shareholders, the fund was the largest shareholder voting on the transaction for Mylan.

Hidden votes

Consider also the reverse of the above scenario: an investor gaining economic exposure while not having the voting rights associated with the shares. Here, an investor enters into a TRS as the equity receiver but may hold no direct position in the underlying shares. Thus, if the stock value goes up, the equity receiver stands to benefit, similar to a long holder of the shares. However, since such equity receiver does not have the power to vote or dispose of the shares, a disclosure obligation does not arise under Section 13 ("Section 13") of the Securities Exchange Act of 1934 ("Exchange Act").[15]

The high-profile proxy battle over CSX Corporation that was launched by two hedge funds illustrates this scenario.[16] Combined, the hedge funds were economically long over 15% of the outstanding shares of CSX Corporation. Mostly, however, this exposure was held via TRS. As such, the hedge funds took the view that they did not beneficially own those shares for the purposes of Section 13 and did not file a Schedule 13D.[17]

Following protracted litigation, neither the Southern District of New York court, nor the Second Circuit reached the pivotal question of whether being long shares via a TRS confers beneficial ownership under Exchange Act Rule 13d-3(a).[18] Still, the case raised significant potential issues for banks and market intermediaries that enter into TRS; in particular, the possibility of banks that facilitate the assembly of hedge funds' positions through TRS being deemed to form a group with such hedge funds and thereby becoming subject to Section 13 disclosure requirements, or more significantly, becoming subject to insider status under Section 16 of the Exchange Act ("Section 16").[19] Because neither the Securities and Exchange Commission nor subsequent litigation has fully clarified the matter, banks and other financial intermediaries remain subject to such characterisation risks and have generally sought to mitigate the risk by obtaining certain representations and warranties from their hedge fund counterparties, as described in the following section.

Market and Industry Responses

Regulators have expressed concerns about potential manipulation or market distortions in connection with these strategies.[20] Partly in response to the regulatory attention and related controversy and criticism among market participants, the International Swaps and Derivatives Association, Inc. ("ISDA") recently implemented certain amendments to its Credit Derivatives Definitions. In addition, debtors and creditors have tried to disincentivise or otherwise thwart such behaviour, including by making certain modifications to credit agreements or bond indentures. Similarly, banks and market intermediaries have sought to police activist hedge funds' use of TRS via contractual representations and covenants.

ISDA amendments to credit derivatives definitions

In the summer of 2019, ISDA published amendments to its standard Credit Derivatives Definitions intended to address

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concerns regarding narrowly tailored credit events and associated manipulative behaviour.[21] Such amendments effect two changes for in-scope trades (those for which the amendments have been made applicable, either by way of ISDA's published supplement incorporated into new trades, or by adherence to a protocol for legacy trades):

- *Credit deterioration requirement*: the Failure to Pay credit event has been modified such that it will not be triggered if the failure to pay "does not directly or indirectly either result from, or result in, a deterioration in the creditworthiness or financial condition of the Reference Entity".[22]
- *Modification to definition of "outstanding principal balance"*: such definition has been modified to take into consideration any discount from par value at which debt is issued by a reference entity, in order to prevent a windfall to a protection buyer if settlement amounts were to be determined looking only at par value.

Other market responses – underlying debt transactions/ credit default swaps

Additional protective strategies observed or proposed in the market to date on leveraged finance credit facilities and high yield bond offerings include the following:[23]

- *Net short representations and notification covenants*: Lenders or bond investors would be required to make representations that they do not hold a "net short" position (*i.e.*, short exposure exceeding long exposure, taking into account synthetic positions), and/or covenants to cooperate and provide evidence upon request to confirm such representations (which could be paired with disenfranchisement if not provided to the debtor's satisfaction) or to notify of any change in status.
- *Prohibitions or loss of voting rights (net short creditor disenfranchisement)*: Lenders or bondholders that are determined to hold net short positions could also lose their votes on amendments, waivers, defaults and/or the exercise of remedies, and/or have their votes deemed to be cast in proportion to those cast by the other creditors.[24] A related consideration would be whether to treat any such excluded votes as abstentions or to remove them from both the numerator and denominator in counting votes, or whether to exclude certain creditors due to their market-making activities.
- *Forced assignment ("yank-a-bank")*: Credit facilities or bond indentures could also include provisions requiring a net short lender or bondholder to assign its position to another lender or investor (and possibly a designated set of transferees, or other punitive features such as an unfavourable redemption price or loss of accrued interest or make-whole payments).
- *Prepayment*: Certain borrowers or issuers could also reserve the right to redeem or repay a net short lender or bondholder's loan or bonds on a non-*pro rata* basis to remove it from the creditor group (however, such an arrangement may be controversial as it could be viewed as rewarding the net short investor at the expense of remaining creditors and depleting the debtor's assets).
- *Time limits* on creditors' rights to trigger defaults could be imposed in order to prevent or discourage a creditor from an opportunistically timed exercise of such powers[25] (or, alternatively, language could be included to provide for any applicable grace periods to be stayed or permitted to be stayed by a court pending litigation over whether a default has occurred).
- *Increase in creditor threshold*: Debtors and traditional long creditors could seek to increase the minimum position or threshold that a creditor must hold in order to cause a default to be triggered, which could make it more difficult or costly for activist investors to acquire a long position in order to trigger a default. In seeking to implement such protective measures effectively, debtors and creditors will need to consider various factors, including the way in which a "net short position" is defined and the various constituent positions are valued and aggregated/netted, what types of hedges or short positions to include, how and whether to take into consideration holdings of creditor affiliates (for example, whether to exclude affiliates screened by an ethical wall or that are not considered to be "acting in concert") or broader market hedges.

Other market responses – equities/total return swaps

Similarly, banks and market intermediaries have introduced or proposed certain contractual provisions in their TRS documentation when facing hedge funds or other potential activist investors (some of which can be expected to be agreed to regularly, while others may be subject to significant negotiation):

- *Hedging*: Virtually all TRS contracts will include language that affirmatively states the market intermediary may hedge, but is not obligated to hedge, its exposure to the underlying shares. This is intended to make clear that the TRS does not require any market activity at all by the market intermediary. To the extent hedging does occur, it is done at the discretion of the market intermediary as opposed to at the direction of the counterparty.
- *Voting*: The equity receiver is given no voting rights in the underlying shares. Bank policies have varied on how to vote shares that are held to hedge the bank's position under the TRS. Although not contractually obligated under the TRS to vote in a certain manner, some banks will abstain entirely, some will vote in their discretion and others attempt to vote proportionately along with other shareholders.
- *Settlement*: Many TRS will specify cash settlement as the exclusive settlement option. If physical settlement were available (allowing an equity receiver to elect to receive the underlying shares at maturity) an argument could be advanced that the equity receiver had the option to receive the stock and therefore should be considered the beneficial owner under Section 13.[26] Conversely, some banks have required swaps with activists to be structured as a put/call combo, which would be economically identical to a TRS, but structured as a purchased call option and a sold put option; an American call option provides the holder with the right to acquire the underlying shares, thus the option buyer would no longer be able to argue that ownership of a stake over 5% does not need to be disclosed.
- *Pricing*: If a TRS were set up to unwind at the same price (*e.g.*, at a "market on close" order) at which the short party unwinds its hedge, the long party's TRS position could be recharacterised as owning the shares outright. As such, banks often try to retain some level of pricing basis risk. For example, the unwind price might be based on a volume weighted average price.
- *Ownership limitations*: Banks have often tried to limit the amount of aggregate exposure their counterparties can have. Often this has been as high as 9.9% of market capitalisation value. But importantly, such a cap will often include synthetic long exposure as well as physical ownership of the shares, which allows the banks a certain degree of comfort that even were one to argue a Section 13 group was formed, it would at least not exceed the insider threshold of 10% under Section 16.

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Conclusion

The foregoing responses are not an exhaustive list. The viability of such approaches, effectiveness in curbing opportunistic behaviour and acceptability to issuers and other creditors or shareholders are all subject to further consideration and evaluation and will continue to evolve in tandem with and in response to activist investor strategies. Market participants should also take into consideration the potential impact of such restrictions on the liquidity of relevant CDS or TRS and/or underlying debt and equity securities.

In addition, it should be noted that, despite such responses, there remain several areas in which the markets remain vulnerable to opportunistic behaviour.[27] As noted above, the CFTC, the SEC and the U.K. FCA have all expressed concerns regarding strategies such as those described in this article;[28] ISDA also commented that the Dodd-Frank Act in the U.S. and the European Market Infrastructure Regulation in the E.U. require transparency over the trades and positions held by market participants.[29] The extent to which ISDA and/or the banks and other market participants will make further efforts to address the other remaining issues discussed herein, or if continued opportunistic behaviour could result in additional regulatory action (and, possibly, litigation) in the future, remains to be seen.

Endnotes

1. For CDS on reference entities in the North American corporate and financial sectors, applicable trigger events typically include bankruptcy or failure to pay on specified obligations.
2. Pursuant to rules set forth in the ISDA Credit Derivatives Definitions, if an ISDA Determinations Committee determines that a specified credit event has occurred and certain other applicable conditions are satisfied, the protection seller would owe the protection buyer an amount calculated based upon the decline in value of the reference entity debt following the default (generally calculated using auction procedures).
3. A notable example was the 2018 restructuring of Hovnanian Enterprises Inc. *See, e.g.*, Mary Childs, *The Hedge Fund Skirmish that Could Kill the CDS Market*, Barron's (Jan. 26, 2018), https://www.barrons.com/articles/the-hedge-fund-battle-that-could-kill-the-cds-market-1517013136; Andrew Scurria, *Blackstone Stands Down on Hovnanian Swaps Wager*, Wall St. J. (May 30, 2018), https://www.wsj.com/articles/blackstone-stands-down-on-hovnanian-swaps-wager-1527722945. Hovnanian entered into an arrangement with a hedge fund in which the fund provided debt financing on favourable terms, and Hovnanian arranged to have an affiliate purchase, and then trigger a payment default on, an existing issue of Hovnanian bonds. Due to the CDS contracts having a lower credit event threshold than the cross-default provisions in Hovnanian's other outstanding debt, such payment default would trigger payments to the fund as protection buyer under its CDS while avoiding a broader cross-default for Hovnanian. Another hedge fund that had sold credit protection on the CDS sued alleging market manipulation and fraud. After a federal district court ruled in the protection buyer's favor and refused to block the arrangement, the U.S. Commodity Futures Trading Commission ("CFTC") exerted pressure through both private and public channels, expressing a concern that such manufactured defaults could constitute market manipulation. *See* Solus Alt. Asset Mgmt. *LP v. GSO Capital Partners L.P.*, No. 18 CV 232-LTS-BCM (S.D.N.Y. Jan. 29, 2018). *See also* CFTC Public Statements and Remarks, *Statement on Manufactured Credit Events by CFTC Divisions of Clearing and Risk, Market Oversight, and Swap Dealer and Intermediary Oversight*, CFTC.gov (Apr. 24, 2018), https://www.cftc.gov/PressRoom/peeches Testimony/divisionsstatement042418. The parties to the CDS reportedly reached a compromise settlement whereby the protection buyer received some compensation for forbearing from triggering the credit event and Hovnanian made the missed payment during the grace period to cure the credit event. *See, e.g.*, Gabriel Rubin and Andrew Scurria, *How Regulators Averted a Debacle in Credit-Default Swaps*, Wall St J. (Jul. 8, 2018), https://www.wsj.com/articles/how-regulators-averted-a-debacle-in-credit-default-swaps-1531047600.
4. While such arrangements can, in some cases, be motivated by a manipulative or opportunistic intent, it is important to note that, in many other cases, a protection buyer may simply be a prudent investor or lender seeking to hedge its exposure to the debtor and responding in a rational manner to its incentives as modified by its CDS hedge. For example, an investor may enter into a negative basis trade – a type of trade where a holder can lock in positive carry or spread by holding a long bond position and buying protection under a matching CDS. This would disincentivise the investor from supporting certain refinancing efforts, and its incentives may diverge from those of unhedged creditors, but such an investor would not necessarily have a manipulative objective or intent to harm the debtor or other creditors.
5. Certain protection buyers under RadioShack CDS asked ISDA to declare that a failure to pay had effectively occurred on the grounds that RadioShack's refinancing was "structured with a purpose to manipulate the CDS market". *See* ISDA Americas Determinations Committee Question Presented, *Has a Failure to Pay Credit Event Occurred with respect to RadioShack Corporation?*, CDSdeterminationscommittees.org (Dec. 9, 2014), https:// www.cdsdeterminationscommittees.org/documents/2014/12/20140401_question-presented-v2.pdf/; ISDA Americas Determinations Committee Decision, *Has a Failure to Pay Credit Event Occurred with respect to RadioShack Corporation?*, CDSdeterminationscommittees.org (Dec. 12, 2014), https://www.cdsdeterminationscommittees.org/documents/2014/12/20141212-dc-decision.pdf/. ISDA determined that a failure to pay had not occurred as a result of such refinancing (allowing the protection seller to avoid payments under the CDS), although it later determined that RadioShack triggered a bankruptcy credit event upon its filing for bankruptcy in February 2015. *See* ISDA Americas Determinations Committee Decision, *Has a Bankruptcy Credit Event occurred with respect to RadioShack Corporation?* CDSdeterminationscommittees.org (Feb. 9, 2015), https://www.cdsdeterminationscommittees.org/documents/2015/02/dc-decision-020915-radioshack.pdf/. *See, e.g.*, Jodi Xu Klein, *Radio Shack Kept Alive by $25 Billion of Swaps Side Bets*, Bloomberg (Dec. 17, 2014), https://www.bloomberg.com/news/articles/2014-12-18/radioshack-kept-alive-by-25-billion-of-swaps-side-bets; Michael Aneiro, *What's Keeping Radio Shack Afloat? Credit Derivatives*, Barron's (Dec. 19, 2014), https://www.barrons.com/articles/whats-keeping-radio-shack-afloat-credit-derivatives-1419003199; Mike Kentz, *CDS Allegations Surround RadioShack*, Reuters (Dec. 15, 2014), https://www.reuters.com/article/radioshack-cds/cds-allegations-surround-radioshack-idUSL1N0TZ0V720141215.

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6. For example, the McClatchy Co. restructuring in 2018 initially involved an agreement between the company and a hedge fund protection seller that would "orphan" the company's CDS by moving certain outstanding bonds into a subsidiary whose default would not trigger the CDS, before being restructured to avoid that outcome. *See, e.g.*, Claire Boston and Sridhar Natarajan, *McClatchy Hands Win to CDS Buyers as it Tweaks Debt Deal*, Bloomberg (Jun. 27, 2018), https://www.bloomberg.com/news/articles/2018-06-27/mcclatchy-hands-win-to-cds-buyers-as-it-tweaks-refinancing-deal.
7. The 2019 debt refinancing of Neiman Marcus Group Ltd. involved a debt swap that materially increased the value of the company's CDS by converting certain subsidiaries' debt into joint obligations that would qualify as deliverable obligations for the purposes of determining the CDS settlement value. *See, e.g.*, Claire Boston and Eliza Ronalds-Hannon, *Neiman Struck 'Devil's Bargain' with CDS Traders, Fund Says*, Bloomberg (Mar. 4, 2019), https://www.bloomberg.com/news/articles/2019-03-04/neiman-struck-devil-s-bargain-with-cds-traders-fund-says.
8. In the 2018–19 restructuring of Sears Holdings Corp., a creditor that was also a protection seller on CDS referencing a Sears affiliate arranged for Sears to limit sales of certain intercompany notes to other investors (in hopes of modifying the pool of deliverable obligations in the CDS settlement auction and thereby increasing the payout under the CDS). Because such a "short squeeze" could be said to limit the company's ability to raise funds, this was alleged to be a manipulative action. *See, e.g.*, Bart Chilton, *Sears' Death Gives Life to Crisis-Era Derivatives Demons*, Forbes (Dec. 8, 2018), https://www.forbes.com/sites/bartchilton/2018/12/05/sears-death-gives-life-to-crisis-era-derivatives-demons/#37a5895a55dd. It has been noted that CDS settlement auctions can be vulnerable to such manipulation when the notional amount of CDS is high in relation to debt outstanding (in the case of RadioShack, for example, it was observed that, at one point, the notional amount of its CDS outstanding was 28 times the principal amount of its debt outstanding; s*ee also* Klein, *Radio Shack Kept Alive by $25 Billion of Swaps Side Bets*, endnote 5 above).
9. *See* endnote 6 above.
10. The Thomas Cook Group plc restructuring was reportedly held up by differing incentives arising in part due to a technical difference between the trigger events in the 2014 and 2003 ISDA Credit Derivatives Definitions (used in newer CDS and in some older legacy CDS, respectively), which ultimately resulted in one set being triggered by Thomas Cook's U.S. Chapter 15 filing (as a "failure to pay" credit event) while the other was triggered by Thomas Cook's liquidation in England (as a "bankruptcy" credit event). In addition, there was also a stalemate between creditors who had hedged by buying credit protection and others who had effectively doubled down on their long exposure by also becoming protection sellers and preferred to have a refinancing avoid a CDS credit event. *See, e.g.*, Alice Hancock, *Thomas Cook files for US bankruptcy protection*, Fin. Times (Sep. 17, 2019), https://www.ft.com/content/c495f92e-d954-11e9-8f9b-77216ebe1f17; Alice Hancock and Daniel Thomas, *Thomas Cook locked in rescue talks*, Fin. Times (Sep. 21, 2019), https://www.ft.com/content/986c4e6e-db81-11e9-8f9b-77216ebe1f17.
11. As this replicates the economics of a purchase or sale of the underlying stock without the buyer providing the purchase price upfront, the equity receiver will also pay a spread to compensate for the cost of funds, and the equity receiver will generally receive payments reflecting dividends or other proceeds that would otherwise be paid to a holder.
12. Generally, though, a TRS is entered into with a bank or market intermediary that will either own the stock as a hedge if it is the equity payer, or short the stock as a hedge if it is the equity receiver.
13. Investors may also acquire long and short positions (and potentially divided incentives) across both the debt and equity markets, as observed in the case of Pershing Square's $2.6 billion windfall profit during the recent period of Coronavirus-related volatility. The fund was accused of potentially manipulating debt and equity markets through television interviews emphasising impending financial distress, but subsequently released a detailed timeline of its trades and public statements showing that it had already made gains on large short CDS positions prior to those statements and had separately accumulated long TRS positions after equity markets had already collapsed. *See, e.g.*, Dan McCrum and Ortenca Aliaj, *Inside Bill Ackman's $2.6bn big short*, Fin. Times (Apr. 10, 2020), https://www.ft.com/content/70a5566c-5c02-4dcd-9360-c2b0001f2f29.
14. The terms "empty" and "hidden" voting trace their origins to Professors Henry T. C. Hu and Bernard S. Black in their article *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006).
15. Generally, a beneficial owner of more than 5% of a class of equity securities must make a disclosure on Schedule 13D, 17 C.F.R. § 240.13d-101 ("Schedule 13D"). Beneficial ownership is defined in Exchange Act Rule 13d-3 to include those who have the power to vote or dispose of the securities.
16. *See CSX Corp. v. Children's Investment Fund Management (UK) LLP*, 654 F.3d 276 (2d Cir. 2011).
17. Ultimately, the funds filed a Schedule 13D once they determined they had formed a "group" for purposes of Rule 13d-5. But this was not until a year after the funds were actively pursuing a leveraged buyout.
18. *See CSX Corp.*, 654 F.3d 276; *CSX Corp. v. Children's Investment Fund Management (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008). The District Court did find that TCI was deemed a beneficial owner under Exchange Act Rule 13d-3(b) because the TRS were entered into with the purpose and effect of preventing the vesting of beneficial ownership.
19. 17 CFR § 240.16a-2. Insiders include those with beneficial ownership of more than 10%. Such a status subjects the insider to short-swing profit disgorgement on trades made within six months.
20. "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. However, recent arrangements appear to involve intentional, or 'manufactured', credit events that could call that premise into question." CFTC Public Statements and Remarks, *Statement on Manufactured Credit Events by CFTC Divisions of Clearing and Risk, Market Oversight, and Swap Dealer and Intermediary Oversight*, CFTC.gov (Apr. 24, 2018), https://www.cftc.gov/PressRoom/SpeechesTestimony/divisionsstatement042418. *See also* U.S. Securities and Exchange Commission Chairman Jay Clayton, U.S. Commodity Futures Trading Commission Chairman J. Christopher Giancarlo, and U.K. Financial Conduct Authority Chief Executive Andrew Bailey, *Joint Statement on Opportunistic Strategies in the Credit Derivatives Market*, SEC.gov (Jun. 24,

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2019), https://www.sec.gov/news/press-release/2019-106; U.S. Securities and Exchange Commission Chairman Jay Clayton, *Statement Announcing SEC Staff Roundtable on the Proxy Process*, SEC.gov (Jul. 30, 2018), https://www.sec.gov/news/public-statement/statement-announcing-sec-staff-roundtable-proxy-process, noting as potential topics "over-voting and under-voting of securities by broker-dealers, the reasons this may occur, and ways to address it. In addition, the extent to which "empty voting" (e.g., acquiring voting rights over shares but having little or no economic interest in the shares) is of concern to market participants and the regulatory steps, if any, that should be taken to address those concerns".

21. International Swaps and Derivatives Association, Inc., *2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions*, ISDA.org (Jul. 15, 2019), https://www.isda.org/a/KDqME/Final-NTCE-Supplement.pdf.
22. ISDA also released interpretive guidance setting forth a non-exhaustive list of factors to determine whether the new "credit deterioration" requirement is satisfied. The interpretive guidance indicates that a reference entity having entered into a forbearance or standstill "for *bona fide* commercial reasons" will be taken into consideration as a factor indicating credit deterioration, and establishes certain scenarios where credit deterioration is presumed. The guidance further acknowledges that certain creditors may have hedged through CDS (leaving them protected from a default and incentivised to resist a restructuring that would impair the value of their debt investments), and so *bona fide* debt restructurings that would trigger such creditors' CDS in order to incentivise participation in the restructuring should not be deemed to be narrowly tailored credit events, in circumstances where the reference entity would be likely to enter bankruptcy without such a restructuring.
23. Such provisions have sometimes been referred to as "Windstream provisions" in reference to practices observed in the Windstream Holdings Inc. restructuring, where a net short creditor was able to trigger a default and get paid out as a CDS protection buyer by virtue of a smaller long position it held in the company's debt. *See, e.g.*, Sujeet Indap, *Windstream files for Ch 11, call for regulation of CDS market*, Fin. Times (Feb. 25, 2019), https://www.ft.com/content/1e767d0c-3931-11e9-b856-5404d3811663; Mary Childs, *Windstream Blames Bankruptcy on Hedge Fund Aurelius and CDS Market*, Barron's (Feb. 26, 2019), https://www.barrons.com/articles/windstream-files-for-bankruptcy-calls-for-credit-default-swap-regulation-51551133206.
24. *See* Kristen Haunss, *Sirius Computer moves to block derivatives holders from speculation*, Reuters (May 22, 2019), https://www.reuters.com/article/sirius-cds/sirius-computer-moves-to-block-derivatives-holders-from-speculation-idUSL2N22Y0EF.
25. Such time limits could help avoid opportunistic behaviour such as in the Windstream restructuring, where a fund acquired a long position in the company's senior notes and then sought to trigger a default based on covenant breaches that had occurred more than two years earlier, resulting in a large payment to the fund as CDS protection buyer. *See U.S. Bank Nat'l Ass'n. v. Windstream Services, LLC*, No. 17-CV-07857 (S.D.N.Y. Feb. 15, 2019). Such limits would serve a similar function in concept to "fish or cut bait" or deemed waiver provisions negotiated into some derivatives or prime brokerage agreements. In the absence of a contractual time limit, the ability to trigger such remedies would be subject to applicable statutes of limitation on contractual claims (*e.g.,* six years under New York law).
26. *See* Exchange Act Rule 13d-3(d).
27. U.S. and U.K. regulators acknowledged such remaining vulnerabilities in their joint response following ISDA's publication of its credit derivatives amendments in September 2019, in which they noted that many of the previously identified concerns remained unaddressed. *See* U.S. Securities and Exchange Commission Chairman Jay Clayton, U.S. Commodity Futures Trading Commission Chairman J. Christopher Giancarlo, and U.K. Financial Conduct Authority Chief Executive Andrew Bailey, *Update to June 2019 Joint Statement on Opportunistic Strategies in the Credit Derivatives Market*, SEC.gov (Sep. 19, 2019), https://www.sec.gov/news/public-statement/update-june-2019-joint-statement-opportunistic-strategies-credit-derivatives.
28. *See* endnote 20 above.
29. *See* ISDA Chief Executive Officer Scott O'Malia's informal comments (Mar. 14, 2019), https://www.isda.org/2019/03/14/an-important-milestone/.

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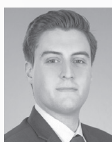

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