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SEC Proposes Rules Relating to Security-Based Swaps

SEC Re-Proposes Rule to Prevent Fraud, Manipulation and Deception in Connection With Security-Based Swap Transactions and Proposes Large Position Reporting and CCO Independence Rules.

SUMMARY

On December 15, 2021, the Securities and Exchange Commission (the "SEC") re-proposed Rule 9j-1 under the Securities Exchange Act of 1934 (the "Exchange Act"). Proposed Rule 9j-1, which was proposed initially in 2010, is an anti-fraud and anti-manipulation provision focused specifically on security-based swap transactions. The SEC also proposed new Exchange Act Rule 10B-1 to require any person with a security-based swap position that exceeds specified thresholds to file with the SEC a schedule disclosing certain information related to its position in security-based swaps and related instruments. Finally, the SEC proposed new Exchange Act Rule 15Fh-4(c) to prohibit undue influence over the chief compliance officer ("CCO") of a security-based swap dealer or a major security-based swap participant (each, an "SBS Entity").

As proposed, new Rule 9j-1 would prohibit a range of acts, omissions and fraudulent inducements, along with attempted misconduct, in connection with security-based swaps, including fraud in connection with the exercise of any right or performance of any obligation under a security-based swap. In addition, the proposed rule would prohibit manipulation or attempted manipulation of the price or valuation of any security-based swap or any payment or delivery related thereto. Further, the re-proposed rule makes clear that market participants cannot avoid liability under the rule by effecting a fraudulent scheme through the purchase or sale of an underlying security or a group or index of securities including the underlying security, rather than the purchase or sale of the security-based swap on which it is based. The re-proposed rule provides limited safe harbors for actions taken in accordance with binding contractual obligations and portfolio compression exercises.

Proposed Rule 10B-1 would require any person, or group of persons, with a security-based swap position that exceeds specified reporting thresholds to promptly file a Schedule 10B disclosing certain information related to the position. Proposed Rule 10B-1 is not limited to SBS entities and broadly covers any security-based swap that is required to be reported under Regulation SBSR, or if the reference security underlying the security-based swap is issued by an entity organized in the United States or is registered under the Exchange Act. The proposed rule provides that any Schedule 10B must be filed no later than the first business day following the day of execution of the security-based swap transaction that results in the position exceeding the threshold. Schedule 10B would require persons to disclose certain information, including the identity of the reporting person and the security-based swap position, as well as the ownership of underlying loans or securities and positions in any index of any securities and loans.

Finally, proposed new Rule 15Fh-4(c) would prohibit any officer, director, supervised person or employee of an SBS Entity, or any person acting under such person's direction, to take any action to coerce, manipulate, mislead or fraudulently influence the SBS Entity's CCO in the performance of his or her duties under the federal securities laws.

The SEC is seeking comment from the public on all aspects of the proposed rules. Comments are due 45 days after the proposed rules are published in the Federal Register.

BACKGROUND

Section 761 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") amended the definition of "security" in Section 3(a)(10) of the Exchange Act and Section 2(a)(1) of the Securities Act of 1933 (the "Securities Act") to include security-based swaps.[1] As "securities," then, security-based swaps are subject to the general anti-fraud and anti-manipulation provisions of the federal securities laws, including Section 10(b) of the Exchange Act, Rule 10b-5 thereunder and Section 17(a) of the Securities Act. Those provisions prohibit fraud, deception and material misstatements and omissions in connection with the purchase and sale of a security or security-based swap. In addition, Section 9(j) of the Exchange Act, which was enacted as part of Dodd-Frank, expressly prohibits fraud and manipulation in connection with security-based swaps and authorizes the SEC to adopt rules to further specify the scope of the prohibitions. Pursuant to this authority, the SEC, in 2010, proposed Rule 9j-1 (the "2010 Proposed Rule"), to make "explicit the liability of persons that engage in misconduct to trigger, avoid, or affect the value of such ongoing payments or deliveries."[2] As proposed, the 2010 Proposed Rule would have applied to offers, purchases and sales of security-based swaps in the same way that the general anti-fraud provisions apply to all securities, but also would have explicitly applied to cash flows, payments, deliveries, and other ongoing obligations and rights that are specific to security-based swaps.

In the 11 years since the original proposal, the Commodity Futures Trading Commission (the "CFTC") has largely completed its own rulemaking related to swaps, including by adopting anti-fraud and anti-

manipulation rules under the Commodity Exchange Act (the "CEA"). In making these proposals, the SEC stated that "now is an opportune time to move forward with the anti-fraud and anti-manipulation rules required by Section 9(j) as well as the rules contemplated by Section 10B(d)."[3]

SUMMARY OF PROPOSED RULES

Re-Proposed Rule 9j-1, Anti-Fraud, Manipulation and Deception

The SEC re-proposed Rule 9j-1, which is intended to prevent fraud, manipulation and deception in connection with security-based swap transactions. Re-proposed Rule 9j-1 is generally consistent with the 2010 Proposed Rule on the same topic, though the re-proposed rule expands the conduct subject to the rule.

The SEC includes in the Release a discussion of so-called "manufactured credit events" and other "opportunistic strategies" in the credit default swap ("CDS") market. According to the SEC, these strategies "generally involve CDS buyers or sellers taking steps, with or without the participation of a company whose securities underlie, or are referenced by, a CDS (a 'referenced entity') to avoid, trigger, delay, accelerate, decrease, and/or increase payouts on CDS."[4] The SEC gives a number of examples of strategies, including a CDS buyer and reference entity working together to create a technical failure-to-pay-credit event, CDS sellers offering financing to restructure a reference entity in a way that "orphans" the CDS by eliminating or reducing the likelihood of a credit event by moving debt off the balance sheet of the reference entity and onto the balance sheet of an affiliate, or taking actions to increase the supply of deliverable obligations to increase the likelihood of a credit event. The SEC has sought to address these activities in the proposed rule.

General Anti-Fraud and Anti-Manipulation Provisions

The anti-fraud and anti-manipulation provisions of the re-proposed Rule 9-1(a) would make it unlawful for any person, directly or indirectly: (i) to purchase or sell (or attempt to induce the purchase or sale of) any security-based swap; (ii) to effect any transaction in (or attempt to effect any transaction in) any security-based swap; (iii) to take any action to exercise any right, or any action related to performance of any obligation, under any security-based swap, including in connection with any payments, deliveries, rights, or obligations or alterations of any rights thereunder; or (iv) to terminate (other than on its scheduled maturity date) or settle any security-based swap, in connection with which such person:

(1) Employs or attempts to employ any device, scheme, or artifice to defraud or manipulate; or

(2) Makes or attempts to make any untrue statement of a material fact, or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

(3) Obtains or attempts to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(4) Engages or attempts to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Like the 2010 Proposed Rule and consistent with Section 10(b), Rule 10b-5 and Section 17(a), the re-proposed rule applies different standards of conduct to its various anti-fraud and anti-manipulation provisions. In particular, re-proposed Rule 9j-1(a)(1) (the prohibition on employing or attempting to employ any device, scheme or artifice to defraud or manipulate) and Rule 9j-1(a)(2) (the prohibition on making or attempting to make any untrue statement of a material fact, or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading) would, like Section 10(b) and Rule 10b-5 from which they are modeled, require scienter, while Rule 9j-1(a)(3) (the prohibition on obtaining or attempting to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading) and Rule 9j-1(a)(4) (the prohibition engaging or attempting to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person) would, like Section 17(a) after which they are modeled, not require scienter. While the SEC acknowledged that certain commenters on the 2010 Proposed Rule opposed the lack of a scienter requirement in paragraph (3) and paragraph (4) of Rule 9j-1, the SEC decided to use the same standards as were initially proposed in 2010 on the basis that Rule 9j-1 should be as broad as, and consistent with, Section 10(b) and Rule 10b-5 and Section 17(a).

Like the 2010 Proposed Rule, the Release does address whether a private right of action would exist for a violation of re-proposed Rule 9j-1. Notably, Section 9(f) of the Exchange Act provides a private right of action for violations of Section 9(a) (regarding transactions relating to the purchase or sale of a security), Section 9(b) (regarding certain transactions relating to puts, calls, straddles, options, futures or security-based swaps) and Section 9(c) (regarding endorsement or guarantee of puts, calls, straddles or options), but not for violations of Section 9(j). If conduct with respect to the purchase or sale of a security-based swap violates Section 10(b), the existing private right of action would be available.

"Purchases" and "Sales" in the Context of Security-Based Swaps

The Release notes that the anti-fraud provisions of the re-proposed rule would apply not just to the "purchase" and "sale" of security-based swaps,[5] but also to:

- effecting transactions, or attempting to effect transactions in, security-based swaps;
- taking actions to exercise any right or actions related to performance of any obligation pursuant to any security-based swap including any payments, deliveries, rights, or obligations or alterations of any rights thereunder; or

- terminating (other than on its scheduled maturity date) or settling any security-based swap, in connection with which such person engages in fraudulent, manipulative or deceptive conduct.

While acknowledging the concerns raised in certain comments on the 2010 Proposed Rule as to the scope of the anti-fraud and anti-manipulation provisions, the Release nevertheless notes that the rule would apply to activities involving the exercise of any rights and performance of any obligations over the term of the security-based swap, including partial executions, terminations, assignments, exchanges, transfers or extinguishments of rights or obligations.

The Release clarifies that not every payment or delivery made during the course of a security-based swap transaction is itself a purchase or sale of a security-based swap under the applicable statutory authority and not therefore within the scope of the proposed rule. Instead, according to the Release, fraudulent or manipulative conduct would be deemed to be in connection with the purchase or sale of a security-based swap if it either:

- alters any material terms of the security-based swap (as set forth in the applicable trading relationship documentation); or
- has a material impact on any payment or delivery under the security-based swap, such that it would not be consistent with what a reasonable person would have expected to pay, deliver or receive absent such conduct.[6]

The SEC explains that it will treat a material change in a payment or delivery obligation as the purchase or sale of a new security-based swap. This approach is consistent with the approach taken by the SEC with respect to the amendment of "derivative securities" under Section 16 of the Exchange Act.[7] The SEC indicates that a material change would include, among other things, a counterparty misstating information about a transaction that results in a missed or late payment or loss of an opportunity to call collateral.

According to the SEC, the rule would also apply to other actions that have an impact on some, but not all, rights and obligations under a security-based swap, such as a margin payment that represents only part of what one counterparty owes the other.

Prohibition on Price Manipulation

The re-proposed rule also includes provisions designed to address price manipulation, similar to CFTC Rule 180.2 regarding swaps. Specifically, the re-proposed rule would make it unlawful for any person to, directly or indirectly, manipulate or attempt to manipulate the price or valuation of any security-based swap, or any payment or delivery related thereto. As previously noted, this paragraph of the proposed rule lacks a materiality qualifier. The Release notes that the provision is intended, in part, to address, among other things, manufactured credit events or other opportunistic CDS strategies observed by the SEC and the markets over the last decade, including situations where a party intentionally distorts a payment related to a security-based swap for the benefit of one of the security-based swap counterparties, such as actions

that serve little to no economic purpose other than to artificially influence the composition of the deliverable obligations in a CDS auction. The re-proposed rule is also intended to prohibit, among other things, a situation where a person (or group of persons) improperly and intentionally causes or avoids the purchase or sale of a security-based swap for the benefit of a counterparty to a security-based swap, such as intentionally and improperly "orphaning" a CDS, avoiding termination of a CDS for a period of time or causing the termination of a CDS.

Despise the breadth of the new proposed paragraph (b), the SEC indicates not all actions related to payment or delivery obligations are meant to be captured within the new prohibition. First, the SEC makes clear that a person would not violate proposed Rule 9j-1(b) by simply profiting from a CDS position after the reference entity's bankruptcy, which the CDS holder could have prevented by participating in a financing to the referenced entity. The SEC recognizes that reference entities often rely on financing and other forms of relief to avoid defaulting on their debt, and the proposed rule is not intended to discourage lenders and prospective lenders from discussing or providing such financing or relief, even when those persons also hold CDS positions. Instead, proposed Rule 9j-1(b) is supposed to account for actions taken outside the ordinary course of a typical lender-borrower relationship (or a prospective lender-borrower relationship). Second, paragraph (b) is not intended to apply to actions taken in the ordinary course of a security-based swap transaction or in connection with the underlying referenced security; instead, it is designed to capture situations where payment under the swap is "intentionally distorted." The SEC notes that this determination would be made on a facts and circumstances basis, but that it would expect to bring an enforcement action when a party takes action for the purposes of avoiding, causing, increasing or decreasing a payment under a security-based swap in a manner that would not have otherwise occurred, but for such actions.

Liability in Connection with the Purchase or Sale of a Security

The re-proposed rule also makes clear that market participants cannot avoid liability under the rule by effecting a fraudulent scheme through the purchase or sale of an underlying security or a group or index of securities including the underlying security, rather than the purchase or sale of the security-based swap on which it is based, and vice versa. Specifically, the re-proposed rule provides that (1) a person could not escape liability for trading based on possession of material non-public information ("MNPI") about a security by purchasing or selling a security-based swap based on that security (as opposed to trading in the security itself) and (2) a person could not escape liability under Section 9(j) or re-proposed Rule 9j-1 in connection with a fraudulent scheme involving a security-based swap by purchasing or selling the underlying security or a group or index of securities including the underlying security (as opposed to purchasing or selling a security-based swap that is based on that security).

While the SEC refers to the proposed new paragraph (c) and paragraph (d) to Rule 9j-1 as clarifications and intended to prevent persons from doing indirectly what they could not do directly, the scope of these paragraphs is unclear. First, while the Release in at least one place indicates the references in

paragraph (c) and paragraph (d) to groups or indices of securities that include the underlying reference security are intended to refer to narrow-based groups or indices of securities, the proposed paragraphs do not include that limitation and could arguably be interpreted to encompass broad-based groups of indices or securities. The lack of a narrow-based limitation is particularly noteworthy since the SEC appears to indicate in a footnote that Section 20(d) of the Exchange Act, on which paragraph (c) and paragraph (d) are based, might actually prohibit a person aware of MNPI on one security in the S&P 500 from effecting purchases and sales of security-based swaps on the S&P 500.

Second, while the SEC states that neither Section 9(j) nor re-proposed Rule 9j-1 is intended to create liability "solely on the impact of [a person's] transactions on the equity, debt, or loan markets," the re-proposed rule does not expressly include this limitation. Rather, the re-proposed rule requires that the transacting person, or an affiliate of the transacting person or a person "acting in concert" with the transacting person be a party to a security-based swap in order to have liability. The reference to "affiliates" may broadly expand liability, especially for large financial institutions engaged in securities trading in multiple jurisdictions. The coverage of affiliates is also troubling in light of the SEC's failure to propose an affirmative defense standard similar to Rule 10b5-1(c)(2), as discussed below under "Safe Harbor."

Last, while the Release refers to "loans" and "groups or indices of loans," those do not appear in paragraph (c) and paragraph (d) of the re-proposed rule.

Safe Harbors

In response to concerns raised in comments on the 2010 Proposed Rule regarding the scope of potential liability for interim performance obligations, the SEC is proposing two limited safe harbors from re-proposed Rule 9j-1 designed to address situations where a counterparty to a security-based swap is required to take certain actions, pursuant to the previously agreed-upon terms of the transaction or a portfolio compression exercise, while aware of MNPI.

The first safe harbor would provide that a person would not be liable under re-proposed Rule 9j-1(a) solely by reason of being aware of MNPI while taking actions in accordance with binding contractual rights and obligations under a security-based swap (as reflected in the written security-based swap documentation governing such transaction or any amendment thereto) if the person could demonstrate that:

- the security-based swap was entered into, or the amendment was made, before the person became aware of MNPI; and
- the entry into, and the terms of, the security-based swap were not themselves a violation of any provision of Rule 9j-1(a).

As an example, this proposed safe harbor would generally apply to making a standardized coupon payment or delivering collateral to a counterparty (and would also permit the counterparty to receive the coupon payment or collateral), while such person is aware of MNPI, so long as both actions are explicitly required

by the terms of the transaction and documented in writing. However, the safe harbor would not apply if a counterparty took some action to fraudulently increase (in the case of the receiving counterparty) or decrease (in the case of the delivering counterparty) the amount of such payment or collateral transfer.

The second safe harbor applies with respect to certain types of portfolio compression exercises.[8] This safe harbor recognizes that portfolio compression exercises provide important operational benefits and efficiencies for market participants. This safe harbor provides that a person would not be liable under Rule 9j-1 solely for reason of being aware of MNPI when effecting security-based swap transactions pursuant to a bilateral or multilateral portfolio compression exercise so long as:

- any such transactions are consistent with all of the terms of a bilateral or multilateral portfolio compression exercise, including as it relates to, without limitation, the transactions to be included in the exercise, the risk tolerances of the persons participating in the exercise and the methodology used in the exercise; and
- all such terms were agreed to by all participants of the bilateral or multilateral portfolio compression exercise prior to the commencement of the applicable exercise.

The SEC, however, did not propose to adopt, as requested by commenters, an analog to the current affirmative defense from liability under Rule 10b-5 provided by Rule 10b5-1(c)(2). Rule 10b5-1(c)(2) provides an affirmative defense from Rule 10b-5 liability for entities if:

- the individual making the investment decision for the entity was not aware of MNPI; and
- the entity had implemented reasonable policies and procedures to prevent violations of Rule 10b-5.

The SEC did not provide any explanation on why it did not adopt a similar affirmative defense for Rule 9j-1.

Large Security-Based Swap Position Reporting Requirements

The SEC indicates in the Release that Section 10B(d) authorizes it not only to adopt position limits for security-based swaps, but also to require the reporting of security-based swap positions. Accordingly, the SEC is proposing to require the public reporting of security-based swaps, including positions in related instruments, above certain thresholds described below. This is the first time that the SEC has proposed a rule using its authority under Section 10B(d) to require reporting of large positions in securities-based swaps.

The purpose of proposed Rule 10B-1 is to increase transparency in the security-based swap market. The SEC believes that the benefits of proposed Rule 10B-1 include:

- providing market participants and regulators with access to information that may indicate that a person (or group of persons) is building up a large security-based swap position, which in some cases could be indicative of potentially fraudulent or manipulative purposes;
- alerting market participants and regulators to the existence of concentrated exposures to a limited number of counterparties, which should inform those market participants and regulators of the

attendant risks, allow counterparties to manage risk and lead to better pricing of the security-based swaps with respect to transactions with persons holding large positions in those security-based swaps; and

- in the case of so-called manufactured or other opportunistic strategies in the CDS market, providing market participants and regulators with notice that a person (or group of persons) is building up a large CDS position, which could create an incentive to vote against their interests as a debt holder, possibly with an intent to harm the company, even if such conduct is not inherently fraudulent.

U.S. regulators have been concerned with large security-based swap positions in the wake of the collapse of investment firm Archegos Capital ("Archegos").[9] Archegos, which had particularly concentrated positions in certain U.S. and Chinese technology and media companies through positions in security-based swaps, defaulted on March 26, 2021, causing large losses across several large banks. The SEC alludes to the Archegos situation in the following example: "[I]f a single counterparty has a $5 billion security-based swap position distributed equally among five different dealers on the same underlying equity security, public reporting of that security-based swap position would alert each dealer to the total exposure of the reporting counterparty."[10]

The Release notes that, given that a number of these benefits accrue not only to regulators—including the SEC, as primary regulator of security-based swap market—but also to market participants (including the reference entities), the SEC believes that such reports should be made available to the public.

Who Must Report and What Positions Must be Reported

Proposed Rule 10B-1 would require any person (and any entity controlling, controlled by or under common control with such person) or group who is directly or indirectly the owner or seller of a Security-Based Swap Position that exceeds the Reporting Threshold Amount (as such terms are defined below) to promptly file with the SEC, via EDGAR, a statement containing the information required by Schedule 10B.[11]

Section 10B provides the SEC with authority to require reporting by "any person that effects transactions for such person's own account or the account of others [in security-based swaps and related financial instruments]." The Release notes that the SEC considered whether to limit the reporting requirement to certain types of persons, such as limiting it to SBS Entities. However, the SEC is taking the view that the proposed rule is intended to provide both the SEC and the market with information about any large position in security-based swaps and any related securities that, in the event of a default, could have an impact on the markets, counterparties or other market participants, including those positions that could adversely affect referenced entities and their stakeholders, and those that could influence counterparties' risk management decisions or pricing of security-based swaps. Accordingly, the requirements in proposed Rule 10B-1 apply to any person, regardless of whether that person is registered with the SEC in any capacity.

The SEC estimates approximately 800 entities will become subject to reporting under proposed Rule 10B-1 and that there will be approximately 1,000 reports a week. Further, the SEC estimates 850 entities will have sufficiently large security-based swap positions to necessitate the implementation of systems and policies to monitor their reporting obligations. Surprisingly, the SEC estimates that these 850 entities will be able to put into place the required information to calculate and report ownership positions for a one-time cost of $101,740 each. Equally surprising is the SEC estimate that it will cost each entity only $77,000 annually to operate and maintain the infrastructure. We expect significant comment by market participants on these cost estimates.

Key Definitions

Proposed Rule 10B-1 contains key definitions for determining the scope of the position to be disclosed.

Security-Based Swap Position

Proposed Rule 10B-1(3) defines "Security-Based Swap Position" to mean all security-based swaps based on:

- a single security or loan, or a narrow-based security index, or any interest therein or based on the value thereof;
- any securities issued by the same issuer (each, an "issuing entity") of the securities, loans or securities included in the narrow-based index described immediately above; or
- any narrow-based security index that includes any of those issuing entities or their securities (including any interest therein or based on the value thereof), in each case as applicable.

Where a Security-Based Swap Position is based on a single security or loan that is included in a narrow-based security index, the calculation of the Security-Based Swap Position with respect to a particular component of the index would be based on the weighting of the reference entity or securities as a component of the index. For security-based swaps based on equity securities, a Security-Based Swap Position will include all security-based swaps based on a single class of equity securities.

A security-based swap that is based on a narrow-based security index could trigger a reporting obligation under the proposed rule in two different ways. First, reporting would be required if a person had a Security-Based Swap Position composed of security-based swaps based on a narrow-based security index that itself exceeded the relevant Reporting Threshold Amount. Second, if a person had a Security-Based Swap Position composed of security-based swaps based on a single security or loan, that person would need to include in the calculation of that position all security-based swaps based on the applicable single security or loan, in an amount proportionate to the weighting of the security or loan in the narrow-based security index.

The Release notes the SEC's belief that the reporting requirements in the proposed rule should represent a person's gross position in a security-based swap,[12] rather than a net position, because the proposed rule

is intended to, among other things, identify those circumstances when a market participant has a large, concentrated position in a security-based swap on a single issuer, which may have the potential to affect not only the market for other security-based swaps on the same issuer, but also the applicable reference securities, even if that gross position consists of smaller positions that offset each other.

Reporting Threshold Amount

Security-based swaps based on a single class of equity securities issued by a reference entity would constitute a separate Security-Based Swap Position from security-based swaps based on debt securities of the same reference entity. A Security-Based Swap Position that is a CDS also would constitute a separate Security-Based Swap Position. For this reason, proposed Rule 10B-1(b) provides a separate definition of Reporting Threshold Amount for Security-Based Swap Positions that are CDSs, debt security-based swaps (excluding CDS) and equity security-based swaps. Separate Schedules 10B must be filed if a reporting person exceeds both the debt-based Security-Based Swap Position threshold and the equity-based Security-Based Swap Position threshold, although cross-references between the filings would be permitted.

The thresholds were constructed to be low enough to capture any positions that could, according to the SEC, potentially have a significant effect on the equities markets and, potentially, issuers of equity securities and their security holders, yet also high enough to avoid over-reporting, which, in the SEC's view, could limit the effectiveness of the rule. We expect these thresholds to be subject to significant comment.

Reporting Thresholds for Debt Security-Based Swaps (including CDS)

For CDS (including CDS where the underlying reference is a group or index of entities or obligations of entities that is a narrow-based security index), proposed Rule 10B-1(b)(i) would define the reporting threshold to be the lesser of:

- a long notional amount of $150 million, calculated by subtracting the notional amount of any long positions in a deliverable debt security underlying a security-based swap included in the Security-Based Swap Position[13] from the long notional amount of the Security-Based Swap Position;
- a short notional amount of $150 million; or
- a gross notional amount of $300 million.

With respect to the $150 million long notional threshold for CDS positions, the Release cites the SEC's belief that a threshold that identifies parties with a significant naked CDS long exposure could help to more accurately identify situations where a CDS counterparty may be incentivized to act against its own interest as a debt holder, which is a possible indicator of an incentive to create a manufactured or other opportunistic credit event.

The SEC also proposes to use a $150 million notional threshold for short CDS positions to capture scenarios where a CDS seller has a sufficiently large position to allow it potentially to utilize an opportunistic strategy to avoid or delay a credit event, such as by ensuring a credit event occurs after the expiration of the CDS, or taking actions to limit the number and/or kind of deliverable obligations in order to impact the recovery rate following a credit event.

The SEC proposes a third threshold to capture the positions of market participants with significant gross CDS positions, notwithstanding the direction of the person's CDS positions or positions in deliverable bonds. According to the SEC, a gross CDS position that equals or exceeds $300 million would likely create enough counterparty concentration risk to potentially have other effects on the market, even in the absence of a manufactured or other opportunistic credit event.

For security-based swaps based on debt securities that are not CDS, the proposed Rule 10B-1(b)(1)(ii) reporting threshold is a gross notional amount of $300 million, without regard to direction of the CDS positions and without excluding any debt securities underlying a security-based swap included in the Securities-Based Swap Position.[14]

Reporting Threshold for Security-Based Swaps on Equity

For security-based swaps based on equity securities, the SEC proposes that the "Reporting Threshold Amount" be bifurcated such that it would be defined to include both a threshold based on the notional amount of the Security-Based Swap Position and a threshold based on the total number of shares attributable to the Security-Based Swap position as a percentage of the outstanding number of shares of that class of equity security. Accordingly, proposed Rule 10B-1(b)(iii) would define the reporting threshold amount to be the lesser of:

- a gross notional amount of $300 million, but if the gross notional amount of the security-based swap position exceeds $150 million, the calculation of the security-based swap position must also include the value of all of the underlying equity securities owned by the holder of the security-based swap position (based on the most recent closing price of the underlying shares), as well as the delta-adjusted notional amount of any options, security futures or any other derivative instruments based on the same class of equity securities; or
- a security-based swap equivalent position that represents more than 5% of a class of equity securities, but if the security-based swap equivalent position represents more than 2.5% of a class of equity securities, the calculation of the security-based swap equivalent must also include in the numerator all of the underlying equity securities owned by the holder of the Security-Based Swap Position, as well as the number of shares attributable to any options, security futures or any other derivative instruments based on the same class of equity securities.

With respect to a notional amount, a person would be required to file a Schedule 10B once a Security-Based Swap Position based on equity securities meets or exceeds $300 million, calculated on a gross basis (meaning, including both long and short positions without netting). The proposed rule provides further that once a Security-Based Swap Position exceeds a gross notional amount of $150 million, the calculation of

the Security-Based Swap Position will also include the value of all of the underlying equity securities owned by the holder of the Security-Based Swap Position (based on the most recent closing price of the underlying shares), as well as the delta-adjusted notional amount of any options, security futures or any other derivative instruments based on the same class of equity securities.[15]

The Release notes the SEC's concern that this manner of calculating the Reporting Threshold may not capture those situations where the notional amount of such security-based swaps does not trigger either the $150 million or $300 million gross notional thresholds but nevertheless would represent a significant number of shares of a particular issuer and carry the potential to affect the issuer as a result. Accordingly, the SEC proposes the percentage test for Reporting Threshold as relates to security-based swaps of equity securities. Under the percentage test, a person would be required to file a Schedule 10B once the "Security-Based Swap Equivalent Position" represents more than 5% of a class of equity securities. Once a Security-Based Swap Equivalent Position represents more than 2.5% of a class of equity securities, the calculation of the Security-Based Swap Equivalent Position will also include in the numerator all of the underlying equity securities owned by the holder of the Security-Based Swap Position, as well as the number of shares attributable to any options, security futures or any other derivative instruments based on the same class of equity securities.

For purposes of the percentage threshold, "Security-Based Swap Equivalent Position" would be defined to mean the number of shares attributable to all of the security-based swaps comprising a Security-Based Swap Position and the phrase "number of shares attributable" to a derivative instrument (including a security-based swap) to mean the larger of:

- the number of shares of the reference equity security that may be delivered upon the exercise of the rights under the derivative instrument, as determined in accordance with the terms of the applicable documentation (intended to apply primarily to physically settled instruments);
- the number of shares of the reference equity security determined by multiplying (x) the number of shares by reference to which the amount payable under the derivative instrument is determined by (y) the delta of the applicable derivative instrument (intended to apply primarily to cash-settled instruments that provide for a way to calculate the number of shares of the reference security based on the amount payable, with an adjustment to account for derivative instruments with a delta that is not equal to one); and
- the number of shares of the reference equity security determined by (x) dividing the notional amount of such derivative instrument by the most recent closing price of shares of the reference equity security, and then (y) multiplying such quotient by the delta of the applicable derivative instrument (intended to apply primarily to a cash-settled instrument where the methodology in the preceding bullet point does not exist).

Importantly, these calculations would apply not only to all security-based swaps based on a single equity security, but also to security-based swaps based on a narrow-based security index containing that reference security.

The proposed calculations for the 5% threshold test are much more complex and comprehensive than the calculations for Section 13(d). Unlike the calculation of beneficial ownership for Section 13(d), proposed Rule 10B-1 includes:

- the securities underlying all physically settled derivative instruments, even those that may not be exercised or otherwise settled within 60 days;
- the securities underlying cash-settled only derivatives; and
- the proportional representation of securities included in a narrow-based group or index of securities.

Moreover, the calculation for cash-settled derivatives may require a delta calculation, and the calculation for indices requires a calculation of the percentage of the index represented by the reference equity security. As a result, entirely new systems and processes would need to be instituted by market participants to make their calculations, at a cost the SEC estimates to be approximately $100,000.

Finally, the 5% threshold could well result in many more filings on Schedule 10B than would be required under Section 13(d) and Schedule 13D. And Rule 10B-1, unlike the rules under Section 13(d) and Section 13(g), has no concept of delayed or annual filings by qualified or passive investors.

Information Required to be Included in Schedule 10B

Proposed Schedule 10B requires the inclusion of the following information:

- name of reporting person (or names of reporting persons if making a joint filing as a group), whether the reporting person is a member of a group and names of the members of the group if the members of the group making individual filings;
- residency or place of organization of reporting person(s);
- type of reporting person(s);
- for reporting persons that are legal entities, the Legal Entity Identifier (the "LEI") of the reporting person, if such person has an LEI;
- notional amount of the applicable Security-Based Swap Position(s) of the reporting person, along with summary information about the composition of the position as it relates to the direction (*i.e.*, long or short) and the tenor/expiration of the underlying security-based swap transactions and the product ID of the security-based swap(s) included in the Security-Based Swap Position, if applicable;
- in the case of a Security-Based Swap Position based on debt securities (including CDS), ownership of (i) all debt securities underlying a security-based swap included in the Security-Based Swap Position, including the Financial Instrument Global Identifier (the "FIGI") of each underlying debt security, if applicable, and the LEI of the issuer of each underlying debt security, if the issuer has an LEI: and (ii) all security-based swaps based on equity securities issued by the same reference entity, including the FIGI of each underlying equity security, if applicable;
- ownership of any other instrument relating to the Security-Based Swap position and/or any underlying security or loan or group or index of securities or loans, or any security or group or index of securities, the price, yield, value or volatility of which, or of which any interest therein, is the basis for a material term of a security-based swap included in the Security-Based Swap Position; and

- if the Reporting Threshold Amount is based on the number of shares corresponding to a Security-Based Swap Position based on equity securities, the number of shares attributable to the Security-Based Swap Position, along with the closing price used in the calculation and the date of such closing price.

The Release notes the SEC's intent behind the proposal—to alert regulators and the markets, including counterparties to security-based swap trades and the issuers whose securities underlie security-based swaps, that one or more market participants are amassing a large position in security-based swaps—and acknowledges that certain aspects of a security-based swap transaction may be sensitive or proprietary in nature. The information required is intended to achieve the SEC's disclosure objective without requiring market participants to publicly disclose sensitive or proprietary information about their Security-Based Swap Positions, including, in particular, by not requiring reporting persons to disclose information about counterparties, including identities to any security-based swap or other related derivatives.

A Comparison of Rule 10B-1 and Schedule 10B to the Reports under Section 13(d) and Schedule 13D.

To a large extent, proposed Rule 10B-1 and Schedule 10B are based on the Section 13(d) and Schedule 13D framework.[16] Important similarities include:

- the required public reporting of positions;
- the use of a "group" concept encompassing any group of persons, who through any contract, arrangement, understanding or relationship acquire or sell instruments;
- the ability to make group filings;
- the need to update for material changes to the Schedule; and
- the prohibition on the use of a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement or device to evade filing.

Nevertheless, Rule 10B-1 and Schedule 10B differ from the requirements of Section 13(d) and Schedule 13D in several important respects:

- a one-business-day filing deadline from the time a reporting threshold is exceeded or a material change in the Schedule 10B occurs, as compared to 10 days for the filing of a Schedule 13D and "promptly" for material changes to a Schedule 13D;
- the requirement to report beneficial ownership of all instruments underlying the security-based swap as well as any security-based swap in the category not being reported—equity securities in the case of debt and debt in the case of equity securities;
- the requirement to report groups or indices of securities or loans;
- in calculating the 5% threshold for equity-based security swaps, the inclusion of securities underlying cash-settled derivatives and securities represented in narrow-based indices; and
- the lack of delayed or annual reporting for qualified or passive investors.

Cross-Border Application

Section 10B generally provides the SEC with authority to require any person effecting transactions for such person's own account or the account of others in any security-based swap and any underlying security or loan or group or index of securities or loans to report such information as the SEC may prescribe regarding any position or positions in any security-based swap and any underlying or related securities, loans or indexes. The Release notes that "the [SEC] understands that a congressional focus of Section 10B to be the promotion of transparency through disclosure within the U.S. securities markets of security-based swap positions that (at least in part) occur in the United States or other security-based swap transactions that involve persons who have positions in U.S. issuers or U.S. registrants. This congressional focus is reasonably understood to include U.S. security-based swaps that are at least partially within the U.S. securities markets or any other securities that trade within the U.S. securities market where at least one party has an ownership interest in any of the underlying or related U.S. securities or loans."[17]

Security-based swap transactions currently take place across national borders, with agreements negotiated and executed between counterparties in different jurisdictions. Given the global nature of this market, the Release notes that "an effective application of proposed Rule 10B-1 necessitates identifying which transactions in this global market will be subject to these reporting requirements."[18] To that end, proposed Rule 10B-1(d) would provide that the reporting requirements of the rule would apply to all Security-Based Swap Positions so long as:

- any of the transactions that compose the Security-Based Swap Position would be required to be reported under Rule 908 of Regulation SBSR;[19] or
- the reporting person holds any amount of reference securities underlying the Security-Based Swap Position (or would be deemed to be the beneficial owner of such reference securities, pursuant to Section 13(d) of the Exchange Act and the rules and regulations thereunder); and
    - the issuer of such reference security is a partnership, corporation, trust, investment vehicle or other legal person organized, incorporated, or established under the laws of the U.S. or having its principal place of business in the U.S.; or
    - such reference security is part of a class of securities registered under Section 12 or Section 15(d) of the Exchange Act.

CCO Independence Rule

Proposed Rule 15Fh-4(c) aims to protect the independence and objectivity of a CCO of an SBS Entity by prohibiting personnel of an SBS Entity from coercing, manipulating, misleading or otherwise fraudulently interfering with the CCO's duties. SBS Entities are required to designate a CCO under 15Fk-1 of the Exchange Act. Under this rule, the CCO must take reasonable steps to ensure that the SBS Entity establishes, maintains and reviews written policies and procedures designed to achieve compliance with the Exchange Act and to remediate non-compliance issues identified by the CCO, among other duties.[20]

The proposed Rule 15Fh-4(c) seeks to ensure that personnel at SBS Entities do not interfere with the CCO's ability to meet these important obligations.

The SEC previously declined to adopt a rule similar to proposed Rule 15Fh-4(c) on the basis that the CCO's independence was protected by having the CCO's compensation and termination be subject to approval of the SBS Entity's board of directors. However, in light of the adoption of other rules relating to the CCOs of SBS Entities, and the proposed adoption of Rule 9j-1 and Rule 10B-1, the SEC has determined to issue for comment proposed Rule 15Fh-4(c). Proposed Rule 15Fh-4(c) would make it unlawful for any officer, director, supervised person or employee of an SBS Entity, or any person acting under such person's direction, to directly or indirectly take any action to coerce, manipulate, mislead or fraudulently influence the SBS Entity's CCO in the performance of his or her duties under the federal securities laws or the rules and regulations thereunder. Notably, proposed Rule 15Fh-4(c) only applies to personnel of SBS Entities, unlike proposed Rule 9j-1 and proposed Rule 10B-1 which, if adopted, will apply to any person, without exception.

IMPLICATIONS

Proposed Rule 9j-1 draws on existing language in Section 10(b) of the Exchange Act, Rule 10b-5 thereunder and in Section 17(a) of the Securities Act, and expands its scope beyond the scope of those analogous rules in potentially significant ways, if adopted as proposed. The prohibitions reach beyond activity around the entry into a security-based swap transaction (the "purchase" or "sale"), or the novation or termination of a security-based swap, to actions taken in connection with obligations or rights under a security-based swap, including margin payments or early termination of the transaction. In addition, the proposed rule potentially reaches *attempted* fraud, deceit and manipulation, which may create uncertainty for market participants.

Rule 10B-1, as proposed, would require reporting by a large number of market participants, including potentially a large number of unregulated entities, which may require the implementation and maintenance of systems that these entities might not otherwise have in place. Moreover, even in the case of regulated entities subject to existing reporting obligations, the new calculations of the reporting thresholds will require new systems to, for example, calculate the proportional ownership of indices and to determine the "delta" of options, security futures and other derivatives. In addition, by requiring public disclosure of the identities of the reporting parties, the Rule could adversely affect market participants by revealing confidential hedging or trading activities, which could in turn deter or limit certain transactions. Finally, the obligation to submit the Schedule 10B within one business day is far shorter than the time period for other reports required under SEC rules.

What is more, the extraterritorial scope of Rule 10B-1 is significant. Not only does the reporting obligation apply to any security-based swap subject to reporting under Regulation SBSR, but also to any reference

securities issued by a U.S.-domiciled issuer or registered under the Exchange Act. For example, under proposed Rule 10B-1, two non-U.S. persons entering into a security-based swap on unlisted securities of a U.S. domiciled issuer will need to perform the threshold calculations.

Finally, proposed Rule 15Fh-4(c), by encompassing all employees within the scope of the rule, has the potential to bring general employment disputes within the rule.

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ENDNOTES

1 Section 761(a) of the Dodd-Frank Act added new Section 3(a)(68) to the Exchange Act, which defines "security-based swap" as "any agreement, contract, or transaction that is a swap, as defined in Section 1(a) of the Commodity Exchange Act, that is based on a narrow-based security index, or a single security or loan, or any interest therein or on the value thereof, or the occurrence or non-occurrence of any event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition or financial obligations of the issuer." The CFTC, in contrast, has jurisdiction over transactions in swaps based on any other underlier, including commodities, currencies, rates and broad-based indices of securities.

2 Release No. 34-63236 (Nov. 8, 2010), *available at* https://www.sec.gov/rules/proposed/2010/34-63236.pdf. The 2010 Proposed Rule is discussed in SEC Proposes Anti-Fraud Rule Under Title VII of Dodd-Frank: SEC Issues Proposed Rule Prohibiting Fraud, Manipulation and Deception in Connection with Security-Based Swaps, Sullivan & Cromwell (Nov. 9, 2010), *available at* https://www.sullcrom.com/SEC-Proposes-Anti-Fraud-Rule-Under-Title-VII-of-Dodd-Frank.

3 Release No. 34-93784, December 15, 2021, *available at* https://www.sec.gov/rules/proposed/2021/34-93784.pdf (the "Release").

4 Release at 14-15 (footnotes omitted).

5 The Dodd-Frank Act amended the definitions of "purchase" and "sale" in the Exchange Act to include the execution, termination, assignment, exchange and transfer or extinguishment of rights and obligations of a security-based swap.

6 Proposed Rule 9j-1(b), however, lacks any materiality qualification and encompasses any manipulation (or attempt to manipulate) the price or valuation of a security-based swap or a related payment or delivery obligation.

7 *See*, *e.g.*, Foster Pepper & Shefelman, SEC No-Action Letter, Aug. 30, 1991.

8 "Portfolio compression" generally refers to a post-trade processing exercise that allows two or more market participants to eliminate redundant derivatives transactions within their portfolios in a manner that does not change their net exposure.

9 This includes regulators other than the SEC, including the Board of Governors of the Federal Reserve System. *See* Federal Reserve Board reiterates its supervisory expectations for large banks' risk management with investment funds (Dec. 10, 2021), *available at* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20211210a.htm.

10 Release at 21.

11 A person owns a Security-Based Swap Position by virtue of participation in a group of persons pursuant to any contract, arrangement, understanding or relationship. The proposed rule would provide that the group's filing obligation may be satisfied either by a single joint filing or by each of the group members making an individual filing. If the group's members elect to make their own filings, each filing would be required to identify all members of the group, but the information provided concerning the other persons making the filing would only need to reflect information which the filing person knows or has reason to know.

12 The term "gross" means the sum of the absolute values of notional amounts outstanding of all of the security-based swaps included in a Security-Based Swap Position. The Release provides the following example: "[I]f a person has a $75 million long CDS position and a $75 million short CDS position on the same reference entity or security, the person will have a Security-Based Swap Position of $150 million." Release at 70, fn. 123.

ENDNOTES (CONTINUED)

13 Proposed Rule 10B-1(b)(5) provides that "debt security underlying a security-based swap included in the security-based swap position" will include any security that could potentially be deliverable into a credit default swap auction in the event of a default.

14 The SEC explains that it "does not believe it to be appropriate to allow these positions to be netted against any underlying debt securities given that these types of security-based swap transactions operate differently than CDS transactions. For example, a CDS buyer whose security-based swaps are used to hedge some or all of its positions in an underlying bond will likely be less inclined to take actions that would result in a CDS default, given that the payment received should correspond to their losses from the bond. By contrast, a CDS buyer who does not hold the underlying bond may be incentivized to take actions that would result in a CDS default given that the resulting payment would not be offset by the buyer's losses from the bond. Such a dynamic—where there are conflicting motivations as between the CDS transaction and any debt securities underlying that CDS transaction—is less likely to occur in connection with other types of security-based swaps." Release at 75-76.

15 Proposed Rule 10B-1(b)(6) defines the term "delta" to mean the ratio that is obtained by comparing (x) the change in the value of a derivative instrument to (y) the change in the value of the reference equity security. If a derivative instrument does not have a fixed delta, then the delta should be calculated on a daily basis, based on the most recent closing price of shares of the reference equity security. The SEC is not proposing to define "delta-adjusted notional amount" to provide market participants with flexibility in the computation methodology. However, the SEC indicates that the calculation should involve multiplying the notional amount of the derivative by the delta.

16 Section 13(d) and Schedule 13D generally require a person or group that acquires beneficial ownership of more than 5% of a voting class of an issuer's equity securities registered under the Exchange Act to file a Schedule 13D with the SEC within 10 days of such acquisition.

17 Release at 91.

18 *Id.* at 88.

19 Rule 908 provides that a security-based swap is subject to regulatory reporting and public dissemination if: (i) there is a direct or indirect counterparty that is a U.S. person on either or both sides of the transaction; or (ii) the security-based swap is accepted for clearing by a clearing agency having its principal place of business in the United States. The rule also provides that a security-based swap that is not included in these provisions is subject to regulatory reporting, but not public dissemination, if there is a direct or indirect counterparty on either or both sides of the transaction that is a registered security-based swap dealer or a registered major security-based swap participant.

20 *See* 17 C.F.R. § 240.15Fk-1.

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