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SEC Adopts Rules Relating to Security-Based Swaps

SEC Finalizes Rule to Prevent Fraud, Manipulation and Deception in Connection with Security-Based Swap Transactions and CCO Independence Rule

SUMMARY

On June 7, 2023, the Securities and Exchange Commission (the "SEC" or "Commission") adopted Rule 9j-1 under the Securities Exchange Act of 1934 (the "Exchange Act"). Rule 9j-1, which was proposed initially in 2010 and re-proposed in 2021, is an anti-fraud and anti-manipulation provision focused specifically on security-based swap transactions. The SEC also adopted 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").

Rule 9j-1 as adopted reflects modifications from the Commission's proposal in response to comments received on the Commission's December 15, 2021 Proposing Release (the "2021 Proposing Release"). As adopted, Rule 9j-1 prohibits a range of acts, omissions and fraudulent inducements, along with attempted misconduct, in connection with security-based swaps, including fraud in connection with the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of any rights or obligations under, a security-based swap. In addition, the rule prohibits manipulation or attempted manipulation of the price or valuation of any security-based swap or any payment or delivery related thereto. Further, the 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 SEC adopted two affirmative defenses to liability under Rule 9j-1(a)(1)-(5) based on the affirmative defenses in Rule 10b5-1(c) under the Exchange Act. The first covers actions taken in accordance with

binding contractual obligations under a security-based swap when the security-based swap was entered into before the person became aware of material non-public information ("MNPI"). The second confirms the effectiveness of information barriers in the case of non-natural persons.

Rule 15Fh-4(c), which was adopted as proposed, prohibits 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.

Although included in the 2021 Proposing Release, the SEC did not adopt proposed Rule 10B-1. That rule would require any person with a security-based swap position that exceeds specified thresholds to file with the SEC, and disclose publicly, a schedule containing certain information related to its positions in security-based swaps and related instruments. The Commission stated in the adopting release (the "Adopting Release") that it is continuing to consider comments received in connection with proposed Rule 10B-1.

Rule 9j-1 and Rule 15Fh-4(c) will become effective 60 days after the Adopting Release is 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 a 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 and again in 2021, proposed Rule 9j-1 (the "2021 Proposed Rule"), to make "explicit the liability of persons that engage in misconduct to trigger, avoid, or affect the value of ongoing payments or deliveries[.]"[2]

SUMMARY OF FINAL RULES

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

Rule 9j-1, as adopted, is generally consistent with the 2021 Proposed Rule, but includes several modifications and two affirmative defenses in response to comments received on the proposal.

In its Adopting Release, the SEC included 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

"often involve CDS buyers or sellers taking steps, with or without the participation of the underlying entity, to avoid, trigger, delay, accelerate, decrease, and/or increase payouts on CDS." In the Adopting Release and in the 2021 Proposing Release, the SEC gave 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. Despite requests for clarity on when a strategy would be deemed to be manipulative, the SEC declined to provide further guidance and indicated that it would apply a "facts and circumstances" analysis and stressed that manipulation required scienter.

General Anti-Fraud and Anti-Manipulation Provisions

The anti-fraud and anti-manipulation provisions of Rule 9j-1(a) make it unlawful for any person, directly or indirectly: (i) to effect any transaction in (or attempt to effectuate any transaction in) any security-based swap; or (ii) to purchase, sell, or induce (or attempt to induce the purchase or sale of) any security-based swap (including but not limited to, in whole or in part, the execution, termination (prior to scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of any rights or obligations under, a security-based swap, as the context may require), in connection with which such person:

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

(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;

(3) Obtains 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;

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

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

(6) Manipulates or attempts to manipulate the price or valuation of any security-based swap, or any payment or delivery related thereto.

Like the 2021 Proposed Rule, the Adopting Release does not address whether a private right of action would exist for a violation of Rule 9j-1. However, the Adopting Release frequently discusses how the SEC would exercise its enforcement authority under Rule 9j-1, implying the lack of a private right of action.

Intent Standard

Like the 2021 Proposed Rule and consistent with Section 10(b), Rule 10b-5 and Section 17(a), the final rule applies different standards of conduct to its various anti-fraud and anti-manipulation provisions. In particular, paragraphs (1) and (2) above will, like Section 10(b) and Rule 10b-5 thereunder from which they are modeled, require scienter. Paragraphs (3) and (4) above will not, like Section 17(a) after which they are modeled, require scienter and will extend to conduct that is at least negligent. The SEC expressly rejected commenters' concerns that the negligence standard in paragraphs (3) and (4) could chill or disrupt the security-based swap market and would capture errors and other normal and legitimate business activity, and responded that a violation of paragraphs (3) and (4) would require more than a mere mistake.

In a departure from the 2021 Proposed Rule, the Commission adopted above paragraph (5) as a standalone provision to cover attempted conduct described in paragraphs (3) and (4) and to require scienter. Specifically, the Commission stated that paragraph (5)'s "prohibition applies where a person, with scienter, takes a step in furtherance of a fraudulent, deceptive, or manipulative act, practice, transaction, or course of business but for some reason... that act, practice, transaction, or course of business is not completed."

Finally, the Commission confirmed that it will apply a scienter standard, which includes intentional or reckless misconduct, to determine whether conduct is in violation of paragraph (6) above.

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

The Adopting Release notes that the anti-fraud provisions of Rule 9j-1 will apply not just to the "purchase" and "sale" of security-based swaps,[3] but will also include misconduct that occurs in connection with:

- effecting transactions, or attempting to effect transactions, in security-based swaps; or
- inducing, or attempting to induce, the purchase or sale of any security-based swap (including, in whole or in part, executing, terminating (prior to its scheduled maturity date), assigning, exchanging, or a similar transfer or conveyance of, or extinguishing of any rights or obligations, under a security-based swap).

The SEC stated that modifications to the final rule were made to clarify that the "definitions of purchase and sale encompass, among other things, *partial* executions, terminations, assignments, exchanges, transfers or conveyances of, or extinguishing of *any* rights or obligations" under a security-based swap. In this regard, the SEC noted that a partial execution, termination, assignment, exchange, or similar transfer or conveyance or extinguishment of a right or obligation could result in a material amendment to a security-based swap which would constitute the entry into a new security-based swap. This approach is different from the one provided in the 2021 Proposed Rule, which would have applied where a party engages in conduct that "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."

The Adopting Release broadly construes "effecting transactions." According to the SEC, effecting transactions is broader than a purchase or sale and would include:

- placing bids or orders;
- clearance and settlement of a security-based swap transaction; or
- sales, booking and collateral management activities.[4]

Prohibition on Price Manipulation

The final rule also includes provisions designed to address price manipulation, similar to CFTC Rule 180.2 regarding swaps. Specifically, final Rule 9j-1(a)(6) makes 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. This portion of the 2021 Proposing Release garnered significant comment.

The Adopting Release noted 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 or recklessly 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. For example, the final rule is intended to prohibit, among other things, a situation where a person (or group of persons) intentionally or recklessly causes or avoids the purchase or sale of a security-based swap for the benefit of a counterparty, or to harm 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. Though the Commission agreed with commenters that "the types of conduct described [in those situations] may not be the result of manipulation or attempted manipulation," it declined to revise its descriptions of those situations. Instead, the Commission will again utilize a facts and circumstances analysis to determine whether there are violations.

Despise the breadth of final Rule 9j-1(a)(6), the SEC indicates not all actions related to payment or delivery obligations are meant to be captured within the new prohibition, even though the Commission declined to carve out explicitly from the rule any particular categories of market activity and repeatedly reiterated that it will apply a "facts and circumstances" approach. 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 final 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, Rule 9j-1(a)(6) is intended to encompass actions taken outside the ordinary course of a typical lender-borrower relationship (or a prospective lender-borrower relationship). That said, the SEC declined to adopt safe harbors proposed by commenters, such as for hedging in connection with lending activities or

"legitimate" restructurings. The SEC also states that, as a general matter, an action that "appears to be designed almost exclusively to harm counterparties" would likely fall within the prohibition in Rule 9j-1(a)(6).

Second, Rule 9j-1(a)(6) 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, as described in the 2021 Proposing Release, it is designed to capture situations where payment under the swap is "intentionally distorted." The SEC reaffirmed the guidance in the 2021 Proposing Release that, depending on the particular facts and circumstances, 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.[5]

Liability in Connection with the Purchase or Sale of a Security

The final 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, loan 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.[6] Specifically, the final rule provides that:

- a person in possession of MNPI about a security cannot avoid liability under the securities laws by communicating about or making purchases or sales in the security-based swap (as opposed to communicating about or purchasing or selling the underlying security); and
- a person cannot avoid liability under Section 9(j) or Rule 9j-1 in connection with a fraudulent scheme involving a security-based swap by instead making purchases or sales in the underlying security loan, or group or index of securities (as opposed to purchases or sales in the security-based swap).

The Adopting Release fails, like the 2021 Proposing Release, to explicitly limit those sections to narrow-based baskets or indices. Rather, consistent with the 2021 Proposing Release, the SEC again includes a footnote that, without citation to authority, states that Section 20(d) of the Exchange Act, on which Rule 9j-1(b) and Rule 9j-1(c) are based, could potentially 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.[7]

In this context, we believe that the materiality of the non-public information must be assessed in the context of the transaction such that non-public information in respect of a single component of an index would only be material for purposes of securities anti-fraud laws and rules, including Section 20(d), if it is material to the index as a whole. This approach would be consistent with the rules under Section 16 of the Exchange Act, which expressly exclude broad-based publicly traded baskets and indices from Section 16,[8] the SEC Staff's approach to customized baskets under the same rules[9] and the SEC Staff's grant of no-action relief from registration under Section 5 of the Securities Act to dealers if the dealer facilitated customer orders for baskets of stocks comprising publicly traded market baskets and the basket included the dealer's publicly traded parent entity.[10]

Furthermore, while the SEC states that neither Section 9(j) nor 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 rule does not expressly include this limitation. Rather, the final 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.

Affirmative Defenses

The final rule creates two affirmative defenses from Rules 9j-1 claims. The first provides an affirmative defense for actions taken in connection with the binding contractual rights and obligations under a security-based swap when the security-based swap was entered into before the person became aware of MNPI. The second provides an affirmative defense to entities that have adopted information barriers reasonably designed to ensure that individuals making investment decisions would not violate Rule 9j-1. The Commission notes that these affirmative defenses are similar to those provided under Rule 10b5-1 "in that they apply to situations in which a person can demonstrate that [MNPI] did not factor into their investment decision."

The first affirmative defense provides that a person will not be liable under Rule 9j-1(a)(1)-(5), 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 demonstrates that:

- the security-based swap was entered into, or the amendment was made, before the person became aware of MNPI; and
- the security-based swap was entered into in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 9j-1.

The SEC indicates, as examples, that the affirmative defense 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 affirmative defense 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.

Unlike the Rule 10b5-1(c)(1) affirmative defense, this new affirmative defense would not cover pre-planned transactions in security-based swaps. According to the SEC, "[t]hat flexibility is warranted in the context of corporate insiders and others who periodically come into possession of [MNPI] but may want to schedule orderly trading of securities of an issuer on a liquid public market. It is not appropriate in the context of security-based swaps, which are typically bespoke, created and issued by the counterparties, and thinly traded."

The second affirmative defense provides that an entity will not be liable under Rule 9j-1(a)(1)-(5) for actions taken by a person if:

- the individual making the investment decision on behalf of the person was not aware of the MNPI; and
- the entity had implemented reasonable policies and procedures, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not be in violation of Rule 9j-1(a)(1)-(5).

The Commission notes that this affirmative defense is modeled on Rule 10(b)5-1(c)(2) and is intended to address concerns that the rule would have a chilling effect on markets. The affirmative defense is also intended to recognize that many market participants have information barriers that prevent access to MNPI by their employees who engage in security-based swap transactions for hedging or other purposes.

The Commission declined to adopt the proposed safe harbor for certain portfolio compression exercises. While reiterating its support for portfolio compression, the SEC noted that such a safe harbor would have "sanctioned *the use*" of MNPI under Rule 9j-1, when such use is prohibited under Rule 10b-5. The Commission further stated its belief that the second affirmative defense, described above, should provide market participants with the flexibility needed to engage in portfolio compression exercises and "eliminate[] concerns that compression exercises may be more than merely administrative and could be made on the basis of [MNPI]."

CCO Independence Rule

Rule 15Fh-4(c), which the Commission adopted as proposed, 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 pursuant to Rule 15Fk-1 under 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.

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, the SEC has now determined to adopt Rule 15Fh-4(c) to help ensure that actions of others will not undermine the independence and responsibilities of the CCO. The final Rule makes 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. The SEC rejected commenters' concerns that Rule 15fh-4(c) would have a chilling effect on communications with a CCO because the Rule does not extend to good-faith disagreement, or legitimate discussions. Rather, the Rule seeks to

prevent actions that would compel the CCO to act in a certain way through pressure, threats, trickery, misrepresentation, or some other form of purposeful action.

IMPLICATIONS

While 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, its scope extends beyond that of analogous rules in potentially significant ways. The prohibitions apply not just to activity around the entry into a security-based swap transaction (the "purchase" or "sale"), or the novation or termination of a security-based swap, but also to actions taken in connection with obligations or rights under a security-based swap (that is, actions taken to "effect[] transactions"), including margin payments and clearance and settlement of a transaction. Furthermore, while the affirmative defenses are similar to those provided under Rule 10b5-1(c), they are not identical. For example, the first affirmative defense is, in the Commission's words, narrower and provides for less flexibility than what is provided in Rule 10b5-1(c)(1), as it does not extend to pre-planned trades executed pursuant to instructions provided to another person or a written trading plan, prior to the person becoming aware of MNPI. Finally, we note that the Commission declined to narrow, or adopt safe harbors or affirmative defenses in connection with, the anti-manipulation provision provided in Rule 9j-1(a)(6) despite commenters' concerns that the provision could disrupt important aspects of the security-based swap market, including certain hedging and restructuring activities.

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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. 34-93784 (Dec. 15, 2021), *available at* https://www.sec.gov/rules/proposed/2021/34-93784.pdf. The 2021 Proposed Rule is discussed in SEC Proposes Rules Relating to Security-Based Swaps, Sullivan & Cromwell (Dec. 29, 2021), *available at* https://www.sullcrom.com/SullivanCromwell/_Assets/PDFs/Memos/sc-publication-SEC-proposes-rules-security-based-swaps.pdf.

3 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.

4 The SEC uses as an example the misappropriation of customer margin.

5 Commissioner Peirce's statement dissenting from the final rule flags a concern with respect to the lack of a safe harbor for an "ordinary course" actions carve-out from the text of the rule: "As did the proposing release, the adopting release does attempt to provide assurance to market participants that the Commission will use this provision to pursue only "actions taken outside the ordinary course of a typical lender-borrower relationship." . . . [T]he Commission repeatedly notes in this discussion that whether an action is taken in the ordinary course is a 'facts and circumstances' inquiry under which the Commission will review 'all relevant facts.' Although this approach does ensure maximum flexibility for the Commission to pursue misconduct that is hard to describe ex ante, it does so at the expense of clarity for firms that will have to guess at what facts the Commission may, in hindsight, determine to be relevant." (footnotes omitted)

6 The Commission added "loans" to the final rule and noted that the scope of underlying products is supposed to be consistent with the underlying products included in the Exchange Act's security-based swap definition.

7 Adopting Release at 62-63, n. 202.

8 *See* 17 C.F.R. § 240.16a-1(a)(5); 17 C.F.R. § 240.16a-1(c)(4).

9 *See* SEC No-Action Letter: Goldman Sachs & Co. (Oct. 15, 1997).

10 *See* SEC No-Action Letter: Bank of America Corporation (June 11, 2009); SEC No-Action Letter: J.P. Morgan Securities, Inc. (June 5, 2007); *see also* SEC No-Action Letter: New York Stock Exchange Inc. (Oct. 26, 1989).

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