

SEC Reporting & Compliance Alert

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SEC Revives Proposed Antifraud Rule for Security-Based Swap Transactions

On December 15, 2021, the Securities and Exchange Commission (SEC) re-proposed for comment Rule 9j-1 (Rule), an antifraud provision for security-based swaps (SBS) initially proposed in 2010. In the same release, the SEC also proposed Rule 15Fh-4(c), which primarily seeks to prevent undue influence over the chief compliance officer of an SBS dealer or major market participant, and Rule 10B-1, which creates new position reporting requirements for large SBS positions and appears to be partly driven by the collapse of Archegos Capital Management.

While the 2010 version of the Rule has mostly been carried over unchanged, the SEC has expanded the newly proposed version through edits and the addition of new subsections, perhaps in recognition of a changing market. For example, it appears that the new proposal takes into consideration that, over the past decade, there have been a number of manufactured or opportunistic credit strategies in the market for credit default swaps, a prominent type of SBS. In the newly proposed Rule, these strategies are a focal point and the impetus for one of its subsections.

One key feature that remains unchanged, however, is that — as it was in 2010 — the proposed rule for SBS is not limited by the restriction contained in other SEC anti-fraud provisions that the fraud must occur “in connection with a purchase or sale” or “in the offer or sale” of a security for the SEC to have jurisdiction. The absence of that limitation recognizes that fraudulent conduct can occur over the sometimes years-long term of an SBS, and not only at the initial formation, as SEC Chairman Gary Gensler noted when he observed that the re-proposed rule “is designed to take into account the unique features of a security-based swap,” since “it would explicitly reach misconduct in connection with the ongoing payments and deliveries that typically occur throughout the lifecycle of these instruments.”

While SEC Commissioners Allison Herren Lee and Caroline A. Crenshaw gave statements in support, the other two Commissioners dissented. Commissioner Elad L. Roisman expressed concern that the re-proposed rule could lead to confusion for market participants, which could detrimentally affect their ability to use SBS for hedging and risk management. Commissioner Hester M. Peirce stated the proposed Rule “take[s] a maximalist approach that seems disproportionate to the regulatory concerns [it is] designed to address and that may exceed [the SEC’s] statutory authority.”

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Key Aspects of Rule 9j-1

The re-proposed Rule addresses potential misconduct in SBS markets, which include the markets for CDS and equity or total return swaps, in the following ways, many of which are new:

- Like the 2010 version, the Rule tracks the language of well-known antifraud provisions, Rules 10b-5(a) and (b) under the Securities Exchange Act of 1934 and Sections 17(a)(2) and (3) of the Securities Act of 1933. As with the provisions on which they are modeled, Rules 9j-1(a)(1) and (2) require scienter and Rules 9j-1(a)(3) and (4) can be satisfied with a showing of negligence.
- Unlike the 2010 version, the newly proposed Rule has been expanded to cover attempted violations in many respects.
- The Rule introduces a new subsection, modeled after CFTC Rule 180.2, that prohibits the completed or attempted manipulation of the price of an SBS or any payment or delivery related to that swap. The proposing release states that this language is intended to address manufactured or opportunistic credit strategies.
- In an expansion of insider trading liability, new proposed Rule 9j-1(c), modeled after Section 20(d) of the Exchange Act, prohibits the purchase or sale of an SBS while in possession of material nonpublic information with respect to the security underlying such swap.
- The Rule, however, also lists circumstances in which a person would not be liable when possessing material nonpublic information and provides a safe harbor for transactions effected pursuant to certain types of portfolio compression exercises.

- Cross-product manipulation is addressed in another new addition, Rule 9j-1(d), which clarifies that conduct prohibited by the other subsections also applies to conduct involving the underlying reference entity, security, loan, or group or index of securities or loans.

Some Takeaways

- The new proposed Rule, if approved, may run into judicial headwinds. For example, some courts have imposed a high bar for establishing market manipulation under the antifraud provisions on which Rule 9j-1 is based. Some, for example, view manipulative intent without the injection of inaccurate information or the creation of a false impression of market activity as insufficient to establish a violation.¹ This line of cases may result in judicial limitations on those aspects of Rule 9j-1 related to manipulation.
- Recognizing that many lenders hold a CDS position relating to a prospective borrower, the proposing release seeks to provide comfort that not all lending arrangements in these circumstances will be considered a manufactured or opportunistic credit strategy under the Rule. However, given the varied strategies executed in the past and a recognition in the proposing release that it will be a facts-and-circumstances determination, sufficient clarity may not be provided by the release for CDS holders who consider financing.

Next Steps for the Proposed Rule

Comments on the proposal will be due 45 days after publication in the *Federal Register*.

¹ See, e.g., *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 205 (3d Cir. 2001).

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