

## SEC'S NEW FRAUD RULE FOR SECURITY-BASED SWAPS

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On August 29, 2023, two new rules adopted by the Securities and Exchange Commission to address misconduct in the security-based swaps market took effect. The first and more significant rule, Rule 9j-1, prohibits fraud, manipulation and deception in connection with effecting or entering security-based swap transactions. The second rule, which will have a narrower impact, Rule 15Fh-4(c), prevents undue influence over the chief compliance officer of security-based swap dealers and major security-based swap participants ("SBS Entities").<sup>1</sup> The following is an analysis of both rules, although with a focus on Rule 9j-1.

### I. BACKGROUND

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which was signed into law on July 21, 2010, established a new regulatory framework for swaps and security-based swaps.<sup>2</sup> The Dodd-Frank

Act gave the SEC the authority to regulate security-based swaps by adding security-based swaps to the definition of a "security" in Section 3(a)(10) of the Securities Exchange Act of 1934 ("Exchange Act")<sup>3</sup> and Section 2(a)(1) of the Securities Act of 1933 ("Securities Act").<sup>4</sup> By adding security-based swaps to the definition of securities, they became subject to Sections 9(a) and 10(b) of the Exchange Act as well as 17 C.F.R. § 240.10b-5 ("Rule 10b-5"),<sup>5</sup> and Section 17(a) of the Securities Act.<sup>6</sup>

In addition to subjecting security-based swaps to the general antifraud and antimanipulation provision of the federal securities laws, Section 763(g) of the Dodd-Frank Act also expanded Section 9 of the Exchange Act to make it unlawful for:

any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange, to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security-based swap, in connection with which such person engages in any fraudulent, deceptive, or manipulative act or practice, makes any fictitious quotation, or engages in any transaction, practice, or course of business which operates as a fraud or deceit upon any person.<sup>7</sup>

Section 763(g) also required that the SEC "by rules and regulations define, and prescribe means reasonably designed to prevent, such transactions, acts, practices, and courses of business as are fraudulent,

deceptive, or manipulative, and such quotations as are fictitious.”<sup>8</sup>

The SEC first sought to fulfill its statutory mandate with regard to Section 763(g) when it proposed, on November 3, 2010, new Rule 9j-1. The 2010 proposal would have prohibited the same conduct as Rule 10b-5 for security-based swaps, but would have also applied to cash flows, payments, deliveries, and other ongoing obligations and rights that are specific to security-based swaps.<sup>9</sup>

On December 15, 2021, the SEC re-proposed for comment Rule 9j-1.<sup>10</sup> The 2021 proposal mostly carried over unchanged the 2010 proposal, although it expanded the rule through edits and the addition of a new subsection addressing price manipulation. Those changes, according to a Commissioner’s statement in support of the proposal, reflected “the Commission’s experience with the security-based swap market as well as more recent market developments such as the proliferation of manufactured credit events and other opportunistic credit default swap strategies.”<sup>11</sup> The prohibition on price manipulation was added to the 2021 proposal in light of the SEC’s apparent view that there is incentive and opportunity for parties to engage in misconduct by triggering, avoiding or affecting the value of ongoing payments or deliveries in connection with security-based swaps.<sup>12</sup> The SEC specifically cited the following types of manufactured credit events using credit default swap (CDS) strategies, among others, as examples of price manipulation concerns in the security-based swap market:

- A CDS buyer working with a reference entity to trigger a payment on a CDS—to

the detriment of the CDS seller—by creating an artificial, technical or temporary failure-to-pay credit event.<sup>13</sup>

- A CDS seller “orphans” the CDS, reducing the likelihood of a credit event, by moving the reference entity’s debts to a subsidiary or an affiliate that is not referenced by the CDS.<sup>14</sup>

In the same release, the SEC also proposed Rule 15Fh-4(c), which would primarily prevent undue influence over CCOs of security-based swap dealers and major market participants, and Rule 10B-1, which would create new position reporting requirements for large security-based swap positions.<sup>15</sup> On June 7, 2023, the SEC adopted Rule 9j-1 and Rule 15Fh-4(c), but did not finalize Rule 10B-1.<sup>16</sup>

## II. RULE 9j-1: PROHIBITION AGAINST FRAUD, MANIPULATION AND DECEPTION IN CONNECTION WITH SECURITY-BASED SWAPS

Rule 9j-1 prohibits fraudulent, deceptive and manipulative misconduct related to security-based swap transactions.<sup>17</sup> Specifically, Rule 9j-1(a) states:

- a) It shall be unlawful for any person, directly or indirectly, to effect any transaction in, or attempt to effect any transaction in, any security-based swap, or to purchase or 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 its 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.<sup>18</sup>

#### A. SCOPE OF THE RULE

Three aspects of the new rule operate to give it a particularly broad scope. Rule 9j-1 prohibits misconduct—fraud, deceit and manipulation—“in connection with” effecting, or attempting to effect, any transaction in any security-based swap. The “in connection with” standard lends itself to a broad interpretation, such that conduct that merely “coincide[s]” with a securities transaction is prohibited,<sup>19</sup> and the standard can be met even if the person defrauded is not the counterparty to the transaction.<sup>20</sup> Accordingly, Rule 9j-1(a) will prohibit misconduct that occurs in connection with effecting, purchasing or selling any security-based swap, even if the security-based swap was not the subject of misconduct.<sup>21</sup>

The SEC has also defined “purchase” and “sale” of a security broadly to encompass both complete and partial executions, termination, assignments, exchanges and similar transfers or conveyances of, or extinguishing of rights or obligations, under a security-based swap.<sup>22</sup> The SEC opted for a broader definition of purchase and sale to avoid leaving market participants vulnerable to the risks that may arise not only at the time of sale but also during the buyer’s and seller’s ongoing obligations to each other, and also to prevent market participants from evading liability by structuring their conduct so that some counterparty rights and obligations remain in place.<sup>23</sup>

Lastly, Rule 9j-1(a) extends to misconduct that “effect[s] any transaction.” The SEC has inter-

preted “to effect any transaction” in various other provisions of the securities laws broadly to include “activity such as placing bids or orders, and clearance and settlement of a securities transaction.”<sup>24</sup> Accordingly, Rule 9j-1(a) will prohibit misconduct that occurs in connection with a broad range of activities related to security-based swap transactions, and not just the purchase or sale of security-based swaps.

## B. FRAUDULENT, MANIPULATIVE AND DECEPTIVE CONDUCT

Rule 9j-1(a) prohibits four categories of fraudulent, manipulative and deceptive conduct. Subsection (a)(1), which prohibits “[e]mploy[ing] or attempt[ing] to employ any device, scheme, or artifice to defraud or manipulate,” primarily follows the language of Rule 10b-5 but also covers manipulation. Subsection (a)(2) also adopts language from 10b-5 and prohibits making or attempting to make any untrue statement of material fact, or making an omission of a material fact necessary to make the statement, under the circumstances, not misleading. Subsection (a)(3) prohibits obtaining money or property via an untrue statement of a material fact, or omission of a material fact necessary to make a statement, in context, not misleading. Subsection (a)(4) prohibits engaging in any act, practice or course of business that operates, or would operate, as a fraud or deceit on any person. Subsection (a)(5) addresses the same conduct as subsections (a)(3) and (a)(4), but applies to attempted conduct.

### 1. NEGLIGENT CONDUCT IS ACTIONABLE

Certain types of fraudulent, manipulative and deceptive conduct prohibited under the final Rule 9j-1 will require a showing of only negligence.

Specifically, a finding that money or property was obtained through a material misstatement or omission under subsection (a)(3), or a finding that an act, practice or course of business operates as a fraud or deceit under subsection (a)(4) require only a showing of negligence.<sup>25</sup> (A finding under subsections (a)(1), (2) and (5), however, will require a showing of scienter.<sup>26</sup>) In explaining the lack of a scienter requirement for subsections (a)(3) and (a)(4), the SEC relied on the Supreme Court’s decision in *Aaron v. SEC*,<sup>27</sup> which held that Sections 17(a)(2) and 17(a)(3) of the Securities Act, unlike subsection 17(a)(1), do not require a showing of scienter because those provisions did not use words such as “device,” “scheme” and “artifice to defraud.”<sup>28</sup> Accordingly, because Rules 9j-1(a)(3) and (4) “use language identical” to Sections 17(a)(2) and 17(a)(3) of the Securities Act, the SEC justified the lack of a scienter requirement for those rules as necessary to avoid inconsistent standards.<sup>29</sup>

### 2. ATTEMPTS ARE COVERED

The rule applies to attempted as well as completed fraudulent, manipulative and deceptive conduct. For the provisions that prohibit fraudulent conduct and false statements/material omissions, the prohibition on attempted conduct and completed misconduct are contained in the same subsections (subsection (a)(1) and (a)(2), respectively). However, the SEC separated the provision that prohibits attempting to obtaining money or property by making a material misstatement/omission and attempting to engage in fraudulent acts or practices from the provisions that prohibit the same completed conduct. A finding of attempt with regard to that conduct must be made under subsection (a)(5), whereas the completed conduct is prohibited by subsections

(a)(3) and (a)(4), respectively. This accounts for the fact that a violation of (a)(3) and (a)(4) can be based on negligence, whereas completed conduct of the same type charged under (a)(5) requires a showing of scienter.<sup>30</sup>

### C. PRICE MANIPULATION IS PROHIBITED

In subsection (a)(6), the SEC adopted a prohibition on price manipulation and attempted price manipulation that is modeled after CFTC Rule 180.2.<sup>31</sup> The prohibition on price manipulation came “in response to manufactured credit events and other . . . CDS strategies” that the SEC believed have adversely affected credit derivatives markets.<sup>32</sup> Consistent with Supreme Court decisions that the term “manipulative” in a statute evidences intent to prohibit only knowing or intentional misconduct,<sup>33</sup> the SEC stated that it would apply a scienter standard to the prohibition on price manipulation.<sup>34</sup> However, the scienter standard includes both “intentional [and] reckless misconduct.”<sup>35</sup> In determining whether a person has violated Rule 9j-1(a)(6), SEC guidance indicates that it will utilize a “facts and circumstances” analysis to make an objective determination as to whether prohibited manipulation occurred.<sup>36</sup>

The price manipulation rule applies only to actions taken outside the ordinary course of a typical lender-borrower relationship, such as actions taken to avoid, cause, increase or decrease payments under a security-based swap, or actions designed almost exclusively to harm counterparties.<sup>37</sup> In its guidance, the SEC provided assurance that the final rule should not discourage lenders from discussing or providing financing or relief to avoid default.<sup>38</sup>

The Supreme Court has directed that the “[u]se of the word ‘manipulative’ is . . . virtually a term of art when used in connection with securities markets” as it “connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.”<sup>39</sup> As a result, Courts of Appeals have imposed a high bar for establishing market manipulation under Section 10(b). For example, in *Set Capital LLC v. Credit Suisse Group AG*,<sup>40</sup> the Second Circuit stated that market activity artificially affects a security’s price generally if it “sends a false pricing signal to the market or otherwise distorts estimates of the underlying economic value of the securities traded” and that “the market is not misled when a transaction’s terms are fully disclosed.”<sup>41</sup> Similarly, in *GFL Advantage Fund, Ltd. v. Colkitt*,<sup>42</sup> the Third Circuit required that “the alleged manipulator injected ‘inaccurate information’ into the market or created a false impression of market activity” in order to prevail on a claim of market manipulation.<sup>43</sup> Courts may impose a similar standard to Rule 9j-1(6) and narrow the application of the price manipulation rule in the security-based swaps market to match the rules for the securities market.

### D. RULE 9J-1(B), (C) AND AFFIRMATIVE DEFENSES

The new rule includes two provisions that are intended to make it clear that market participants cannot avoid liability by engaging in fraudulent conduct by purchasing or selling an underlying security, rather than the security-based swap on which it is based, and vice versa.<sup>44</sup> Although the SEC has taken the position that Rule 10b-5 already prohibits using material nonpublic information about a security in connection with the

purchase or sale of a security-based swap, it adopted Rule 9j-1(b) to provide additional clarity that such conduct is prohibited.<sup>45</sup> Rule 9j-1(c) addresses a similar situation to Rule 9j-1(b) by providing that when a counterparty to a security-based swap (or any affiliate or person acting in concert) engages in the misconduct prohibited by 9j-1(a) in connection with a purchase or sale of a security, loan or group or index of securities on which a security-based swap is based that they also violate Rule 9j-1(a). This part of the Rule prevents a person from escaping liability by limiting his or her actions to the purchase or sale of the underlying security, loan or index of a security-based swap and does not create a separate category of prohibited activity.<sup>46</sup>

The rule also includes two affirmative defenses to the antifraud provisions in Rules 9j-1(a)(1) through (a)(5) in response to concerns raised during the 2010 rulemaking process.<sup>47</sup> The first defense is available, under Rule 9j-1(e)(1), where the action was taken pursuant to binding rights and obligations in written security-based swap documentation, so long as the security-based swap transaction occurred before the person became aware of the material nonpublic information, and the person acted in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 9j-1.<sup>48</sup> The second defense is available, under Rule 9j-1(e)(2), to entities that demonstrate that the investment decision-maker was not aware of material nonpublic information and that the entity had reasonable policies and procedures in place to prevent violations of subsections (a)(1) through (5).<sup>49</sup> The affirmative defenses do not apply to the prohibition on market manipulation contained in subsection (a)(6).<sup>50</sup> By explicitly providing these affirmative defenses, the SEC has indicated that subsections (a)(1)

through (5) will apply to misconduct involving the possession of material nonpublic information.

#### E. LOOKING FORWARD: FUTURE INTERPRETATION AND ENFORCEMENT QUESTIONS

By prohibiting misconduct in connection with a wide range of activity beyond just buying and selling security-based swaps, Rule 9j-1 provides the SEC broad and sweeping new authority to regulate the security-based swap market. It remains to be seen how the SEC will exercise its prosecutorial discretion in determining whether to bring enforcement actions in the security-based swap space, particularly in regard to the rules that permit the SEC to bring enforcement actions for negligent and attempted conduct. And, with regard to the price manipulation that was specifically designed to address certain manufactured credit events in the credit default swap market, the SEC may have to contend with a judiciary that has placed significant limitations on manipulation cases. However, because many of the provisions were modeled after prior rules, including SEC Rule 10b-5 and CFTC Rule 180.2, prior enforcement actions and judicial decisions in those areas may provide the industry initial guidance as to how the security-based swap rules will be interpreted and applied.

#### III. RULE 15FH-4(C): PREVENTING UNDUE INFLUENCE OVER SBS ENTITIES' CCOS

The second rule adopted by the SEC, Rule 15fh-4(c), “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 their duties under the Federal securities laws or the rules and regulations thereunder."<sup>51</sup>

The new CCO rule is aimed at protecting the independence and objectivity of CCOs by preventing coercion, misleading acts and other interference with CCOs by other SBS personnel.<sup>52</sup> The broad rule covers, among other actions, attempts by officers, directors or other employees to hide transactions, submit false valuations or otherwise manipulate the CCO.<sup>53</sup> Liability under Rule 15fh-4(c) will not require a showing of scienter or materiality, which the SEC stated it believed would promote market integrity and encourage directors, officers and others to exercise reasonable attention and care when dealing with CCOs.<sup>54</sup>

Notably, by adopting a rule prohibiting improper coercion, the SEC has charted a different path from the CFTC, which determined that such a rule was not necessary with respect to CCOs of futures commission merchants, swap dealers and major swap participants.<sup>55</sup>

#### ENDNOTES:

<sup>1</sup> Final Rule, Prohibition Against Fraud, Manipulation, or Deception in Connection With Security-Based Swaps; Prohibition Against Undue Influence Over Chief Compliance Officers, 88 Fed. Reg. 42546 (June 30, 2023) (to be codified at 17 C.F.R. pt. 240) [hereinafter "Final Rule"].

<sup>2</sup>Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 761-774, 124 Stat. 1376, 1754-1802 (2010).

<sup>3</sup>15 U.S.C.A. § 78c(a)(10).

<sup>4</sup>15 U.S.C.A. § 77b(a)(1). The Dodd-Frank Act also amended the definition of "purchase" and "sale" in Section 2(a)(18) of the Securities Act, 15 U.S.C.A. § 77b(a)(18), the definitions of "buy" and "purchase" in Section 3(a)(13) of the Exchange Act, 15 U.S.C.A. § 78c(a)(13) and "sale" and "sell" in Section 3(a)(14) of the Exchange Act, 15 U.S.C.A. § 78c(a)(14), to include the execution, termination (prior to its scheduled maturity date), assignment, exchange, transfer or conveyance of, or extinguishing of rights or obligations of a security-based swap.

<sup>5</sup>15 U.S.C.A. § 78j(b).

<sup>6</sup>15 U.S.C.A. § 77q(a).

<sup>7</sup>15 U.S.C.A. § 78i(j) (Regulations relating to security-based swaps).

<sup>8</sup>*Id.*

<sup>9</sup>Proposed Rule, Prohibition Against Fraud, Manipulation, and Deception in Connection With Security-Based Swaps, 75 Fed. Reg. 68560, 68561-62 (Nov. 8, 2010) (to be codified at 17 C.F.R. pt. 240).

<sup>10</sup>Proposed Rule, Prohibition Against Fraud, Manipulation, or Deception in Connection With Security-Based Swaps; Prohibition Against Undue Influence Over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions, 87 Fed. Reg. 6652, 6655-56 (Feb. 4, 2022) (to be codified at 17 C.F.R. pt. 240) [hereinafter "Proposed Rule"].

<sup>11</sup>U.S. Sec. & Exch. Comm'n, Statement of Comm'r Allison Herren Lee, *Standing Up the Security-Based Swap Regime: Statement on Proposed Rules for Antifraud, Position Reporting and CCO Support* (Dec. 15, 2021), <https://www.sec.gov/news/statement/lee-statement-proposed-rules-antifraud-position-reporting-and-cco-support-121521>.

<sup>12</sup>Proposed Rule, *supra* note 10, 87 Fed. Reg. at 6655-56.

<sup>13</sup>*Id.* at 6655.

<sup>14</sup>*Id.*

<sup>15</sup>*Id.* at 6656

<sup>16</sup>Final Rule, *supra* note 1, 88 Fed. Reg. at

42546 & 42548.

<sup>17</sup>*Id.* at 42552.

<sup>18</sup>17 C.F.R. § 240.9j-1(a).

<sup>19</sup>*S.E.C. v. Zandford*, 535 U.S. 813, 819-20, 122 S. Ct. 1899, 153 L. Ed. 2d 1, Fed. Sec. L. Rep. (CCH) P 91795 (2002).

<sup>20</sup>*U.S. v. O'Hagan*, 521 U.S. 642, 656, 117 S. Ct. 2199, 138 L. Ed. 2d 724, Fed. Sec. L. Rep. (CCH) P 99482, 191 A.L.R. Fed. 747 (1997).

<sup>21</sup>Final Rule, *supra* note 1, 88 Fed. Reg. at 42553.

<sup>22</sup>*Id.* at 42553-54.

<sup>23</sup>*Id.* at 42554.

<sup>24</sup>*Id.* at 42555.

<sup>25</sup>*Id.* at 42556.

<sup>26</sup>*Id.*

<sup>27</sup>*Aaron v. Securities and Exchange Commission*, 446 U.S. 680, 100 S. Ct. 1945, 64 L. Ed. 2d 611, Fed. Sec. L. Rep. (CCH) P 97511 (1980).

<sup>28</sup>Final Rule, *supra* note 1, 88 Fed. Reg. at 42556-57 & n.135 (quoting *Aaron*, 446 U.S. at 696).

<sup>29</sup>*Id.* at 42557-58

<sup>30</sup>*Id.*

<sup>31</sup>*Id.* at 42560.

<sup>32</sup>*Id.* at 42559.

<sup>33</sup>*See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197, 96 S. Ct. 1375, 47 L. Ed. 2d 668, Fed. Sec. L. Rep. (CCH) P 95479 (1976).

<sup>34</sup>Final Rule, *supra* note 1, 88 Fed. Reg. at 42560.

<sup>35</sup>*Id.*

<sup>36</sup>*Id.* at 42561.

<sup>37</sup>*Id.*

<sup>38</sup>*Id.*

<sup>39</sup>*Ernest & Ernest*, 425 U.S. at 199.

<sup>40</sup>*Set Capital LLC v. Credit Suisse Group AG*, 996 F.3d 64, Fed. Sec. L. Rep. (CCH) P 101097 (2d Cir. 2021).

<sup>41</sup>*Id.* at 76-77 (internal quotation marks and citations omitted).

<sup>42</sup>*GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, Fed. Sec. L. Rep. (CCH) P 91634 (3d Cir. 2001).

<sup>43</sup>*Id.* at 205.

<sup>44</sup>Final Rule, *supra* note 1, 88 Fed. Reg. at 42563.

<sup>45</sup>*Id.*

<sup>46</sup>*Id.*

<sup>47</sup>*Id.* at 42564.

<sup>48</sup>*Id.* at 42566.

<sup>49</sup>*Id.* at 42566-67.

<sup>50</sup>*Id.* at 42564.

<sup>51</sup>*Id.* at 42551.

<sup>52</sup>*Id.* at 42568.

<sup>53</sup>*Id.* at 42569.

<sup>54</sup>*Id.*

<sup>55</sup>Final Rule, Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 Fed. Reg. 20128, 20160 (Apr. 3, 2012) (to be codified at 17 C.F.R. pts. 1, 3 & 23) (“[T]he Commission believes that a provision prohibiting improper coercion is unnecessary because [17 C.F.R. § 3.3(a)(1)-(2)] adequately ensures CCO independence through a direct reporting line to the board or senior officer and by requiring compensation decisions to be made by the board or a senior officer.”).