

SEC Adopts Rules to Prohibit Fraud in Security-Based Swaps and Exertion of Undue Influence over SBS CCOs, and Reopens Comment Period for Large SBS Position Reporting

June 29, 2023

On June 7, 2023, the U.S. Securities and Exchange Commission (the “SEC”) adopted new Rules 9j-1 and 15fh-4(c) under the Securities Exchange Act of 1934 (the “Exchange Act”). Rule 9j-1 aims to prevent fraud, manipulation and deception connected with security-based swap (“SBS”) transactions. In adopting the rule, the SEC emphasized the size of the market (gross notional value of \$8.5 trillion as of year-end 2022) and that the “particular aspects and characteristics of security-based swaps provide opportunities and incentives for misconduct,”¹ and called Rule 9j-1 an “important additional tool”² to strengthen the SEC’s oversight of SBS transactions and pursuit of fraud and misconduct in this market. Rule 9j-1:

- makes it unlawful for any person, directly or indirectly, to effect any transaction in, or attempt to effect any transaction in, any SBS, or to purchase or sell, or induce or attempt to induce the purchase or sale of any SBS in connection with:
 - employing or attempting to employ any device, scheme or artifice to defraud or manipulate;
 - making or attempting to make misstatements of material fact or omitting material facts;
 - obtaining or attempting to obtain money or property by means of a material misstatement or omission of fact;
 - engaging or attempting to engage in any act, practice, or course of business that operates or would operate as a fraud or deceit on any person; and
 - manipulating or attempting to manipulate the price or valuation of any SBS.

¹ *Fact Sheet: Final Rules: SBS Fraud & Manipulation; CCO Independence*, U.S. Securities and Exchange Commission (June 7, 2023).

² *Id.*

Rule 9j-1 also establishes affirmative defenses (a) for actions taken in accordance with binding rights and obligations in written SBS documentation and (b) for transactions by entities, when the individual making the investment decision was unaware of material nonpublic information (“MNPI”) and the entity had reasonable policies and procedures to prevent violations of the rule.

Rule 15fh-4(c) prohibits any officer, director, employee or supervised person of an SBS entity (or any person acting under such person’s direction) from taking any action to coerce, manipulate, mislead or fraudulently influence the Chief Compliance Officer of an SBS dealer in the performance of their duties under the federal securities laws.

The key provisions of Rule 9j-1 are discussed below. The full text of the rules is available [here](#). The rules will become effective on August 6, 2023.

Background

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) amends the Exchange Act to provide the SEC with regulatory jurisdiction over SBS, and directs the SEC to promulgate rules to regulate SBS, including in Section 9(j) of the Act, which directs the SEC to adopt antifraud rules.³ In November 2010, the SEC first sought to effectuate this mandate, proposing Rule 9j-1. The proposed rule did not proceed to finalization at that time, however. In December 2021, the SEC re-proposed Rule 9j-1, along with Rule 15fh-4(c) and Rule 10B-1, which would require reporting of large SBS positions.

On June 7, 2023, the SEC adopted the final version of Rule 9j-1 and Rule 15fh-4(c). Although the SEC did not adopt a final Rule 10B-1 at that time, it recently reopened the comment period on this proposed rule,⁴ and the SEC’s Division of Economic and Risk

³ Section 9(j) of the Exchange Act makes 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 shall operate as a fraud of deceit upon any person.” Additionally, it provides that the SEC “shall...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.” See 15 U.S.C. § 78i(j).

⁴ Press Release, *SEC Reopens Comment Period for Position Reporting of Large Security-Based Swap Positions*, U.S. Securities and Exchange Commission (June 20, 2023), https://www.sec.gov/news/press-release/2023-113?utm_medium=email&utm_source=govdelivery.

Analysis simultaneously issued a memorandum providing supplemental data analysis for the proposed reporting thresholds in the equity SBS market.⁵

Rule 9j-1(a)'s Components

Rule 9j-1(a) establishes that it is unlawful for anyone, directly or indirectly, to effect any transaction in, or attempt to effect any transaction in, any SBS, or to purchase, sell, or induce or attempt to induce the purchase or sale of any SBS in connection with several types of fraudulent or misleading conduct outlined in six provisions:

- Paragraph (a)(1) is based on the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and on Section 17(a)(1) of the Securities Act of 1933 (the “Securities Act”), and also incorporates the term “manipulate” from the text of Section 9(j). It provides that it is unlawful to employ or attempt to employ any device, scheme or artifice to defraud or manipulate in connection with an SBS transaction. Paragraph (a)(2), which was drafted to parallel Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, provides that it is unlawful to make or attempt to make an untrue statement of material fact or omit to state a material fact during an SBS transaction. Because they were drafted to parallel the scienter-based antifraud provisions of the federal securities laws, paragraphs (a)(1) and (a)(2) have a scienter requirement.
- Paragraphs (a)(3) and (a)(4), by contrast, are based on Sections 17(a)(2) and 17(a)(3) of the Securities Act (and parallel provisions from Section 9(j)), and accordingly do not have a scienter requirement but rather address negligent conduct. Paragraph (a)(3) provides that it is unlawful to obtain money or property by means of any untrue statement of material fact or omission to state a material fact necessary to make the statements not misleading, and paragraph (a)(4) prohibits any act, practice or course of business that would operate as a fraud or deceit.
- Paragraph (a)(5) contains a new stand-alone scienter-based provision under which it is unlawful to attempt to obtain money or property by means of a material misstatement or omission or to attempt to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. While proposed Rule 9j-1(a) had embedded attempt into negligence-based paragraphs (a)(3) and (a)(4), the final rule separates attempt into its own prong, reflecting concerns from commenters who observed that the analogous provisions

⁵ Memorandum of the Staff of the Division of Economic and Risk Analysis, *Supplemental Data and Analysis Regarding the Proposed Reporting Thresholds in the Equity Security-Based Swap Market* (June 20, 2023), <https://www.sec.gov/comments/s7-32-10/s73210-207819-419422.pdf>.

of Sections 17(a)(2) and 17(a)(3) of the Securities Act (the analogues to Rules 9j-1(a)(3) and (a)(4)) do not prohibit “attempts” and that the SEC should accordingly eliminate references to attempts or clarify the standard required for liability.⁶ While the SEC disagreed with the assessment of certain commenters that the proposed rule would chill legitimate business activity, it agreed that scienter was the proper standard for attempted conduct and separated this provision into its own section.

- Paragraph (a)(6) is a price manipulation provision based on CFTC Rule 180.2⁷ that makes it unlawful to manipulate or attempt to manipulate the price or valuation of any SBS (or any payment or delivery thereto). This provision also requires scienter.

The most notable change from the proposed rule to the final rule is that proposed Rule 9j-1(a) imposed liability on interim performance obligations under SBS contracts (such as ongoing payments and deliveries occurring throughout the life cycle of an SBS), which triggered significant concern in the notice and comment process.⁸ Acknowledging these concerns, the SEC narrowed the final rule to carve out interim performance obligations from covered conduct and to apply only to conduct “in connection with” the purchase or sale of an SBS.⁹

That said, the final rule sweeps in a considerable range of conduct involving SBS transactions. The SEC noted that, consistent with the long-standing interpretation of these terms under the federal securities laws, the concepts of “in connection with,” “purchase” and “sale” likewise are very broad under Rule 9j-1(a) and would also encompass “partial” conduct within those definitions.¹⁰ Accordingly, the final rule provides that the “purchase or sale” of any SBS includes, but is 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 any rights or obligations under, a security-based swap, depending on the context,¹¹ including “ongoing payments or deliveries under a security-based swap if that misconduct occurs in connection with any activity that falls within those broad definitions”¹² of purchase or sale. The SEC further observed that Rule 9j-1(a) covers misconduct “in connection with effecting an [SBS] transaction,” which has “a broader meaning than purchases or

⁶ Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition against Undue Influence over Chief Compliance Officers, Exchange Act Release No. 34-97656, at 47-48 (June 7, 2023).

⁷ 17 CFR § 180.2.

⁸ See Exchange Act Release No. 34-97656, at 26.

⁹ *Id.* at 24-26.

¹⁰ *Id.* at 28-29.

¹¹ 17 CFR § 240.9j-1(a).

¹² Exchange Act Release No. 34-97656, at 29.

sales” and can include activity such as placing bids or orders and clearing and settling a transaction.¹³

End-Run Provisions

Rule 9j-1(b) provides that a person cannot avoid liability for trading while in possession of MNPI about a security by purchasing or selling an SBS. Rule 9j-1(c) provides that, whenever conduct would violate or result in liability under Rule 9j-1(a), that same conduct undertaken by an SBS counterparty in the underlying security, loan or group or index of securities on which an SBS is based would also violate Rule 9j-1(a).¹⁴ This provision “prevents a person from escaping liability” with respect to an SBS “by limiting all of its actions to purchases or sales of the security, loan or narrow-based security index underlying that security-based swap.”¹⁵

Affirmative Defenses

While proposed Rule 9j-1 included two limited safe harbors, the final rule contains two affirmative defenses similar to Rule 10b5-1’s affirmative defenses involving MNPI. Commenters observed that SBS market participants maintain information barriers to meet the requirements of Rule 10b5-1(c)(2) and that the absence of an affirmative defense analogous to Rule 10b5-1’s affirmative defenses for SBS transactions would create significant confusion and regulatory uncertainty (because identical conduct involving an SBS transaction could implicate both Rule 10b-5 and Rule 9j-1, but an affirmative defense would only be available under Rule 10b-5).¹⁶

The SEC agreed with commenters that affirmative defenses addressing MNPI would “address concerns regarding market disruption” but did not adopt affirmative defenses as broad as those in Rule 10b5-1(c)(1). The affirmative defenses apply to provisions (a)(1) through (a)(5), but not to the anti-manipulation provisions of (a)(6):

- Rule 9j-1(e)(1) provides an affirmative defense for actions taken in accordance with written binding contractual rights and obligations under an SBS, so long as the SBS was entered into (or the amendment was made) before the person became aware of

¹³ *Id.* at 33 (internal quotation marks and citations omitted).

¹⁴ *See id.* at 63.

¹⁵ *Id.* at 64.

¹⁶ *See id.* at 67-68.

MNPI and the SBS was entered into in good faith and not as part of a plan or scheme to avoid liability under Rule 9j-1(a)(1) through (a)(5).

- Rule 9j-1(e)(2) provides that a person other than a natural person demonstrates that the individual making the investment decision was not aware of the MNPI and the person had implemented reasonable policies and procedures (incorporating the nature of the person's business) to ensure that individuals making investment decisions would not violate Rule 9j-1(a)(1) through (a)(5).

Dissenting Statements

Commissioners Hester Peirce and Mark Uyeda issued dissenting statements on the adoption of Rules 9j-1 and 15fh-4(c), asserting that the final rule left open numerous interpretive questions.

While Commissioner Peirce acknowledged that the final rule was narrower and more specific than the proposed version, she argued that the final rule was “still overly broad,” observing that the affirmative defenses lacked “sufficient clarity,” that the negligence standard applicable to paragraphs (a)(3) and (a)(4) “may facilitate second-guessing in enforcement actions” and that the anti-manipulation provision was “overbroad.”¹⁷ She expressed concern that the SEC’s attempts to “preserve maximum flexibility” would “chill” legitimate trading strategies and exercise of rights under an SBS instead of “prevent[ing] truly manipulative activity.”¹⁸ She then listed several questions involving SBS trading scenarios for which she said the rule did not provide sufficient clarity.

Commissioner Uyeda expressed concerns that the rule did not address the “special features of various types of security-based swaps,”¹⁹ and that the SEC’s repeated statement in the adopting release that violations would turn on the “facts and circumstances” of each matter failed to provide sufficient clarity and guidance to market participants about the boundary between permissible and prohibited conduct.²⁰ He also said that the adopting release failed to clarify which conduct was covered by existing

¹⁷ Commissioner Hester M. Peirce, Flexibility at the Expense of Clarity: Statement on Adoption of Exchange Act Rules 9j-1 and 15fh-4(c) (June 7, 2023).

¹⁸ *Id.*

¹⁹ Commissioner Mark Uyeda, Statement on Rules Regarding Prohibitions Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps and Against Undue Influence over Chief Compliance Officers (June 7, 2023).

²⁰ *Id.*

antifraud and anti-manipulation provisions and which conduct was newly subject to liability.²¹

Takeaways

Rule 9j-1 builds upon the SEC's SBS registration and transaction reporting framework to provide the SEC with a significant new basis for examination and enforcement activity involving SBS transactions. The rule will undoubtedly sharpen the focus of the [Division of Examination's Security-Based Swaps Joint Venture with the Division of Trading and Markets](#), and provides the Division of Enforcement with a new tool to investigate and charge cases involving complex financial market transactions.

As observed in the dissents of Commissioners Peirce and Uyeda, substantial ambiguity unfortunately persists in the full scope of conduct covered by the rule. The adopting release does not contain examples of violative conduct and, as Commissioner Uyeda noted, the SEC has repeatedly stated that potential violations of Rule 9j-1 will turn on the "facts and circumstances" of each situation.²² Accordingly, the Divisions of Examinations and Enforcement will likely shape the contours of the rule through exam deficiencies and enforcement actions, and their opening salvo will likely be conduct that squarely falls within the rule's scienter-based provisions.

In order to rely on the rule's affirmative defenses, firms may wish to review their information barriers and policies and procedures for safeguarding MNPI to ensure their applicability to SBS transactions. Firms may also wish to consider training business and compliance professionals on the new antifraud provisions of Rule 15fh-4.

Finally, Chair Gary Gensler has stated that Rule 10B-1 remains a priority,²³ and the SEC has scheduled final action on these reporting rules by the end of the SEC's fiscal year.²⁴

We would be happy to discuss these new rules. Please do not hesitate to contact us with any questions.

²¹ See *id.*

²² See Exchange Act Release No. 34-97656.

²³ See Chair Gary Gensler, Statement on Rule 9j-1 and Rule 15fh-4(c) (June 7, 2023).

²⁴ OIRA RegInfo, Reporting of Security-Based Swap Positions, 87 Fed. Reg. 6652 (proposed Dec. 15, 2021) (to be codified at 17 CFR § 240.10B-1).

NEW YORK



Andrew J. Ceresney
aceresney@debevoise.com



Jeff Robins
jrobins@debevoise.com



Charu A. Chandrasekhar
cchandrasekhar@debevoise.com



Philip A. Fortino
pafortino@debevoise.com



Charlotte Blatt
cblatt@debevoise.com



Kristin A. Snyder
kasnyder@debevoise.com

SAN FRANCISCO

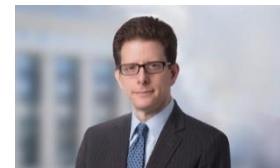
**SAN FRANCISCO /
WASHINGTON, D.C.**



Julie M. Riewe
jriewe@debevoise.com



Arian M. June
ajune@debevoise.com



Robert B. Kaplan
rbkaplan@debevoise.com

WASHINGTON, D.C.



Jonathan R. Tuttle
jrtuttle@debevoise.com



Stephan J. Schlegelmilch
sjschlegelmilch@debevoise.com