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SEC Proposes Rules Against Fraud, Manipulation and Deception in Connection with Security-based Swaps

On November 3, 2010, the Securities and Exchange Commission (the "SEC") proposed new Rule 9j-1 under the Securities Exchange Act of 1934 (the "Exchange Act"), which is intended to prohibit fraud, manipulation and deception in connection with security-based swaps. The proposed rule is issued as a result of the SEC's expanded anti-manipulation powers under new section 9(j) of the Exchange Act. Section 763(g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") added section 9(j) to the Exchange Act and specifically authorized the SEC to adopt rules to prevent fraudulent, deceptive or manipulative practices in connection with security-based swaps. Section 9(j) 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 operates as a fraud or deceit upon any person."

"Security-based swap" is defined in the Exchange Act as any agreement that is a "swap" (as defined in section 1a(47) 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 the value thereof), or the occurrence, nonoccurrence or extent of occurrence of an event relating to (and directly affecting the financial statements, financial condition, or financial obligations of) a single issuer of a security or the issuers of securities in a narrow-based security index.¹

Proposed Rule 9j-1

Pursuant to proposed Rule 9j-1², "[i]t shall be unlawful for any person, directly or indirectly, in connection with the offer, purchase or sale of any security-based swap, the exercise of any right or performance of any obligation under a security-based swap, or the avoidance of such exercise or performance:

- To employ any device, scheme, or artifice to defraud or manipulate;
- To knowingly or recklessly make any untrue statement of a material fact, or to knowingly or recklessly omit to state a material fact necessary in order to make the

¹ See section 3(a)(68) of the Exchange Act, section 761(a)(6) of the Dodd-Frank Act.

² See 17 C.F.R. § 240.9j-1 (2010).

statements made, in the light of the circumstances under which they were made, not misleading;

- 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
- To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.”

The Dodd-Frank Act amended the definition of “security” in the Exchange Act and the Securities Act of 1933, as amended (the “Securities Act”), to include “security-based swaps” for purposes of the federal securities laws.³ As a consequence, security-based swaps will be subject to the general antifraud and anti-manipulation provisions of the securities laws, most notably section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and section 17(a) of the Securities Act, once the Dodd-Frank Act becomes effective.⁴ However, due to structural differences between security-based swaps and most other securities, the SEC deemed it necessary to go beyond the reach of the current provisions and to explicitly outline the scope of the antifraud and anti-manipulation provisions of the Exchange Act as they relate to security-based swaps.

A key characteristic of most security-based swaps is the rights and obligations of the parties to the swap to make and receive periodic payments and/or deliveries throughout the life of the swap in accordance with its terms. Security-based swaps may provide for payment obligations based on the economic performance of an underlying reference asset (such as payments on account of dividends, interest and fees received by the total return payer, or appreciation/depreciation payments, in the case of a total return swap that is a security-based swap). Security-based swaps also generally provide for ongoing collateral transfer obligations by at least one of the parties to the swap to reflect any change in value of the underlying reference asset or in the financial condition of the issuer of the reference asset during the term of the swap. These periodic payment and delivery obligations occur after the purchase of (i.e. the entry into) the security-based swap but before the sale (i.e. the termination or expiration) of the security-based swap. In the view of the SEC, the existence of these ongoing rights and obligations “can present opportunities and incentives for fraudulent, deceptive, or manipulative conduct,” and parties may engage in misconduct in connection with security-based swaps (including with respect to the underlying reference assets) in order to “trigger,

³ See section 761(a)(2) of the Dodd-Frank Act, which amends section 3(a)(10) of the Exchange Act, and section 768(a)(1) of the Dodd-Frank Act, which amends section 2(a)(1) of the Securities Act.

⁴ The relevant provisions of the Dodd-Frank Act become effective on the later of July 16, 2011 or, if any provisions require rulemaking, not less than 60 days after publication of a final rule implementing such provision. See section 774 of the Dodd-Frank Act.

avoid, or affect the value of such ongoing payments or deliveries.”⁵ The new rule therefore is intended to clarify that any fraudulent or manipulative act or omission not only in connection with the purchase or sale of a security-based swap, but also in connection with the exercise of any right or performance of any obligation under a security-based swap, or the avoidance of such exercise or performance, falls under the ambit of the prohibition.

The proposed rule is broadly drafted and covers any deceptive or manipulative act “in connection with” a security-based swap. The rule prohibits fraud or manipulation when entering into or selling a security-based swap and is intended to cover insider trading in connection with security-based swaps. Notably, it also would prevent a person from making misleading statements directed at the underlying reference asset or the issuer of the reference asset in order to increase or decrease, create or avoid a payment, delivery or collateral posting obligation under a security-based swap or otherwise benefit from a change in its value.

Proposed Rule 9j-1 is drafted based on the language in existing Rule 10b-5(a) and (b). The stated intent and expectation of the SEC is that Rule 9j-1, in addition to explicitly reaching ongoing performance obligations under security-based swaps, therefore prohibits the same categories of misconduct as currently covered by the existing antifraud and anti-manipulation provisions of the securities laws. Related interpretative statements by the SEC and the pertinent body of case law are intended to apply equally to the new rule. Rule 9j-1 contains certain language that does not appear in Rule 10b-5, such as the words “to defraud or manipulate” in the first prong and the words “knowingly or recklessly” in the second prong. The language is intended to clarify that the prohibition of the Rule reaches manipulative behavior, and that the prohibited acts in the second prong, in contrast to the third prong of the rule, require scienter. The third prong of the rule extends to conduct that is at least negligent. The clarifications, however, are not intended to represent a departure from current law and are intended to be consistent with the prevailing interpretation of the related parts of Rule 10b-5.

Proposed Rule 9j-1 applies to “any person,” which would include security-based swap dealers, major security-based swap participants, broker-dealers, issuers, security-based swap counterparties, customers and others, including commercial end-users that are eligible for an exemption from mandatory clearing.

Conclusion

Security-based swaps, as securities, will be covered by the existing antifraud and anti-manipulation provisions of the securities laws once the Dodd-Frank Act takes effect. Rule 9j-1 would explicitly expand the prohibition of manipulative or deceptive behavior to cover ongoing payment and delivery obligations under security-based swaps, and to reach manipulative or deceptive behavior relating to underlying reference assets and issuers, if it is reasonably closely related to a security-based swap. By prohibiting conduct in connection with the exercise of rights or performance of ongoing obligations under security-based swaps, the SEC intends the proposed rule to prevent conduct that has the effect of distorting the price and

⁵ See *Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps*, Exchange Act Release No. 34-63,236, 75 Fed. Reg. 68,560 (Nov. 3, 2010) at 7-8.

value of security-based swaps, as well as the underlying reference assets and issuers. It remains to be seen if the proposed rule, once adopted, will have a chilling effect on legitimate market activities and performance under security-based swaps — out of a concern that such activities may be in violation of the expanded antifraud and anti-manipulation provisions under the securities laws.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. For questions or further information concerning the issues addressed in this memorandum, please contact Manuel S. Frey ((212) 373-3127), Raphael M. Russo ((212) 373-3309) or Ian J. Pohl ((212) 373-3638).

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