

## SEC Adopts Rules To Combat Fraud and Undue Influence in the Security-Based Swap Market

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On June 7, 2023, the Securities and Exchange Commission (“SEC”) adopted, pursuant to the Securities Exchange Act of 1934 (“Exchange Act”), (i) new Rule 9j-1 to combat fraud, manipulation, and deception in connection with security-based swap (“SBS”) transactions and (ii) new Rule 15Fh-4(c) to prohibit coercion, manipulation, and fraudulent influence of the chief compliance officer (“CCO”) of SBS dealers<sup>1</sup> and major SBS participants<sup>2</sup> (each, a “SBS Entity”).

### Background

Section 763(g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act expanded the anti-manipulation provisions of Section 9 of the Exchange Act to encompass purchases or sales of SBSs and requires the SEC to adopt rules to prevent fraud, manipulation, and deception in connection with SBSs. Specifically, Section 9(j) of the Exchange Act prohibits a broad range of fraudulent and deceptive behavior in connection with transactions involving SBSs. In the SEC release adopting Rules 9j-1 and 15Fh-4(c) (the “release”)<sup>3</sup>, the SEC stated that certain characteristics of SBSs generally provide market participants with opportunities and incentives for misconduct. Parties to an SBS may, for example, engage in misconduct both in connection with the SBS and in the reference underlying assets of the SBS to trigger, avoid, or affect the value of ongoing payments or deliveries under the SBS. Such misconduct, the SEC stated, could negatively affect not only the SBS counterparty (and counterparties to that counterparty) but also the reference underlying assets and investors in those assets. In December 2021, the SEC proposed new Rule 9j-1 to combat misconduct in relation to SBSs.<sup>4</sup>

In the same proposal, and in recognition that CCOs of SBS Entities play an important role in preventing fraud and manipulation by SBS Entities and their personnel, the SEC proposed new Rule 15Fh-4(c) to protect CCOs in furtherance of their duties to ensure their respective SBS Entities establish and maintain appropriate written policies and procedures designed to achieve compliance with the federal securities laws.

After considering comments, the SEC is adopting Rule 9j-1 largely as proposed and Rule 15Fh-4(c) as proposed.

### The Rules

#### Rule 9j-1

##### *Paragraph (a)*

Paragraph (a) makes it unlawful for a person to (i) effect or attempt to effect any transaction in any SBS or (ii) purchase or sell (or induce or attempt to induce the purchase or sale of) any SBS, in connection with which the person engages in the following activities (identified in paragraphs (a)(1) through (a)(6) of the rule):

- **Subparagraph (1):** Employing or attempting to employ any device, scheme, or artifice to defraud or manipulate.
- **Subparagraph (2):** Making or attempting to make any untrue statement of a material fact, or omitting to state a material fact necessary to make the statements made not misleading.
- **Subparagraph (3):** Obtaining money/property by means of any untrue statement of a material

<sup>1</sup> As the term is defined in 17 CFR 240.3a71-1.

<sup>2</sup> As the term is defined in 17 CFR 240.3a67-1.

<sup>3</sup> The text of the Release is available [here](#).

<sup>4</sup> The SEC had originally proposed a form of Rule 9j-1 in 2010 but never adopted the proposal.

fact or any omission to state a material fact necessary to make the statements made not misleading.

- **Subparagraph (4):** Engaging in any act/conduct that operates (or would operate) as a fraud or deceit upon a person.
- **Subparagraph (5):** Attempting to either (i) obtain money/property by means of any untrue statement of a material fact or omission to state a material fact necessary to make the statements made not misleading or (ii) engage in any act/conduct that operates (or would operate) as a fraud or deceit upon a person.
- **Subparagraph (6):** Manipulating or attempting to manipulate the price or valuation of any SBS or any payment or delivery related to the SBS.

#### *Paragraphs (b) and (c)*

Paragraph (b) provides that wherever communicating or trading a security (other than an SBS) while in possession of material nonpublic information ("MNPI") would violate the Exchange Act or Securities Act of 1933 or any rule or regulation thereunder, such conduct **in connection with a purchase or sale of an SBS** based on such security would also violate those laws. In other words, a person will not escape liability for trading on MNPI about a security by purchasing or selling an SBS based on that security rather than the security itself.

In the same vein, paragraph (c) provides that wherever taking any of the actions set forth in paragraph (a) of this new rule involving an SBS would violate Section 9(j) of the Exchange Act (generally prohibiting fraud and deception in relation to SBS transactions) or this new rule, such conduct **in connection with a purchase or sale of a security** on which such SBS is based would also violate that law or this new rule. In other words, a person whose actions violate this rule will not escape liability just because the person purchased/sold the security underlying the SBS rather than the SBS itself.

#### *Paragraph (e)*

Rule 9j-1 includes two affirmative defenses to liability.

The first defense (paragraph (e)(1)) provides that a person will not be liable under paragraphs (a) (1) through (a)(5) of this new rule solely for being aware of MNPI while taking actions in accordance with binding contractual rights and obligations under an SBS (as reflected in the SBS's written documentation). However, the person must demonstrate that the SBS was entered into (i) before the person became aware of such MNPI and (ii) in good faith (and not to evade the prohibitions of this rule).

The second defense (paragraph (e)(2)) provides a defense from liability under paragraphs (a)(1) through (a)(5) solely for being aware of MNPI for actions taken by a nonnatural person who demonstrates (i) the individual making the investment decision on behalf of the acting person was not aware of the MNPI and (ii) the person had implemented reasonable policies and procedures to ensure that individuals making investment decisions would not violate this new rule. Such policies and procedures may include those that (i) restrict effecting a transaction in or trading any security (including any SBS) about which the person has MNPI or (ii) prevent such individuals from becoming aware of such MNPI in the first place.

#### Rule 15Fh-4(c)

This rule makes it unlawful for any officer, director, supervised person, or employee of an SBS Entity, as well as persons acting under their direction, to coerce, manipulate, mislead, or fraudulently influence the SBS Entity's CCO in the performance of the CCO's duties under the federal securities laws. Per the release, this rule aims to protect the independence and objectivity of an SBS Entity's CCO by preventing other SBS Entity personnel from interfering with the CCO's various legal responsibilities.

#### **Our Thoughts**

The conduct for which persons may be held liable under paragraph (a) of new Rule 9j-1 is broad and, as the SEC recognizes, encompasses activities involving the exercise of a right or performance of an obligation under the SBS. The broad language appears to consider the complexity of SBSs in which counterparties have various contractual rights and obligations over the life of the instrument, which could extend for several years. The SEC indicates that paragraph (a) could, depending on the circumstances, encompass conduct that simply affects the payments and deliveries made pursuant to the terms of the SBS agreement. During the term of the SBS, there may come a time, for example, when a party challenges the determinations of a calculation agent under the SBS in relation to payment of margin amounts pursuant to the agreement. If there is evidence that the party's challenge is made in bad faith to delay contractually required margin payments, the challenge could arguably violate Rule 9j-1. Therefore, parties to an SBS will be well advised to appreciate that their conduct over the life of their position in the SBS and not just their conduct related to the initial purchase or ultimate sale of their SBS position could trigger liability.

Parties to an SBS should also appreciate the standards of conduct that will trigger liability under paragraph (a). While findings of misconduct under subparagraphs (1), (2), (5), and (6) require scienter, subparagraphs (3) and (4) do not require scienter,

and liability could occur from conduct that is at least negligent. This is noteworthy considering the broad language used in subparagraphs (3) and (4). Under those subparagraphs, deceptive behavior or materially misleading statements in connection with exercising rights or obligations under an SBS, even if only performed negligently, could potentially trigger liability.

Rule 9j-1's affirmative defenses are also noteworthy considering neither defense was included in the proposed version of the rule. The SEC indicates in the release that its decision to adopt these affirmative defenses under Rule 9j-1(a) for actions taken while aware of MNPI would be more consistent with Rule 10b5-1, applicable to trading securities generally. Though not identical to Rule 10b5-1's affirmative defenses, Rule 9j-1's affirmative defenses similarly apply when persons can demonstrate that MNPI was not a factor in their investment decision.

Moreover, though similarly structured, the Rule 9j-1(e)(1) affirmative defense differs from its Rule 10b5-1 counterpart (Rule 10b5-1(c)(1)) since it protects certain conduct taken pursuant to the comprehensive written documentation governing party rights and obligations over the life of the SBS, while Rule 10b5-1(c)(1) applies to advance planning of trading securities pursuant to certain binding contracts, trading execution instructions, or written trading plans. It should also be noted that Rule 9j-1's defenses do not protect conduct under subparagraph (a)(6) of the rule, regarding price manipulation.

### Next Steps

Final Rules 9j-1 and 15Fh-4(c) will both go into effect 60 days after publication in the Federal Register. Please contact one of the listed authors of this Client Alert or your regular Lowenstein Sandler contact if you have any questions regarding these rules.

## Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

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