Securities Regulation Daily Wrap Up, SWAPS—SEC adopts new rules on security-based-swap fraud and preventing interference with CCOs, (Jun. 7, 2023)

Securities Regulation Daily Wrap Up

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The new rules will help the Commission in its actions directly targeting misconduct related to security-based swaps.

The SEC has adopted two new rules affecting security-based swaps. New Exchange Act Rule 9j-1 is meant to prevent fraud, manipulation, and deception in connection with security-based swap transactions. New Rule 15fh-4(c) prohibits personnel of an SBS entity from coercing, misleading, or otherwise fraudulently influencing the SBS entity's Chief Compliance Officer. The rules will be effective 60 days after publication in the *Federal Register* (*Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition Against Undue Influence over Chief Compliance Officers*, Release No. 34-97656, June 7, 2023).

The adoption of these two rules fulfills a mandate set out by Congress in Section 763 of the Dodd-Frank Act. Section 763(g) requires the Commission to adopt rules to prevent fraud, deception and manipulation in connection with security-based swaps. Chair Gensler pointed out that these new rules mark the completion of 28 rules related to the SBS market since Dodd-Frank passed 13 years ago. This leaves the Commission with two outstanding rulemakings related to Dodd-Frank authorities regarding security-based swaps, one of which relates to swap execution facilities.

The other remaining Dodd-Frank rulemaking involves new Rule 10B-1. The original proposal containing the newly adopted rules also included proposed new Rule 10B-1 requiring any owner of a security-based swap position exceeding the threshold amount set by the rule to file a statement on EDGAR containing the information required by Schedule 10B. The final release states that the Commission is not yet finalizing Rule 10B-1 because comments are still coming in on it.

According to the Commission, the SBS market, which in late 2022 had a gross notional amount outstanding of approximately $8.5 trillion, provides opportunities and incentives for misconduct. "Any misconduct in the security-based swaps market not only harms direct counterparties but also can affect reference entities and investors in those reference entities," said Chair Gensler. "Given these markets' size, scale, and importance, it is critical that the Commission protect investors and market integrity through helping prevent fraud, manipulation, and deception relating to security-based swaps. Today's set of rules will do just that."

Swaps antifraud rule. New Exchange Act Rule 9j-1 prevents fraud, manipulation and deception in connection with SBS transactions. Specifically, the rule includes prohibitions on categories of misconduct prohibited by Exchange Action Section 10(b) and Rule 10b-5 and Securities Act Section 17(a) when effecting a transaction or purchasing or selling any SBS. The rule is designed to account for the fundamental features of security-based swaps and includes a provision prohibiting the manipulating or attempted manipulation of the price or valuation of any security-based swap or any related payment or delivery.

The rule also provides that a person cannot escape liability for insider trading by communicating about or making purchases or sales in the security-based swap (as opposed to the underlying security) or vice versa: liability cannot be avoided by purchasing the underlying security in connection with a fraudulent scheme involving an SBS.

Rule 9j-1 also provides two affirmative defenses from liability: (1) if an otherwise prohibited action is taken in good faith in accordance with binding rights and obligations in written security-based swap documentation and

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the swap was entered into before the person became aware of the material nonpublic information; and (2) if an entity demonstrates that the individual at the entity making the investment decision was not aware of material nonpublic information and the entity had implemented reasonable policies and procedures to prevent violations of the rule.

Commissioners Peirce and Uyeda, who voted against the rules, both took issue with the final Rule 9j-1. Commissioner Peirce said that the final rule did not address any of the concerns she raised about the proposed version. Among other concerns, Peirce said that the rule is overly broad and that the affirmative defenses do not provide market participants with sufficient clarity. Firms will have to guess what the Commission feels is relevant, she said.

Commissioner Uyeda remarked that the rule does not in fact sufficiently take into account the special features of security-based swaps. The release should have been, but was not, crystal clear about what Rule 9j-1 covers that is not already covered by the existing antifraud provisions. Uyeda noted that a violation of the rule depends on the "facts and circumstances," but there are not sufficient specifics about what a fraudulent act is in the SBS context.

Compliance officers. New Exchange Act Rule 15fh-4(c) will prohibit any SBS personnel from taking any action to manipulate or otherwise interfere with the SBS entity's CCO in the performance of their duties. While recognizing that the ultimate responsibility for compliance rests with the SBD entity itself, this rule highlights the important role CCOs play in preventing fraud and manipulation by SBS entities and their personnel. While commenters argued that certain ambiguities in the scope of the rule could have a chilling effect on communications between the CCO and SBS personnel, the Commission declined to make any revisions in the proposed rule, stating that the rule must be broad enough to apply to any actions that might undermine the independence and responsibilities of the CCO.

The release is No. 34-97656.

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