SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-63236; File No. S7-32-10]

RIN 3235- AK77

Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is proposing for comment a new rule under the Securities Exchange Act of 1934 ("Exchange Act") that is intended to prevent fraud, manipulation, and deception 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.

DATES: Comments should be received on or before [insert date 45 days after publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-32-10 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

All submissions should refer to File Number S7-32-10**.** This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Josephine Tao, Assistant Director, Elizabeth Sandoe, Senior Special Counsel, or Joan Collopy, Special Counsel, Office of Trading Practices and Processing, Division of Trading and Markets, at (202) 551-5720, at the Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed Rule 9j-1 under the Exchange Act.

I. Introduction

The Commission is proposing Exchange Act Rule 9j-1, which is intended to prohibit fraud, manipulation, and deception in connection with the offer, purchase or sale of any security-based swap, as well as in connection with the exercise of any right or performance of any obligation under a security-based swap, including the avoidance of such exercise or performance. Section 761(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-

Frank Act")[1] adds new Section 3(a)(68) of the Exchange Act to define a "security-based swap" as any agreement, contract, or transaction that is a swap, as defined in Section 1(a) of the Commodity Exchange Act,[2] that is based on a narrow-based security index, or a single security or loan, or any interest therein or on the value thereof, or the occurrence or non-occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer.[3]

Security-based swaps, as securities,[4] will be subject to the general antifraud and anti-manipulation provisions of the federal securities laws (e.g., Section 10(b) of the Exchange Act

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1 Pub. L. No. 111-203 (July 21, 2010).

2 7 U.S.C. 1a. Section 721(b) of the Dodd-Frank Act amends Section 1(a) of the Commodity Exchange Act to add paragraph (47) defining swap, subject to enumerated exceptions, as "any agreement, contract, or transaction: (i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind; (ii) that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence; (iii) that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level . . . including any agreement, contract, or transaction commonly known as (I) an interest rate swap; (II) a rate floor; (III) a rate cap; (IV) a rate collar; (V) a cross-currency rate swap; (VI) a basis swap; (VII) a currency swap; (VIII) a foreign exchange swap; (IX) a total return swap; (X) an equity index swap; (XI) an equity swap; (XII) a debt index swap; (XIII) a debt swap; (XIV) a credit spread; (XV) a credit default swap; (XVI) a credit swap; . . . (iv) that is an agreement, contract, or transaction that is, or in the future becomes commonly known to the trade as a swap… or (vi) that is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v)."

3 See Section 761(a)(6) of the Dodd-Frank Act. See also 15 U.S.C. 78c(a)(68).

4 See Section 761(a)(2) of the Dodd-Frank Act, which amends the definition of "security" in Section 3(a)(10) of the Exchange Act to include security-based swaps. See also Section 768(a)(1) of the Dodd-Frank Act, which amends the definition of "security" in Section 2(a)(1) of the Securities Act to include security-based swaps.

and Rule 10b-5 thereunder, and Section 17(a) of the Securities Act of 1933 ("Securities Act"))[5] once the relevant provisions of the Dodd-Frank Act take effect.[6] Most security-based swaps are characterized by ongoing payments or deliveries between the parties throughout the life of the security-based swap pursuant to their rights and obligations. Because such payments or deliveries occur after the purchase of a security-based swap but before the sale or termination of the security-based swap,[7] we believe a rule making explicit the liability of persons that engage in misconduct to trigger, avoid, or affect the value of such ongoing payments or deliveries is a measured and reasonable means to prevent fraud, manipulation, and deception in connection with security-based swaps.

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[5] Exchange Act Section 10(b) provides that "[i]t shall be unlawful for any person, directly or indirectly . . . (b) to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. 78j.

Rule 10b-5 under the Exchange Act provides that "[i]t shall be unlawful for any person, directly or indirectly . . . (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 CFR 240.10b-5.

Securities Act Section 17(a) provides that "[i]t shall be unlawful for any person in the offer or sale of securities . . . directly or indirectly – (1) to employ any device, scheme, or artifice to defraud, or (2) 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 are made, not misleading, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." 15 U.S.C. 77q(a).

[6] See Section 774 of the Dodd-Frank Act. Security-based swap agreements, as defined in Section 206B of the Gramm-Leach-Bliley Act, 15 U.S.C. 78c note, are currently subject to the general antifraud and anti-manipulation provisions of the federal securities laws (e.g., Section 10(b) of the Exchange Act and Rule 10b-5 thereunder).

[7] The Dodd-Frank Act amended the definitions of "purchase" or "sale" in the Securities Act and Exchange Act to include, in the context of security-based swaps, execution, termination, assignment, exchange, transfer, or extinguishment of rights. See Sections 761(a)(3) and (a)(4) of the Dodd-Frank Act (amending Sections 3(a)(13) and (a)(14) of the Exchange Act). See also Section 768(a)(3) of the Dodd-Frank Act (amending Section 2(a)(18) of the Securities Act). Therefore, misconduct in connection with these actions will also be prohibited under Exchange Act Section 10(b) and Rule 10b-5 thereunder, and Securities Act Section 17(a).

Proposed Rule 9j-1 would prohibit the same misconduct as Exchange Act Section 10(b) and Rule 10b-5 thereunder, and Securities Act Section 17(a), but would also explicitly reach misconduct that is in connection with the "exercise of any right or performance of any obligation under" a security-based swap. In other words, proposed Rule 9j-1 would apply to offers, purchases and sales of security-based swaps in the same way that the general antifraud provisions apply to all securities but would also explicitly apply to the cash flows, payments, deliveries, and other ongoing obligations and rights that are specific to security-based swaps.

II. Background

On July 21, 2010, the President signed into law the Dodd-Frank Act. Title VII of the Dodd-Frank Act, referred to as the Wall Street Transparency and Accountability Act of 2010, establishes a regulatory framework for the regulation of over-the-counter ("OTC") swaps market. Under this framework, in general, swaps are regulated primarily by the Commodity Futures Trading Commission ("CFTC"), and security-based swaps are regulated primarily by the Commission.

Section 763(g) of the Dodd-Frank Act expands the anti-manipulation provisions of Section 9 of the Exchange Act[8] and authorizes the Commission to adopt rules to prevent fraud, manipulation, and deception in connection with security-based swaps. Specifically, Section 763(g) adds new subparagraph (j) to Section 9 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

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[8] See Exchange Act Section 9, 15 U.S.C. 78i.

fictitious quotation, or engages in any transaction, practice, or course of business which operates as a fraud or deceit upon any person."[9]

Because Exchange Act Section 9(j) applies to "any person,"[10] it would encompass issuers, broker-dealers, security-based swap dealers,[11] major security-based swap participants,[12] persons associated with a security-based swap dealer or major security-based swap participant, security-based swap counterparties, and any customers, clients or other persons that use or employ or effect transactions in security-based swaps, including security-based swaps to hedge or mitigate commercial risk or exposure.[13] Section 763(g) does not include any specific

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[9] See Exchange Act Section 9(j), 15 U.S.C. 78i(j).

[10] Exchange Act Section 3(a)(9) defines "person" as "a natural person, company, government or, political subdivision, agency, or instrumentality of a government." 15 U.S.C. 78c(a)(9).

[11] Section 761 of the Dodd-Frank Act adds new definitions to Exchange Act Section 3(a). Subject to certain exceptions, Exchange Act Section 3(a)(71)(A) defines "security-based swap dealer" to mean any person who: (i) holds themself out as a dealer in security-based swaps; (ii) makes a market in security-based swaps; (iii) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps. 15 U.S.C. 78c(a)(71)(A).

[12] "Major security-based swap participant" is defined in Section 3(a)(67)(A) of the Exchange Act as any person: (i) who is not a security-based swap dealer; and (ii)(I) who maintains a substantial position in security-based swaps for any of the major security-based swap categories, as such categories are determined by the Commission, excluding both positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan; (II) whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (III) that is a financial entity that (aa) is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking regulator; and (bb) maintains a substantial position in outstanding security-based swaps in any major security-based swap category, as such categories are determined by the Commission. 15 U.S.C. 78c(a)(67)(A).

The terms "security-based swap dealer," "major security-based swap participant," as well as "security-based swap," and other terms will be the subject of joint rulemaking by the Commission and the CFTC. The Commission has issued an advance notice of proposed rulemaking seeking comment on the definitions of key terms relating to the regulation of swaps and security-based swaps. See Securities Exchange Act Release No. 62717 (Aug. 13, 2010), 75 FR 51429 (Aug. 20, 2010).

[13] In other words, in contrast to certain other provisions of Title VII of the Dodd-Frank Act, Section 763(g) does not make an exception for end-users.

exceptions. In addition, Exchange Act Section 9(j) directs the Commission to "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."[14]

III. Proposed Rule 9j-1

As noted above, unlike many other securities, a key characteristic of most security-based swaps is the obligation for and rights to ongoing payments or deliveries between the parties throughout the life of the security-based swap pursuant to the rights and obligations under the security-based swap. For example, a total return swap ("TRS") that is a security-based swap may obligate one of the parties (i.e., the total return payer) to transfer the total economic performance (e.g., income from interest and fees, gains or losses from market movements, and credit losses) of a reference asset (e.g., a debt security) (the "reference underlying"),[15] in exchange for a specified or fixed or floating cash flow (including payments for any principal losses on the reference asset) from the other party (i.e., the total return receiver). This stream of payments, deliveries, or other ongoing obligations or rights between parties to a security-based swap can pose significant risk if, for example, the reference underlying of such security-based swap declines in value or the economic condition of the issuer changes (e.g., defaults or goes into bankruptcy).

The exercise of rights or performance of obligations under a security-based swap can present opportunities and incentives for fraudulent, deceptive, or manipulative conduct. Parties

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[14] See supra note 9.

[15] As used in this release, the term "reference underlying" of a security-based swap would include any reference asset underlying a security-based swap, including any security underlying a security-based swap, any deliverable obligation under the terms of a security-based swap, any reference obligation, or reference entity under a security-based swap. This could include, for example, securities, instruments of indebtedness, indices, interest rates, quantitative measures, or other financial or economic interests underlying a security-based swap.

to a security-based swap may engage in misconduct in connection with the security-based swap (including in the reference underlying of such security-based swap)[16] to trigger, avoid, or affect the value of such ongoing payments or deliveries. For instance, a party faced with significant risk exposure may attempt to engage in manipulative or deceptive conduct that increases or decreases the value of payments or cash flow under a security-based swap relative to the value of the reference underlying, including the price or value of a deliverable obligation under a security-based swap. However, because such payments (and the avoidance of such payments) occur after the purchase of a security-based swap but before the sale or termination of the security-based swap, we believe a rule making explicit the illegality of misconduct in connection with such payments is appropriate.

Proposed Rule 9j-1 therefore prohibits the same categories of misconduct as Exchange Act Section 10(b) and Rule 10b-5 thereunder, and Securities Act Section 17(a)[17] in the context of security-based swaps, and explicitly reaches misconduct in connection with these ongoing payments or deliveries. In particular, proposed Rule 9j-1 would specify that it is 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: (a) to employ any device, scheme, or artifice to defraud or manipulate; (b) 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 statements made, in the light of the circumstances under which they were made, not misleading; (c) to obtain money or property by means of any untrue statement of a material fact

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[16] See id.

[17] See supra note 5.

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 (d) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.[18]

The language in paragraph (a) of the proposed rule, which is based on Rule 10b-5(a), differs from Rule 10b-5(a) in that it explicitly prohibits employing any device, scheme or artifice to defraud or manipulate. While the term 'manipulate' does not appear in the text of Rule 10b-5, Rule 10b-5 has been interpreted to reach manipulative activities. In light of that interpretation, we have added language to clarify that manipulation in connection with security-based swaps is unlawful. We do not anticipate or intend this clarification to represent a departure from the past interpretation or scope of Rule 10b-5(a). In addition, the language in paragraph (b) of the proposed rule, which is based on Rule 10b-5(b), differs from Rule 10b-5(b) in that it explicitly prohibits knowingly or recklessly making any untrue statement of a material fact, or knowingly or recklessly omitting 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. This is intended to make clear, consistent with Rule 10b-5 case law, that paragraph (b), in contrast to paragraph (c), would require scienter. We do not anticipate or intend this clarification to represent a departure from the past interpretation or scope of Rule 10b-5(b).

The proposed rule would prohibit a person from engaging in fraudulent and deceptive schemes in order to increase or decrease the price or value of a security-based swap, or disseminating false or misleading statements that affect or otherwise manipulate the price or value of the reference underlying of a security-based swap for the purpose of benefiting such

[18] Proposed Rule 9j-1.

person's position in the security-based swap. The proposed rule would also prevent, for example, disseminating false financial information or data in connection with the sale of a security-based swap or insider trading in a security-based swap.[19]

In addition, the proposed rule would explicitly prohibit misconduct that is in connection with the "exercise of any right or performance of any obligation under" a security-based swap. This would include, for example, misconduct that affects the market value of the security-based swap for purposes of posting collateral or making payments or deliveries under such security-based swap. Thus, the proposed rule would, among other things, prohibit fraudulent conduct (e.g., knowingly or recklessly making a false or misleading statement) in connection with a security-based swap that affects the value of such cash flow, payments, or deliveries, such as by triggering the obligation of a counterparty to make a large payment or to post additional collateral. It would also prohibit a person from taking fraudulent or manipulative action with respect to the reference underlying of the security-based swap that triggers the exercise of a right or performance of an obligation or affects the payments to be made.

The proposed rule also would explicitly prohibit misconduct that avoids the exercise of rights or the performance of obligations under the security-based swap. Thus, it would prohibit a person from making false or misleading statements in order to avoid having to make a large payment, post additional collateral, or perform another obligation under the security-based swap. It would also prohibit a person from taking fraudulent or manipulative action with respect to the reference underlying of the security-based swap that avoids triggering the exercise of a right or performance of an obligation or affects the payments to be made.

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[19] See also supra note 5.

Paragraphs (a) and (b) of proposed Rule 9j-1 are modeled after Exchange Act Section 10(b) and Rule 10b-5,[20] and Securities Act Section 17(a)(1),[21] and therefore would require scienter. In contrast, paragraphs (c) and (d) of the proposed rule would not require scienter like Sections 17(a)(2) and (a)(3) of the Securities Act[22] and Section 206(2) of the Investment Advisers Act of 1940 ("Advisers Act").[23] These paragraphs are proposed to prevent conduct that operates as a fraud, manipulation, or deception.

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[20] To state a claim under Exchange Act Section 10(b) and Rule 10b-5, the Commission must establish that the misstatements or omissions were made with scienter. See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). The Supreme Court has defined scienter as "a mental state embracing intent to deceive, manipulate or defraud." Id. Recklessness will generally satisfy the scienter requirement. See, e.g., Greebel v. FTP Software, Inc., 194 F.3d 185, 198 (1st Cir. 1999); SEC v. Environmental, Inc., 155 F.3d 107, 111 (2d Cir. 1998).

[21] Establishing violations of Securities Act Section 17(a)(1) requires a showing of scienter. See, e.g., Aaron v. SEC, 446 U.S. 680, 701-02 (1980). Scienter is the "mental state embracing intent to deceive, manipulate or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). The Fifth Circuit Court of Appeals has held that scienter is established by a showing that the defendants acted intentionally or with severe recklessness. See Broad v. Rockwell International Corp., 642 F.2d 929 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981).

[22] Actions pursuant to Securities Act Sections 17(a)(2) and 17(a)(3) do not require a showing of scienter. See, e.g., Aaron, 446 U.S. at 701-02. In Aaron, the Supreme Court sought to determine whether scienter was required in a Commission injunctive proceeding pursuant to the antifraud provisions of Exchange Act Section 10(b) and Securities Act Section 17(a). The Court examined the language of both sections and determined that scienter was required under Section 10(b) because the words "manipulative," "device," and "contrivance," which are used in the statute, evidenced a Congressional intent to proscribe only knowing or intentional misconduct. Similarly, the Court concluded that subsection (1) of Section 17(a) required proof of scienter because Congress used such words as "device," "scheme," and "artifice to defraud." Aaron, 446 U.S. at 696. In contrast, the Court concluded that the absence of such words under subsections (2) and (3) of Section 17(a) demonstrated that no scienter was required. Section 17(a)(2) prohibits any person from obtaining money or property "by means of any untrue statement of a material fact or omission to state a material fact," which the Court found to be "devoid of any suggestion whatsoever of a scienter requirement." Aaron, 446 U.S. at 696. Similarly, the Court found, in construing Section 17(a)(3), under which it is unlawful for any person "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit," that scienter was not required because it "quite plainly focuses upon the effect of particular conduct on members of the investing public, rather than upon the culpability of the person responsible." Aaron, 446 U.S. at 697.

[23] See, e.g., Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in "any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client." The Commission is not required to demonstrate that an adviser acted with scienter in order to prove a Section 206(2) violation. SEC v. Steadman, 967 F.2d 636, 643 (D.C. Cir. 1992) (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963)).

While both paragraphs (b) and (c) of the proposed rule would prohibit material misstatements and omissions,[24] they would address different levels of culpability. Paragraph (b) would apply when there is evidence of scienter (e.g., when a party to a security-based swap knowingly or recklessly makes a false statement even though it may not receive any money or property as a result). In contrast, paragraph (c) would extend to conduct that is at least negligent (e.g., when a party to a security-based swap knows or reasonably should know that a statement was false or misleading and directly or indirectly obtains money or property from such statement).

Because the proposed rule would apply to conduct "in connection with . . . a security-based swap" it would apply to fraud, manipulation, or deception involving the reference underlying[25] of such security-based swap to the extent that such misconduct is 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 (e.g., manipulative activity in the reference underlying that affects the price of the security-based swap, including misconduct in the reference underlying of a security-based swap that triggers, avoids, or affects the value of ongoing payments or other delivery obligations under such security-based swap).[26] Depending on the facts and circumstances, misconduct involving a

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[24] Consistent with Exchange Act Section 10(b), such misstatements and omissions must be material to be actionable. See, e.g., Basic v. Levinson, 485 U.S. 224, 233 (1988). Statements and omissions are material if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. See id. at 231-32; TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

[25] See supra note 15 (defining "reference underlying" of a security-based swap to include, for example, any reference asset, reference security, reference entity, or reference obligation underlying a security-based swap).

[26] See Superintendent of Insurance v. Bankers Life and Casualty Co., 404 U.S. 6, 12-13 (1971) (to satisfy the "in connection with" requirement, the fraud need only "touch" on the purchase or sale of a security). See also SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968) (en banc) (concluding that "Congress when it used the phrase "in connection with the purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities").

security that is also a reference underlying of any security-based swap may not necessarily be "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, and therefore a violation of Rule 9j-1. The Commission, in determining whether to bring an enforcement action under Rule 9j-1 for misconduct involving such a security, would consider the facts and circumstances associated with the misconduct, including, among other things, the extent to which the effect of the misconduct on one or more security-based swaps is foreseeable to the party engaging in the misconduct or the purpose or the interest of that party.

Consistent with Section 9(j) of the Exchange Act, the proposed rule would apply to "any person."[27] In addition, the proposed rule would also apply to misconduct "directly or indirectly" engaged in by such person (i.e., whether the person engages in the misconduct alone or through others).[28]

The Commission preliminarily believes that Proposed Rule 9j-1 is reasonably designed to prevent fraud and manipulation in transactions in security-based swaps and inducements to purchase or sell security-based swaps. Because fraud and manipulation that affect the value of the payments or deliveries pursuant to a security-based swap are likely to distort the price and market for such security-based swaps, they can undermine investor confidence in the integrity of the market for security-based swaps, as well as the market for the reference underlying of such security-based swap. The proposed rule is intended to parallel the general antifraud provisions applicable to all securities, while also explicitly addressing the characteristics of cash flows, payments, deliveries, and other obligations and rights that are specific to security-based swaps.

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[27] See text supra at notes 10-13.

[28] The terms "directly and indirectly" are intended to describe the level of involvement necessary to establish liability under the proposed rule. See also id.

By targeting misconduct that is specific to the ways in which security-based swaps are structured and used, the proposed rule should help to prevent such fraudulent and manipulative conduct – without interfering with or otherwise unduly inhibiting legitimate market or business activity.

While the proposed rule is modeled on existing securities laws prohibiting fraud, manipulation, and deception in connection with security-based swaps, it is not intended to limit or extend liability in connection with non-swap securities to "rights or obligations" that do not involve purchases or sales. In other words, the scope of the proposed rule is not intended to affect the application or interpretation of the other antifraud provisions under the federal securities laws.

Finally, as noted above, the Dodd-Frank Act included security-based swaps in the definition of "security" under the Securities Act and the Exchange Act.[29] Thus, once the relevant provisions of the Dodd-Frank Act take effect,[30] persons effecting transactions in, or engaged in acts, practices, and courses of business involving security-based swaps will be subject to the Commission's rules and regulations that define and proscribe acts and practices involving securities that are deemed manipulative, deceptive, fraudulent, or otherwise unlawful for purposes of the general antifraud and anti-manipulation provisions of the federal securities laws, including Exchange Act Section 10(b), Rule 10b-5 (and the prohibitions against insider trading), and Securities Act Section 17(a).[31]

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[29] See supra note 4 (defining "security" under the Securities Act and Exchange Act to include "security-based swaps").

[30] See supra note 6.

[31] See, e.g., Exchange Act Rules 10b-1 through 10b-21; 17 CFR 240.10-1 through 240.10b-21.

IV. Request for Comment

The Commission seeks comment generally on all aspects of proposed Rule 9j-1. We encourage commenters to present data on our proposals and any suggested alternative approaches.

In addition, we seek specific comment on the following:

Does the reference in the proposed rule to "in connection with the offer, purchase or sale of a 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" address the full scope of potentially fraudulent, manipulative, or deceptive conduct that pertains to security-based swaps? If not, how should the scope of these provisions be modified? Are there types of conduct not otherwise discussed above that should be addressed by the proposed rule? Commenters are invited to provide specific examples of such conduct.

Please discuss how and to what extent the proposed rule may affect issuers, broker-dealers, security-based swap dealers, major security-based swap participants, and other swap market participants. Are there other alternatives or additional, or different, approaches that the Commission should consider as means reasonably designed to prevent "such transactions, acts, practices, and courses of business as are fraudulent, deceptive, or manipulative"? In addition, are there specific practices that the Commission should explicitly restrict or permit as part of the proposed rule? Comments are invited regarding any prophylactic rules that would further enhance the integrity of the security-based swap markets.

Although much of the activity that would be prohibited by the proposed rule is already prohibited by the general antifraud and anti-manipulation provisions of the federal securities laws (e.g., Exchange Act Section 10(b) and Rule 10b-5 thereunder, and Securities Act Section

17(a)), to what extent, if any, would the proposed rule affect the nature of the security-based swap market in general, including the extent or nature of information shared between market participants? If so, in what ways and to what degree?

Are there any legitimate market activities that the proposed rule could have the effect of discouraging? Commenters are invited to provide specific examples of any such activities and any such potential effect.

Are there any specific issues with respect to the application of the proposed rule to fraudulent, manipulative, or deceptive activity involving security-based swaps (including the reference underlying of such security-based swaps) that are or will be effected on or through security-based swap execution facilities or national securities exchanges, or over-the-counter? Please explain.

To what extent are transactions in security-based swaps used as a functional or economic substitute or equivalent transaction for transactions or practices that are otherwise prohibited by the antifraud and anti-manipulation provisions of the Exchange Act? Should the proposed rule impose any restrictions on such transactions? Commenters are invited to provide specific examples.

What, if any, costs or burdens would be imposed by the proposed rule? Would the proposed rule create any costs associated with changes to business operations or supervisory practices or systems? How much would the proposed rule affect compliance costs for issuers, broker-dealers, security-based swap dealers, major security-based swap participants, and other swap market participants (e.g., personnel or procedural changes)? We seek comment on the costs of compliance that may arise.

V. General Request for Comment

The Commission seeks comment generally on all aspects of proposed Rule 9j-1. Commenters are requested to provide empirical data or economic studies to support their views and arguments related to proposed rule. In addition to the questions above, commenters are welcome to offer their views on any other matter raised by the proposed rule. With respect to any comments, we note that they are of greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and if accompanied by alternative suggestions to our proposal where appropriate.

VI. Paperwork Reduction Act

Proposed Rule 9j-1 does not contain a "collection of information" requirement within the meaning of the Paperwork Reduction Act of 1995.[32] An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

VII. Consideration of Costs and Benefits

The Commission is considering the costs and benefits of proposed Rule 9j-1. The Commission is sensitive to these costs and benefits, and encourages commenters to discuss any additional costs or benefits beyond those discussed here, as well as any reductions in costs. In particular, the Commission requests comment on the potential costs for any modification market participants' business operations or supervisory practices or systems, as well as any potential benefits resulting from the proposed rule for issuers, investors, broker-dealers, security-based swap dealers, major security-based swap participants, persons associated with a security-based swap dealer or a major security-based swap participant, other security-based swap industry

[32] 44 U.S.C. 3501 et seq.

professionals, regulators, and other market participants. The Commission also seeks comments on the accuracy of any of the benefits identified and also welcomes comments on any of the costs identified here. Finally, the Commission encourages commenters to identify, discuss, analyze, and supply relevant data, information, or statistics regarding any such costs or benefits.

A. Benefits

Proposed Rule 9j-1 would specify that it is 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: (a) to employ any device, scheme, or artifice to defraud or manipulate; (b) 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 statements made, in the light of the circumstances under which they were made, not misleading; (c) 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 (d) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.[33]

Thus, proposed Rule 9j-1 would prohibit the same misconduct as Exchange Act Section 10(b) and Rule 10b-5 thereunder, and Securities Act Section 17(a)[34] but would also explicitly reach misconduct that is in connection with the "exercise of any right or performance of any obligation under" a security-based swap. In other words, proposed Rule 9j-1 would apply to offers, purchases and sales of security-based swaps in the same way that the general antifraud

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[33] See Proposed Rule 9j-1.

[34] See supra note 5.

provisions apply to all securities but would also explicitly apply to the cash flows, payments, deliveries, and other ongoing obligations and rights that are specific to security-based swaps. This would include, for example, misconduct that affects the market value of the security-based swap for purposes of posting collateral or making payments or deliveries under a security-based swap. Thus, the proposed rule would, among other things, prohibit a person who is a party to a security-based swap from later engaging in fraudulent conduct (e.g., knowingly making a false or misleading statement) that affects the value of cash flow, payments, or deliveries, such as triggering the obligation of a counterparty to make a large payment or to post additional collateral.

By prohibiting fraud, manipulation, and deception in connection with the exercise of any rights or performance of any obligations under a security-based swap, including actions taken to avoid the triggering of such exercise or performance, the proposed rule would help to prevent such misconduct from distorting the price and market for such security-based swap, as well as for the reference underlying, and improperly interfering with the independent and proper functioning of the markets. We therefore believe that the proposed rule would benefit market participants and investors by promoting investor confidence in the integrity of the market for security-based swaps, as well as for the reference underlying[35] of such security-based swaps.

The proposed rule should prevent fraud, manipulation, and deception from causing prices of security-based swaps to deviate from their fundamental values. This would allow the Commission to guard against misconduct that improperly interferes with the independent and proper functioning of the markets and help to promote price efficiency, the integrity of the price discovery process, and fair dealing between market participants in connection with security-based swaps.

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[35] See supra note 15.

We solicit comment on any additional short-term and long-term benefits that could be realized with the proposed rule. Specifically, we solicit comment regarding benefits to the efficient operation of security-based swap markets, price efficiency, market integrity, and investor protection.

B. Costs

As an aid in evaluating costs and reductions in costs associated with proposed Rule 9j-1, the Commission requests the public's views and any supporting information.

By targeting misconduct that is specific to how security-based swaps are structured and used, the proposed rule is intended to be a measured and reasonable means to prevent fraudulent, deceptive, or manipulative acts or practices in connection with the exercise of any right or performance of any obligation under a security-based swap without interfering with or otherwise inhibiting legitimate market activity.

Because proposed Rule 9j-1 is intended to parallel the general antifraud provisions already applicable to all securities, while also explicitly addressing the characteristics of cash flows, payments, deliveries, and other obligations and rights that are specific to security-based swaps, we do not believe that the proposed rule would impose any significant costs on persons effecting transactions or otherwise trading in security-based swaps. As noted above, the Commission seeks comment on whether the proposed rule could discourage certain legitimate market activities because of concern that such activities might be viewed as a violation of the rule.

In addition, persons effecting transactions or otherwise trading in security-based swaps may incur costs associated with changes to business operations or supervisory practices or systems. However, we believe that, because most issuers, broker-dealers, security-based swap dealers, major security-based swap participants, and other swap market participants involved with security-based

swaps are already subject to the general antifraud and anti-manipulation provisions, much of these practices and systems would already be in place. Thus, we believe that any costs associated with the proposed rule for such changes (e.g., business or procedural changes) would be minimal.

The Commission believes that the proposed rule would not compromise investor protection. We seek data, however, supporting any potential costs associated with the proposed rule. In addition, we request specific comment on any changes to business operations or supervisory practices or systems that might be necessary to implement the proposed rule.

VIII. Consideration of Burden on Competition and Promotion of Efficiency, Competition and Capital Formation

Section 3(f) of the Exchange Act[36] requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act[37] requires the Commission, when making rules under the Exchange Act, to consider the impact of such rules on competition. Section 23(a)(2) also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Proposed Rule 9j-1 is intended to prevent fraud, manipulation, and deception 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. Proposed Rule 9j-1 would prohibit the same misconduct as Exchange Act

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[36] 15 U.S.C. 78c(f).

[37] 15 U.S.C. 78w(a)(2).

Section 10(b) and Rule 10b-5 thereunder, and Securities Act Section 17(a)[38] but would also explicitly reach misconduct that is in connection with the "exercise of any right or performance of any obligation under" a security-based swap. In other words, proposed Rule 9j-1 would apply to offers, purchases and sales of security-based swaps in the same way that the general antifraud provisions apply to all securities but would also explicitly apply to the cash flows, payments, deliveries, and other ongoing obligations and rights that are specific to security-based swaps.

By targeting specific misconduct that is specific to how security-based swaps are structured and used, the proposed rule is intended to be a measured and reasonable means to prevent misconduct that is "in connection with the exercise of any right or performance of any obligation under" a security-based swap without interfering with or otherwise unduly inhibiting legitimate market activity. Also, because the proposed rule would prohibit the same misconduct as Exchange Act Section 10(b) and Rule 10b-5 thereunder, and Securities Act Section 17(a),[39] except to explicitly reach misconduct that is "in connection with the exercise of any right or performance of any obligation under" a security-based swap, we believe that the proposed rule would not have an adverse effect on price efficiency. If the proposed rule mitigates fraudulent behavior, price efficiency should improve.

By prohibiting fraud, manipulation, and deception in connection with security-based swaps (including the exercise of any right or performance of any obligation under a security-based swap or the avoidance thereof), the proposed rule would help to prevent such conduct from distorting the market and artificially increasing or decreasing prices for security-based swaps.

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[38] See supra note 5.

[39] See id.

Thus, we believe the proposed rule would help to ensure price accuracy and fairness for the parties, which are elements of efficiency.

We also believe a rule highlighting the illegality of these activities would focus the attention of swap market participants on such activities and would reduce regulatory uncertainty for swap market participants and investors and would not impose significant costs on customers. We seek comment regarding whether proposed Rule 9j-1 may have any adverse effects on liquidity, market operations, or risks or costs to customers.

In addition, as discussed above, because the proposed rule would prohibit the same misconduct as Exchange Act Section 10(b) and Rule 10b-5 thereunder, and Securities Act Section 17(a),[40] except to explicitly reach misconduct that is "in connection with the exercise of any right or performance of any obligation (or the avoidance of such exercise or performance) under" a security-based swap, we believe that the proposed rule would have minimal impact on the promotion of capital formation. Fraudulent and manipulative conduct in connection with security-based swaps can undermine the confidence of investors, not only in the market for the security-based swaps but also in the market for the reference underlying of such security-based swaps. For the same reasons, the proposed rule should promote capital formation by discouraging misconduct in connection with the performance of security-based swaps that could otherwise undermine investor confidence or the ability of investors to make investment decisions that are congruent to their investment objectives.

Thus, we believe that the proposed rule would promote capital formation by helping to eliminate abuses in connection with security-based swaps. We seek specific comment and

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[40] See id.

empirical data, if available, on the potential impact of the proposed rule on capital formation, including whether the proposed rule would promote or inhibit capital formation, and if so, how.

In addition, the prohibitions of the proposed rule would apply uniformly to all persons (e.g., issuers, broker-dealers, security-based swap dealers, major security-based swap participants, and all other swap market participants and investors) effecting transactions or otherwise trading in security-based swaps and, therefore, should not impose a burden on competition. Also, the proposed rule would prohibit the same misconduct as Exchange Act 10(b) and Rule 10b-5 thereunder, and Securities Act Section 17(a),[41] except to explicitly reach misconduct that is in connection with the exercise of any rights or performance of any obligations under a security-based swap and, therefore, the proposed rule should not impose a burden on competition. By applying uniformly to all persons and by discouraging swap market participants from engaging in unfair fraudulent, manipulative, and deceptive conduct in connection with security-based swaps, we preliminarily do not believe that the proposed rule will pose a burden on competition and would also promote competition.

We request comment on whether the proposed rule would promote efficiency, competition, and capital formation or have an impact or burden on competition. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

IX. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[42] the Commission must advise the OMB as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it

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41 See id.

42 Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

results or is likely to result in: (1) an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review.

The Commission requests comment on the potential impact of proposed Rule 9j-1 on the economy on an annual basis, any potential increase in costs or prices for consumers or individual industries, and any potential effect on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

X. Regulatory Flexibility Certification

The Regulatory Flexibility Act ("RFA")[43] requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)[44] of the Administrative Procedure Act,[45] as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on "small entities."[46] Section 605(b) of the RFA states that this requirement shall not apply to any proposed rule or proposed rule amendment, which if adopted, would not have a significant economic impact on a substantial number of small entities.[47]

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43 5 U.S.C. 601 et seq.

44 5 U.S.C. 603(a).

45 5 U.S.C. 551 et seq.

46 Although Section 601(b) of the RFA defines the term "small entity," the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term small entity for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0-10, 17 CFR 240.0-10. See Securities Exchange Act Release No. 18451 (January 28, 1982), 47 FR 5215 (February 4, 1982) (File No. AS-305).

47 See 5 U.S.C. 605(b).

For purposes of Commission rulemaking in connection with the RFA, a small entity includes: (i) when used with reference to an "issuer" or a "person," other than an investment company, an "issuer" or "person" that, on the last day of its most recent fiscal year, had total assets of $5 million or less,[48] or (ii) a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act,[49] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[50] Under the standards adopted by the Small Business Administration, small entities in the finance and insurance industry include the following: (i) for entities in credit intermediation and related activities, entities with $175 million or less in assets or, for non-depository credit intermediation and certain other activities, $7 million or less in annual receipts; (ii) for entities in financial investments and related activities, entities with $7 million or less in annual receipts; (iii) for insurance carriers and entities in related activities, entities with $7 million or less in annual receipts; and (iv) for funds, trusts, and other financial vehicles, entities with $7 million or less in annual receipts.[51]

Based on the Commission's existing information about the security-based swap market, the Commission preliminarily believes that the security-based swap market, while broad in

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[48] See 17 CFR 240.0-10(a).

[49] See 17 CFR 240.17a-5(d).

[50] See 17 CFR 240.0-10(c).

[51] See 13 CFR 121.201 (Jan. 1, 2010).

scope, is largely dominated by entities such as those that would be covered by the "security-based swap dealer" and "major security-based swap market participant" definitions.[52] The Commission preliminarily believes that entities that will qualify as security-based swap dealers and major security-based swap market participants, whether registered broker-dealers or not, exceed the thresholds defining "small entities" set out above. Moreover, while it is possible that other parties may engage in security-based swap transactions, the Commission preliminarily does not believe that any such entities would be "small entities" as defined in Exchange Act Rule 0-10.[53] Feedback from industry participants about the security-based swap markets indicates that only persons or entities with assets significantly in excess of $5 million (or with annual receipts significantly in excess of $7 million) participate in the security-based swap market. Even to the extent that a handful of transactions did have a counterparty that was defined as a "small entity" under the Commission Rule 0-10, we believe it is unlikely that proposed Rule 9j-1 would have a significant economic impact on such entity, as the rule prohibits fraudulent and manipulative acts, activities which are in most cases already prohibited. Finally, because the proposed rule applies to any person, the proposed rule applies equally to large and small entities and therefore would not have a disproportionate impact on small entities. Therefore, the Commission preliminarily does not believe that proposed Rule 9j-1 will have an impact on "small entities" in terms of the prohibitions included in the proposed rule.

For the foregoing reasons, the Commission certifies that proposed Rule 9j-1 would not have a significant economic impact on a substantial number of small entities for purposes of the RFA. The Commission encourages written comments regarding this certification. The

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[52] See supra notes 11 and 12.

[53] See 17 CFR 240.0-10(a).

Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

XI. Statutory Authority

Pursuant to Exchange Act and, particularly, Sections 2, 3(b), 9(i), 9(j), 10, 15, 15F, and 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78i(i), 78i(j), 78j, 78o, 78o-8, and 78w(a), the Commission is proposing a new antifraud rule, Rule 9j-1, to address fraud, manipulation, and deception in connection with security-based swaps.

List of Subjects

17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

Text of the Proposed Rule

For the reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 is amended by adding an authority for §240.9j-1 to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78b, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78*l*, 78m, 78n, 78o, 78o-8, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

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Section 240.9j-1 is also issued under sec. 943, Pub. L. No. 111-203, 124 Stat. 1376.

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2. Add §240.9j-1 to read as follows:

§240.9j-1. Prohibition against fraud, manipulation, and deception in connection with security-based swaps.

It 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,

(a) To employ any device, scheme, or artifice to defraud or manipulate;

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

(c) 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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Dated: November 3, 2010