

## **Regulation and Compliance—Proposed Regulation of Security-Based Swaps**

The regulatory fallout from the financial crisis of 2007-2008 continues to mount. In November of this year, the Securities and Exchange Commission (SEC) issued proposed rules regarding security-based swaps. The proposed new rules are reflective of the SEC's enhanced rule-making and enforcement role under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). As indicated in an earlier edition of Cannon Insights:

*“The new law gives the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) increased power to regulate derivatives and swaps.”*

Dodd-Frank adds safeguards to the system by ensuring that dealers and major swap participants have adequate financial resources to meet their responsibilities. Regulators are armed with the authority to impose capital and margin requirements on swap dealers and major swap participants.

### **Background**

Swaps are financial derivatives used to either hedge risks or to profit from speculation. In the classic or “plain vanilla” swap, one party agrees to pay another a pre-determined, fixed rate of interest on an agreed-upon principal value on specific dates for a specified period of time. Concurrently, the other party agrees to make payments based on a floating interest rate on that same agreed-upon principal on the same specified dates for the same time period.

For example, let's say Company A owes bondholders a variable rate of interest, probably tied to the LIBOR rate, on some of its bonds. Company A seeks to protect itself (hedge against) an interest rate increase by entering into a swap with Company B whereby Company A pays Company B fixed interest on an agreed-upon principal amount and in return receives variable interest payments on the same principal amount. Company A has reduced its risk against rising interest rates in return for a fixed payment. Company B has locked in a fixed payment in the hope that interest rates remain level or decline.

Another type of swap is known as a credit-default swap (CDS). Credit-default swaps are financial instruments used as a hedge and protection for debt holders. Basically, Party A invests in a security with a variable return and the potential for loss due to default, and hedges its “bet”

by purchasing (for a fixed payment) a stream of variable payments from Party B and/or the obligation by Party B to reimburse Party A for loss due to degradation in the quality (or outright default) of its underlying security.

You may remember that CDSs were used by investment banks to protect themselves from loss in connection with their ownership of mortgage-backed securities (MBS) in the run-up to the 2007-2008 financial crisis. CDSs have been likened to insurance contracts because they insure the buyer against the risk of loss in return for its fixed payments, which resemble insurance premiums.

In the wake of the AIG and other bail-outs, concern was expressed that lack of transparency and disclosure in the over-the-counter markets in which swaps were traded contributed to the financial crisis. Dodd-Frank was enacted in part to address that concern.

Section 761(a) of the Act 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) while “security-based swaps” are regulated primarily by the Commission. Specifically, Section 763(g) of the Dodd-Frank Act expands the anti-manipulation provisions of Section 9 of the Securities Exchange Act and authorizes the SEC to adopt rules to prevent fraud, manipulation, and deception in connection with security-based swaps.

*The Dodd-Frank Act defines 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, 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.*

## Security-Based Swaps

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Like swaps, generally, security-based swaps are characterized by ongoing payments or deliveries between the parties throughout the life of the swap pursuant to their rights and obligations under the swap contract.

### What the SEC Proposes

Under the Dodd-Frank Act, security-based swaps will be subject to the general antifraud and anti-manipulation provisions of the federal securities laws (for example, Section 10(b) of the Exchange Act and Rule 10b–5 along with Section 17(a) of the Securities Act of 1933 (“Securities Act”).

However, because the exercise of rights or performance of obligations under a security-based swap presents opportunities and incentives for fraudulent, deceptive, or manipulative conduct, and because ongoing payments under the swap (and the avoidance of such payments) occur after the purchase of the swap but before its sale or termination, the SEC believes 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 necessary to prevent fraud, manipulation, and deception.

For example, according to the SEC, parties to a security-based swap may engage in misconduct in connection with a security-based swap (including in the assets underlying the swap) to trigger, avoid, or affect the value of the ongoing payments or deliveries. Thus, a party faced with significant risk exposure could be tempted 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.

Accordingly, Proposed Rule 9j–1 prohibits the same categories of misconduct relating to security-based swaps as the Exchange and the Securities Act, but then goes those provisions

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“one better” by explicitly reaching misconduct in connection with ongoing payments or deliveries under security-based swaps.

*“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 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.”*

## **Bottom Line**

Regulation of the financial services industry is now in full swing with the SEC busy promulgating new rules under Dodd-Frank. Look for a flurry of activity in the next few months.

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