



Financial Services & Products ADVISORY ■

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Opportunistic Credit Default Swap Strategies in the Crosshairs: SEC Finalizes Rule 9j-1

More than a decade after originally proposed, [SEC Rule 9j-1](#) will take effect on August 29, 2023. The rule stems from the Dodd–Frank Act of 2010, in which Congress chose the Securities and Exchange Commission (SEC) as the primary regulator to police the markets for security-based swaps (SBS), which include certain equity derivatives and credit default swaps (CDS). By including SBS within the definition of “security,” Dodd–Frank brought SBS within the scope of the existing anti-fraud and anti-manipulation federal securities laws and regulations, such as Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and SEC Rule 10b-5. But it also added a new Section 9(j) to the Exchange Act, tasking the SEC with prescribing rules specifically designed to prevent fraud and manipulation within the SBS markets.

The SEC promptly responded to this mandate, proposing the original version of Rule 9j-1 in November 2010, but that proposal was shelved for more than a decade in the face of stiff industry opposition. In December 2021, however, a reinvigorated SEC repropose a modified version of the rule, and on June 7, 2023, it officially adopted a further modified version of the rule by way of a 3–2 vote of the commissioners.

Prohibited Behaviors

The most substantive part of the rule is paragraph (a), which prohibits six types of actions in connection with SBS.

- (1) Employs or attempts to employ any device, scheme, or artifice to defraud or manipulate;
- (2) Makes or attempts to make any untrue statement of a material fact, or omits 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;

Rules 9j-1(a)(1) and (2) are largely based on Rules 10b-5(a) and (b), and prohibit misstatements and fraudulent schemes. As with Rules 10b-5(a) and (b), the SEC expects a scienter requirement to be applied under Rules 9j-1(a)(1) and (2). Unlike Rule 10b-5, but like the Commodity Futures Trading Commission’s 2011 rule

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based on 10b-5 (Rule 180.1), Rules 9j-1(a) and (b) also expressly prohibit “attempts” to make misstatements or employ devices, schemes, or artifices to defraud.

- (3) Obtains 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;
- (4) Engages in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person;
- (5) Attempts 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 attempts to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person;

Rules 9j-1(a)(3)–(5) are based on Section 17(a) of the Securities Act of 1933. Rules 9j-1(a)(3) and (4) prohibit obtaining money or property by way of a misstatement of a material fact or engaging in any act that would operate as a fraud or deceit. As under Section 17(a), the SEC intends to apply a simple negligence standard under Rules 9j-1(a)(3) and (4). Rule 9j-1(a)(5) prohibits unsuccessful attempts at the acts identified in Rules 9j-1(a)(3) and (4), and the SEC expects scienter to be required for liability to attach in connection with such attempts.

- (6) Manipulates or attempts to manipulate the price or valuation of any security-based swap, or any payment or delivery related thereto.

The most groundbreaking component of the rule is subparagraph (6). This rule purportedly targets “manufactured credit events” and other “opportunistic strategies” in the CDS market that the SEC and other regulators have [identified](#) as problematic. In the guidance published with the final rule, the SEC specifically addressed several of these strategies, including “orphaning a CDS, avoiding termination of a CDS for a period of time, or causing the termination of a CDS.”

The SEC recognizes efforts markets have undertaken to curb some of these behaviors, such as ISDA’s 2019 incorporation of narrowly tailored credit event provisions into standard CDS documentation and the adoption of anti-net short provisions into syndicated bank loan documentation, but the SEC has concluded that Rule 9j-1(a)(6) remains necessary considering the limited reach of the guardrails enacted by the CDS and credit markets. As the SEC noted, “Rule 9j-1(a)(6) will require that security-based swap market participants take care that their legitimate market activities remain within the scope of the typical lender-borrower relationship and do not cross the line into prohibited manipulation.”

It goes on to say that “as a general matter the Commission would expect to ... bring an enforcement action under Rule 9j-1[(a)(6)] when a party took action for the purposes of avoiding or causing, or increasing or decreasing, a payment under a security-based swap in a manner that would not have occurred but for such actions, or when an action appeared to be designed almost exclusively to harm a counterparty.” The SEC expects a scienter standard to be applied to Rule 9j-1(a)(6) and that any claims brought thereunder to involve a facts and circumstances analysis.

“In Connection With”

Just as important as the list of prohibited actions is the nexus that such actions must have to SBS. In SBS-related cases brought under Rule 10b-5 and existing securities laws, the SEC and private plaintiffs have often faced difficulties in tying the offending behavior to the purchase or sale of a security. For example, there are numerous ways for a market participant to structure a refinancing in a specific manner that will benefit an existing CDS position of that party. If the refinancing is structured as a loan, it may not involve any purchase or sale of a security, so a plaintiff bringing a Rule 10b-5 case would likely need to establish a nexus between the claimed malfeasance and the original “purchase or sale” of the CDS positions. Putting even more strain on such a claim is the fact that CDS typically trade through market-making intermediaries, meaning that victims of such behavior (i.e., parties with opposing CDS positions) are unlikely to have been party to the offender’s original CDS trades.

The SEC has tried to address these limitations in Rule 9j-1, aiming to stay within the bounds of its statutory authority in crafting the text of the rule, but putting market participants on notice through its guidance that it intends to interpret such language broadly. The lead-in for Rule 9j-1(a) makes it unlawful to take any of these actions “in connection with” effecting a transaction in, attempting to effect a transaction in, purchasing or selling, or inducing or attempting to induce the purchase or sale of any SBS (including executing, terminating, assigning, exchanging, or similarly transferring or conveying or extinguishing rights or obligations under an SBS).

In its guidance, the SEC notes that the U.S. Supreme Court has espoused a broad interpretation of “in connection with” and that the Court has held that it is enough for the alleged fraud to “coincide” with a securities transaction. It goes on to say that the requirement for a deception to occur in connection with the purchase or sale of a security does not require an identifiable purchaser or seller to be deceived. A lack of contractual privity between a party employing an opportunistic strategy and those who are ultimately harmed by that strategy appears unlikely to deter the SEC from bringing a claim under Rule 9j-1.

Purchase, Sell, or Effect Any Transaction

The SEC appears similarly inclined to broadly interpret what constitutes a purchase or a sale. Although paragraph (d) of the rule incorporates the meanings of “purchase” and “sale” from Section 3(a)(13) of the Exchange Act, the SEC’s guidance suggests it may be willing to push the boundaries of those definitions: “if conduct that affects ongoing payments or deliveries results in the extinguishment of a right or obligation under a security-based swap, such as the right to such a payment or delivery, or otherwise results in a new transaction, then a purchase or sale will have occurred, and any related fraudulent, deceptive, or manipulative misconduct will fall within Rule 9j-1’s prohibitions.”

Based on the guidance, the SEC clearly intends to view any amendment to an existing SBS that alters the rights and obligations of the parties as a purchase and sale. But what about actions taken away from SBS that have the effect of extinguishing rights or obligations under SBS? Will a financing that is structured in a way that orphans the CDS on a reference entity, eliminating the obligation of CDS sellers to make payments upon a credit event, constitute a purchase and sale under each outstanding CDS trade on that reference entity? The guidance suggests the SEC may be willing to argue that it does.

In addition to purchases and sales and attempts to induce purchases and sales, Rule 9j-1 also applies to misconduct in connection with effecting transactions and attempting to effect transactions. The SEC says this will encompass a broad range of activities beyond just purchases and sales, including placing bids and offers and clearing and settling trades. It notes that manipulation of the ongoing payments and deliveries under SBS that artificially affects the market by raising or depressing security prices would be viewed as effecting transactions in SBS.

Rules 9j-1(b) and (c) and the Affirmative Defenses

As for the remainder of Rule 9j-1, paragraphs (b) and (c) are intended to sync up Rule 9j-1(a) with Rule 10b-5, clarifying that a person may not avoid liability under Rule 10b-5 by transacting through SBS or avoid liability under Rule 9j-1(a) by transacting in underlying securities.

Rule 9j-1(e) provides two affirmative defenses from liability under Rules 9j-1(a)(1)–(5), like those provided under Rule 10b-5, for persons taking actions while in possession of material nonpublic information (MNPI). A person that has rights and obligations under SBS it entered into in good faith before obtaining MNPI will not be prohibited from exercising those rights and obligations based on the fact that it has since acquired MNPI.

Similarly, a person that is not a natural person and has MNPI will not be prohibited from trading if the individual making the investment decisions is not aware of the MNPI and the entity has reasonable policies and procedures in place to ensure the individual making investment decisions would not be in violation of Rules 9j-1(a)(1)–(5). Notably, these affirmative defenses do not apply to actions taken in violation of Rule 9j-1(a)(6).

Neither Rule 9j-1 itself, nor the SEC's guidance, addresses whether a private right of action exists for claims under Rule 9j-1, so it appears that will be left for courts to determine.

Takeaway

It should be interesting to see if the SEC is indeed willing to bring actions based on the broad interpretations of the text of Rule 9j-1 that it has asserted in its guidance and, if so, if courts will be inclined to agree with those interpretations. In any case, the SEC has put market participants on notice that it remains focused on opportunistic CDS strategies and that it is now better equipped to police them.

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