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SEC Proposes Rule Prohibiting Fraud, Manipulation and Deception in Connection with Security-Based Swaps

Co-authored by Janet M. Angstadt

On November 3, the Securities and Exchange Commission proposed 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 obligations under a security based-swap, or the avoidance of such exercise or performance.

Section 761(a) of the Dodd-Frank Wall Street Reform and Consumer Protection 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 statement, financial condition or financial obligations of the issuer.”

A key characteristic of most security-based swaps, as compared to other securities, is the obligation for and right to ongoing payments or deliveries between the parties throughout the life of the security-based swap. The exercise of such rights or performance of such obligations under a security-based swap presents opportunities and incentives for fraudulent conduct. Parties to a security-based swap may engage in misconduct to trigger, avoid or affect the value of such ongoing payments or deliveries. To address the increased exposure to fraudulent conduct related to security-based swaps, the SEC is proposing Exchange Act Rule 9j-1.

The proposed rule would subject security-based swaps, as securities, 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, and Section 17(a) of the Securities Act of 1933), 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. Therefore, the proposed rule would explicitly reach misconduct in connection with the ongoing payments or deliveries characteristic of security-based swaps. Misconduct to trigger, avoid or affect the value of such ongoing payments or deliveries would be explicitly prohibited.

Click here to read the full text of the SEC release.

Katten Muchin Rosenman LLP
Charlotte Chicago Irving London Los Angeles New York Washington, DC