

An hourglass with blue sand is centered in the frame against a solid blue background. The sand is flowing from the top bulb to the bottom bulb. The hourglass is made of clear glass, and the sand is a vibrant blue color. The lighting is soft, creating a slight shadow of the hourglass on the background.

This webinar will begin shortly.

FIA



SEC Enforcement Priorities

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Presenters

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Presentation prepared by **CLEARY GOTTLIB**



SEC Enforcement Priorities: Through the Lens of Security Based Swaps Enforcement

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SEC v. Hwang (2022)

- Hwang controlled Archegos Capital Management LLC, a family office
- Entered billions of dollars in total return swaps on equities using multiple counterparties and traded in those equities
- Margin allowed Hwang to leverage trades by as much as 400-1,000%.
- Archegos's total exposure was 40-70% for its top holdings, and often comprised 20-40% of daily trading volume
- SEC alleged Hwang's trading had "no economic purpose" and instead was done to "artificially and dramatically" increase the price of the securities, inducing others to buy
- Trading caused Archegos' value to go from \$1.5 billion to more than \$36 billion in a year
- SEC Alleged that Archegos misled SBS counterparties about its exposure, concentration, and liquidity
- SEC sued Archegos, Hwang, and Archegos's CFO, Head Trader, and Chief Risk Officer for fraud
- DOJ brought criminal case and CFTC brought parallel enforcement action



SEC v. Hwang: “Indicia of Manipulation”

- Context: Archegos’s exposure was 50-70% of the market for some of its top ten securities
- Added exposure “aggressively” – quickly and at large volumes, departure from past practice
- Often 20-40% of issuers’ daily trading volume
- Noneconomic trades: not based on “a principled view” of value – “sidelined his research operation”
- **Setting the tone:** frequent pre-market trading for purpose of pushing price up and induce others to trade
- **Marking the close:** substantial trading during last 30 minutes of trading day to push price up and lead to increase in Archegos’s SBS margin, which was based on end-of-day valuations
- Placing incrementally increasing limit orders throughout the day to push price up and induce trading
- Placing trades with express intent to counteract selling pressure and place a floor under price



Proposed Rule 9j-a1 Background

- SBS are currently subject to Rule 10b-5's antifraud provisions.
- The SEC originally proposed Rule 9j-1 in 2010; it re-proposed the rule, along with some changes, at the end of 2021.
- The SEC, along with the CFTC and the UK's FCA, stated that a major impetus for Rule 9j-1 is the increase in "manufactured credit events."
 - "Manufactured or other opportunistic CDS strategies can take a number of different forms but generally involve CDS buyers or sellers taking steps, with or without the participation of a company whose securities underlie, or are referenced by, a CDS . . . to avoid, trigger, delay, accelerate, decrease, and/or increase payouts on CDS."



Proposed Rule 9j-1 Overview

- General anti-fraud and anti-manipulation provisions extend to: (1) the purchase and sale of SBS; (2) transactions in SBS; (3) exercise of rights or performance of obligations under an SBS; and (4) terminations of SBS.
- Price manipulation provisions are based upon CFTC Rule 180.2.
- Anti-evasion provisions target sales of underlying securities or indices.
- Two limited safe harbors:
 - Trading on material non-public information if contractually obligated; and
 - Trading on material non-public information in connection with certain compression exercises.
- Key differences from Rule 10b-5:
 - Liability extends beyond just the purchase and sale of SBS;
 - Liability also reaches *attempted* fraud or manipulation and forms of negligence; and
 - No Rule 10b5-1(c)(2) affirmative defense analog.



Text of Proposed Rule 240.9j-1(a)-(b)

(a) It shall be unlawful for any person, directly or indirectly, to purchase or sell, or attempt to induce the purchase or sale of, any security-based swap; to effect any transaction in, or attempt to effect any transaction in, any security-based swap; to take any action to exercise any right, or any action related to performance of any obligation, under any security-based swap, including in connection with any payments, deliveries, rights, or obligations or alterations of any rights thereunder; or to terminate (other than on its scheduled maturity date) or settle any security-based swap, in connection with which such person:

- (1) Employs or attempts to employ any device, scheme, or artifice to defraud or manipulate; or
- (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; or
- (3) Obtains or 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
- (4) Engages 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;

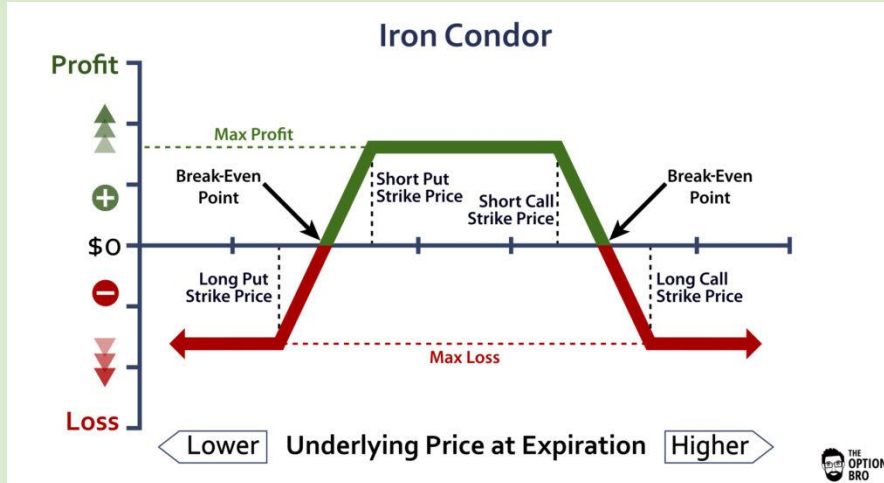
(b) It shall be unlawful for any person to, directly or indirectly, manipulate or attempt to manipulate the price or valuation of any security-based swap, or any payment or delivery related thereto.

Negligence in Practice: UBS YES (2022)

SEC allegations

- UBS YES offered to to advisory clients
- Options overlay strategy used existing securities as collateral to buy and sell combination of S&P 500 options, promising modest returns during low volatility, but experienced losses during high volatility
- Sells short term out of the money puts and above-market calls with matched durations
- UBS allegedly failed to adequately train financial advisers in the strategy
- Allegedly inadequate description of risk
- Internal risk monitoring showed daily max losses of 10-20% (against 5% max gains), but not disclosed to clients; strategy lost 18% in 2018
- UBS settled to charge of violating Section 206(2) of the Advisers Act – almost identical to Proposed Rule 9j-1(a)(4)

"Yield enhancement strategy"



Other negligence case studies: complex financial products

<i>Disclosure</i>	<i>Failure to Adequately Train Sales Force</i>	<i>Exchange Traded Product Initiative</i>
<p><i>Merrill Lynch Strategic Return Notes</i></p> <ul style="list-style-type: none"> •Merrill sold notes linked to proprietary volatility index meant to measure the return of an investment in the forward implied volatility of the S&P 500 index for a three-month period with a mid-point approximately five months in the future •Calculation of the index involved daily rebalancing fee (“Execution Factor”) equal to 1.5% cost per quarter •SEC alleged Execution Factor was not adequately disclosed; it was quantified only in a complex formula in a pricing supp appendix: “The Execution Factor is equal to 1.015 and . . . is only applied to the equation where n1 or n2 is to be increased from the level n1 t-1 or n2 t-1, respectively.” •Merrill \$10 million settlement in 2016 for alleged negligent violation of Securities Act§17(a)(2) 	<p><i>UBS Reverse Convertible Notes (2016)</i></p> <ul style="list-style-type: none"> •Charged with failing to educate and train financial advisors to understand risks and rewards of notes with embedded derivatives driven by implied volatility of stocks they are linked to: \$15 million penalty for alleged negligent violation of Securities Act§17(a)(3) and Exchange Act§15(b)(4)(E) <p><i>Wells Fargo Inverse ETFs (2020)</i></p> <ul style="list-style-type: none"> •Charged with failing to educate, train and supervise advisors on risk of complex product intended for short-term holdings, resulting in buy-and-hold recommendations to retail investors: \$35 million penalty for alleged negligent violation of Securities Act§17(a)(3) and Advisers Act §206(4) 	<ul style="list-style-type: none"> • 2020 sweep charging five registered investment advisers and broker-dealers with making unsuitable recommendations of complex, volatility-linked ETPs to retail investors • Combined \$3 million in civil penalties for alleged negligent violations of Securities Act§17(a)(3), Advisers Act §206(4), Exchange Act§15(b)(4)(E) <ul style="list-style-type: none"> • Products had significant roll yields, not suitable for long-term holding • Buy-and-hold recommendations for retail accounts <p><i>UBS VXX (2021)</i></p> <ul style="list-style-type: none"> • Charged with failing to adequately train advisors on risks of volatility products; failed to apply the same controls applied to other risky products • \$8 million penalty for alleged negligent violation of Advisers Act §206(4)





Proposed Rule 10b-1 Background

- Adopted, in part, as a response to the Archegos collapse – “[I]f a single counterparty has a \$5 billion security-based swap position distributed equally among five different dealers on the same underlying equity security, public reporting of that security-based swap position would alert each dealer to the total exposure of the reporting counterparty.”
- The stated purpose of the rule is to:
 - Provide market participants and regulators with access to information related to large positions in SBS, which may indicate fraud or manipulation;
 - Alert market participants to concentrated exposures for risk management purposes; and
 - Alert market participants and regulators that a person or group or persons is building up positions in CDS and could engage in manufactured or other opportunistic strategies that involve an incentive to vote against their interests as a debt holder.



Proposed Rule 10b-1 Overview

- Any person or group of persons with SBS positions above a certain level must promptly file a Schedule 10B.
 - Schedule 10B requires disclosing things like the identity of the reporting person, the notional amount and composition of SBS positions, and the ownership of underlying loans, securities, or positions.
 - It must be filed no later than one business day following the SBS transaction that exceeds the threshold.
- There are separate thresholds for SBS positions in: (1) CDS; (2) non-CDS debt securities; and (3) equity securities. A separate Schedule 10B must be filed for exceeding each threshold.
 - For CDS, the threshold is the lesser of: (i) a long notional amount of \$150 million; (ii) a short notional amount of \$150 million; or (iii) a gross notional amount of \$300 million.
 - For debt securities that are not CDS, the threshold is a gross notional of \$300 million.
 - For equity securities, the threshold is the lesser of: (i) a gross notional amount of \$300 million; and (2) a “Security-Based Swap Equivalent Position” of 5%.
 - If the equity securities positions exceed \$150 million and/or 2.5%, then that calculation must also take into account certain options, securities futures, and other derivative instruments.



Proposed Rule 10b-1 Overview

- Rule 10b-1 covers SBS entities, any SBS required to be reported under Regulation SBSR, and any SBS where the reference security is issued by a U.S. entity or registered under the Exchange Act.
 - The SEC estimated that 800 entities would be immediately subject to Rule 10b-1 reporting, and 850 entities would require systems to monitor reporting.
 - The SEC also estimated that it will cost each entity only \$101,470 up front to set up such systems, and \$77,000 per year to maintain them.



Timeline of Early Swap Dealer Enforcement

October 16, 2013

- CFTC settles charges against JPMorgan for manipulative trades made in 2012 in connection with credit default swaps.
- First case charging Dodd-Frank prohibitions on manipulative conduct under CFTC Rule 180.1.

August 19, 2015

- CFTC settles charges against FCStone for failure to adequately monitor discretionary trades in 2013.
- First case charging violations of Rule 23.602 for swap dealer supervision standards.

September 17, 2015

- CFTC settles charges against Australia and New Zealand Banking Group for failing to file accurate larger trader reports between 2013-14.
- First case charging violations of Dodd-Frank large trader reporting requirements under Section 4s(f) and CFTC Part 20 regulations.

September 30, 2015

- CFTC settles charges against Deutsche Bank for failing to properly report swap transactions between 2013-15.
- First case charging violations of Dodd-Frank requirements for real-time reporting of swap transactions under CFTC Part 43 and 45 regulations.



Appendix: Common Antifraud Provisions



Exchange Act Rule 10b-5

17 CFR § 240.10b-5 Employment of manipulative and deceptive devices.

It shall be 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](#),

(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 the light of the circumstances under which they were 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](#).



Securities Act Section 17(a)

15 U.S.C. Section 77q

(a) USE OF INTERSTATE COMMERCE FOR PURPOSE OF FRAUD OR DECEIT It shall be unlawful for any person in the offer or sale of any securities (including [security-based swaps](#)) or any [security-based swap](#) agreement (as defined in [section 78c\(a\)\(78\) \[1\]](#) of this title) by the use of any means or instruments of transportation or communication in [interstate commerce](#) or by use of the mails, 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 were 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.



Exchange Act Section 9(a): Market Manipulation

15 U.S.C. Section 78i

(a) TRANSACTIONS RELATING TO PURCHASE OR SALE OF SECURITY It shall be unlawful for any [person](#), directly or indirectly, by the use of the mails or any means or instrumentality of [interstate commerce](#), or of any [facility](#) of any national securities [exchange](#), or for any [member](#) of a national securities [exchange](#)— **(1)** For the purpose of creating a false or misleading appearance of active trading in any [security](#) other than a government [security](#), or a false or misleading appearance with respect to the market for any such [security](#), (A) to effect any transaction in such [security](#) which involves no change in the beneficial ownership thereof, or (B) to enter an order or orders for the [purchase](#) of such [security](#) with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the [sale](#) of any such [security](#), has been or will be entered by or for the same or different parties, or (C) to enter any order or orders for the [sale](#) of any such [security](#) with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the [purchase](#) of such [security](#), has been or will be entered by or for the same or different parties.

(2) To effect, alone or with 1 or more other [persons](#), a series of transactions in any [security](#) registered on a national securities [exchange](#), any [security](#) not so registered, or in connection with any [security-based swap](#) or [security-based swap agreement](#) with respect to such [security](#) creating actual or apparent active trading in such [security](#), or raising or depressing the price of such [security](#), for the purpose of inducing the [purchase](#) or [sale](#) of such [security](#) by others.

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The image features the letters 'FIA' in a bold, sans-serif font. The 'F' is dark grey. The 'I' is dark grey with a green triangle overlapping its right side. The 'A' is blue with a green triangle overlapping its left side. The background consists of several overlapping geometric shapes: a light green triangle pointing down from the top left, a light blue triangle pointing up from the bottom left, a light green triangle pointing up from the bottom right, and a light blue triangle pointing down from the top right. The overall composition is clean and modern.