

SEC and CFTC Turn to Swaps and Security-Based Swaps Enforcement

June 24, 2015

The week of June 15, 2015 saw two of the first publicly announced enforcement actions brought by the Securities and Exchange Commission (“**SEC**”) and the Commodity Futures Trading Commission (“**CFTC**”) to enforce security-based swap and swap regulatory requirements under Title VII of the Dodd-Frank Act. The SEC accepted an offer of settlement from a web-based “exchange” for, among other things, offering security-based swaps to retail investors in violation of the Securities Act of 1933 and the Securities Exchange Act of 1934. In a separate action, the CFTC obtained a federal court order against a Kansas City man in a case alleging violations of the antifraud provisions of the swap dealer external business conduct rules in Part 23 of the CFTC regulations.¹ Swap dealers and security-based swap market participants may wish to consider these orders and the agencies’ approach to enforcement as firms further develop, review and update their compliance programs.

Illegal Transactions in Security-Based Swaps

On June 17, 2015, the SEC entered into an enforcement order with a web-based exchange that allowed its members to buy and sell contracts in the form of “fantasy stock” based on the value of private companies in advance of expected liquidity events, such as initial public offerings, mergers or dissolutions. In February 2015, the exchange’s operators introduced a platform through which members could buy and sell “smart contracts,” the value of which related to actual, privately owned start-up companies. The returns on these contracts would be based on the expected future value of these companies; if a company experienced a liquidity event, the buyer of the corresponding contract would receive one dollar for every \$1 billion that the company was valued at the time of the event.

In bringing the enforcement order, the SEC characterized these “smart contracts” as security-based swaps, stating that the contracts were swaps based on events relating to a single issuer, each underlying start-up company. As a result, the exchange and its operators are alleged to have violated Section 5(e) of the Securities Act of 1933 and Section 6(l) of the Securities Exchange Act of 1934, which make it unlawful to offer to enter into or to enter into a security-based swap with any person who is not an eligible contract participant without an effective registration statement for the offering or unless the transaction is conducted on a national securities exchange, respectively. The exchange was ordered to cease and desist from any future violations of the securities laws and ordered to pay a civil monetary penalty of \$20,000. The size of this penalty appears to be based on the small size and scope of the exchange’s operations.

This action is noteworthy for several reasons. First, it represents the first time that the SEC has publicly wielded its newly acquired authority under Title VII of the Dodd-Frank Act over security-based swaps. Even though the SEC has yet to finalize the majority of its substantive rulemakings under Title VII, this

¹ See Order Instituting Cease-And-Desist Proceedings Pursuant To Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-And-Desist Order. In the Matter of Sand Hill Exchange, Gerrit Hall, and Elaine Ou, No. 3-16598 (SEC June 17, 2015), available [here](#); and Consent Order of Permanent Injunction, Civil Monetary Penalty, and Other Equitable Relief Against Gregory Christopher Evans. U.S. Commodity Futures Trading Commission v. Gregory Christopher Evans, No. 14-0839-CV-W-ODS (W.D. Mo. June 16, 2015), available [here](#).

A **security-based swap** is, generally, and subject to certain exceptions: any agreement, contract, or transaction that:

- is a swap, as defined in Section 1a(47) of the Commodity Exchange Act; and
- is based on:
 - an index that is a narrow-based security index, including any interest therein or on the value thereof;
 - a single security or loan, including any interest therein or on the value thereof; or
 - the occurrence, nonoccurrence, or extent of the 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.

action shows that the SEC is willing to exercise its statutory authority over security-based swaps. In addition, it shows the SEC's willingness to bring enforcement actions, even in situations where the volume of transactions is relatively small. In the press release accompanying the order, the SEC signaled its intention to particularly scrutinize attempts to offer these products to retail investors.

The CFTC Enforces Swap Dealer External Business Conduct Rules

On June 16, 2015, the CFTC entered into and released a consent order that addressed the actions of a former employee and associated person ("**AP**") of a provisionally registered swap dealer. The employee is alleged to have violated CFTC regulation 23.410(a)(3), which prohibits a registered swap dealer from engaging in fraudulent conduct and is part of the CFTC's suite of swap dealer external business conduct requirements.² Though the CFTC has entered into enforcement orders related to swap activity over the past few years, this is the first time the agency has publicly brought an action for violations of the new regulations specifically applicable to swap dealers.

The employee was responsible for negotiating and trading commodity swaps on behalf of two customers of the swap dealer. The employee was designated as an AP of the swap dealer for these activities. The fraud allegations stem from the employee's entering into unauthorized swap transactions for the clients'

accounts, with an intent to recoup losses in those client accounts resulting from earlier, authorized swap and futures trading conducted by the employee. In addition, the order alleges that the employee's conduct was fraudulent because he willfully omitted material facts relating to the swap trading activity for one client's account, including the unauthorized swap transactions, the profits and losses incurred by those transactions, and the magnitude of the risks to which the client account was subject.

The CFTC has long brought enforcement actions against registered firms and their employees for alleged fraudulent conduct under a variety of Commodity Exchange Act antifraud provisions. The type of conduct that is the subject of this order is typical of past enforcement actions in the context of futures, foreign exchange, and other trading activities that are the subject of long-standing CFTC jurisdiction. This consent order is noteworthy, however, in that it describes the first publicly available enforcement action taken by the CFTC under the relatively new Title VII swap dealer regulations. In addition, the order makes clear that the antifraud provisions of the swap dealer external business conduct rules apply not only to the registered swap dealers but also separately and directly to the APs and other employees of swap dealers. Finally, in addition to a lifetime ban from engaging in commodity interest trading, the order levies a significant monetary penalty against the employee – in excess of \$1 million, the amount of losses incurred by the client accounts – despite the swap dealer having already reimbursed the clients for those losses.

² The consent order also included allegations of violations of other antifraud provisions of the Commodity Exchange Act and CFTC regulations, including CFTC regulations 180.1 and 166.2.

Conclusion

The SEC action shows that the SEC is monitoring actively the security-based swap market, even in advance of final rules implementing the majority of the security-based swap regulatory regime. The CFTC action highlights the CFTC's focus on the activities of swap dealers and their personnel, particularly when those activities may be fraudulent or misleading to customers. While these orders are the first publicly announced actions taken by the SEC and CFTC to enforce the new security-based swap provisions and swap dealer regulations, respectively, they are unlikely to be the last.

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