

The SEC Invokes Its Enforcement Authority Over What It Asserts Are Security-Based Swap Agreements

By Patricia C. O'Prey and Eva Marie Carney

The market for interest rate swaps – a derivative product in which one party pays to the other party interest based on a fixed rate in exchange for payment of interest based on a floating rate – now exceeds \$309 trillion. Interest rate swaps are used by investors to hedge or insure against interest rate risk, and also are used for speculative purposes because there is no requirement of actual exposure to the interest rate risk.

The market for interest rate swaps has burgeoned with little regard for potential U.S. Securities and Exchange Commission (“SEC”) enforcement interest. Interest rate swaps and, indeed, most other types of swaps, are not “securities.” Nonetheless, at the beginning of this decade, Congress subjected those swaps that are “security-based” to the federal securities laws’ antifraud jurisdiction. Now, in a federal district court complaint filed against the sitting mayor of Birmingham, Alabama, among other defendants – a complaint that illustrates the power of the “security-based” distinction – the SEC is litigating allegations that the antifraud provisions of the securities laws were violated in certain transactions involving interest rate swap agreements that the SEC has pleaded are security-based swaps. See Complaint, *SEC v. Langford, et al.*, Case No. 08-cv-00761 (N.D. Ala. filed April 30, 2008). In the Alabama vernacular, it appears that the time has come for participants in the muni-interest rate swap market to “listen up.”

The Swaps at Issue

The swap agreements at issue in the *Langford* case are interest rate swap agreements. In an interest rate swap agreement, each counterparty agrees to pay either a fixed or floating rate denominated in a particular currency to the other counterparty. The fixed or floating rate is multiplied by a notional amount, which is not exchanged between counterparties, but is used only for calculating the cashflows to be exchanged.

In *Langford*, Jefferson County, Alabama entered into several interest rate swap agreements whereby Jefferson County agreed to pay a fixed interest rate to its counterparties in exchange for the counterparties’ agreement to pay a floating interest rate tied to the “Municipal Swap Index” of the Bond Market Association (now known as the Securities Industry and Financial Markets Association (“SIFMA”)). As specifically pleaded by the SEC, one of the swap agreements further specified that the floating rate tied to the SIFMA index would be replaced after a set period by an interest rate tied to the “floating value” of the London Inter-Bank Offering Rate (“LIBOR”). The notional principal amount of the swaps equaled the bonds issued by Jefferson County. Thus, Jefferson County (i) issued fixed rate bonds, and (ii) hedged its interest rate risk by converting the fixed rate to a floating rate through the interest rate swaps.

Memorandum

May 30, 2008

“The *Langford* Complaint is a ‘listen up’ warning to the derivatives market that counterparties and their advisors may be called to account by the SEC.”

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The Complaint in *SEC v. Langford*

The SEC filed its Complaint against Birmingham Mayor Larry Langford in late April 2008, to address his alleged acceptance of undisclosed payments from a broker-dealer in connection with the purchase and sale of almost \$2.9 billion in Jefferson County municipal bonds and \$3.5 billion of swap agreements. The SEC alleges that such conduct violated Section 17(a) of the Securities Act of 1933 (the “Securities Act”), Section 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) and Rule 10b-5 promulgated thereunder, and has lodged other allegations against the broker-dealer and others.

The Complaint alleges that the SEC has jurisdiction to prosecute these violations because the swap agreements “were security-based swap agreements . . . defined in Section 206B of the Gramm-Leach-Bliley Act, as amended by the Commodity Futures Modernization Act of 2000, as agreements of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.”

Indeed, Section 206C of the Gramm-Leach-Bliley Act provides that the SEC’s antifraud jurisdiction applies to “security-based swap agreements.” At the same time, that provision specifies that the SEC has no jurisdiction, including under the antifraud (e.g., insider trading) provisions, with respect to non-security-based swap agreements. Section 206C of the Gramm-Leach-Bliley Act, 15 U.S.C. §78c note.

In *Langford*, the SEC alleges that because the swap agreements at issue provided that Jefferson County was entitled to receive floating interest payments based on the value of the SIFMA’s Municipal Swap Index, an index of securities that includes variable rate demand notes, a material term of the swap was based upon the price, yield, value or volatility of a security or an index of securities.¹

The SEC seeks to bolster its assertion of jurisdiction with the novel allegation that because the municipality negotiated, executed and entered into two particular swap agreements simultaneously with two bond offerings, “the swap agreements were therefore part of the bond offerings over which the Court already has jurisdiction” (because those offerings involve the purchase or sale of securities in the form of “bonds”). This latter argument predictably could be extended to swap agreements entered into simultaneously with the offering of other standard-fare securities. For example, if a public company simultaneously issues floating rate notes that are commonly viewed as securities and enters into an interest rate swap or currency swap to hedge its interest rate or currency exposure, it is possible that the SEC’s generally expansive view of its jurisdiction would result in the agency pleading that such a transaction is subject to SEC enforcement authority under the antifraud provisions.

Statutory Authority for the SEC’s Position

As asserted by the SEC, “[t]he express terms of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 . . . give the [SEC] the authority to prosecute anti-fraud violations of those sections in connection with security-based swap agreements.” Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act², and the rules promulgated thereunder, prohibit fraud, manipulation, and insider trading and, by their terms as revised earlier this decade, apply to security-based swap agreements to the same extent as they apply to securities.

In addition, the following federal securities law provisions also apply expressly to security-based swap agreements:

¹ According to the SEC, the swap agreements “constituted security-based swap agreements because a material term in each agreement was based on an index of securities.” See Section 206B of Gramm-Leach-Bliley Act, 15 U.S.C. §78c note (defining “security-based swap agreements,” a subset of “swap agreements,” as “swap agreement[s]” that have a material term based on the price, yield, value, or volatility of any security or any group or index of securities).

² Both statutes explicitly refer to security-based swap agreements. See 15 U.S.C. § 77q(a); 15 U.S.C. § 78j(b).

(1) Exchange Act, Section 9, 15 U.S.C. § 78i (provision prohibiting manipulation of securities prices);

(2) Exchange Act, Section 15, 15 U.S.C. § 78o (broker-dealer registration and regulation provision);

(3) Exchange Act, Section 16, 15 U.S.C. § 78p (reporting and short-swing profit provision for directors, officers and principal stockholders applicable to equity securities);

(4) Exchange Act, Section 20, 15 U.S.C. § 78t (controlling person provision which states that any person who, directly or indirectly, controls any person liable under any provision of the Exchange Act, or of any rule or regulation issued under the Exchange Act, shall also be liable jointly and severally with and to the same extent as the controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action); and

(5) Exchange Act, Section 21A, 15 U.S.C. § 78u-1 (provision outlining the SEC’s authority to obtain civil penalties for insider trading against the person who committed the violation and against controlling persons).³

Implications for Market Participants

The *Langford* Complaint is a “listen up” warning to the derivatives market that counterparties and their advisors may be called to account by the SEC, pursuant to the agency’s authority to invoke the federal securities laws’ antifraud provisions in appropriate cases, if the instruments in which they deal can be forced into the “security-based swap” definition. Participants in the swaps markets are well-advised to pay particular heed to their conduct, including public/private information issues and their

disclosures to counterparties, if they are dealing in swap agreements for which a material term is based on the price, yield, value or volatility of a stock, bond or index of securities or which are entered simultaneously with a securities offering. Caution is the watchword. The stakes are high, as is the risk of reputational and other fallout, should SEC fraud allegations be brought against a market participant.

The legal risk in this arena might also be managed by confining a firm’s dealings to LIBOR-pegged swap agreements. In most interest rate swap agreements, the value of the floating interest payments is determined by reference to LIBOR. LIBOR is not determined “based on the price, yield, value or volatility of any security or any group or index of securities,” but rather by rates that banks participating in the London money market offer each other for short-term deposits. The *Langford* Complaint is not entirely transparent on the point but appears to telegraph SEC avoidance of a claim of enforcement authority over exclusively LIBOR-based swap agreements. A close reading of the Complaint suggest that two of the swap agreements entered into by Jefferson County provided for floating interest rate payments based on LIBOR, not on the Municipal Swap Index. The SEC expressly included those two swap agreements in its *Langford* Complaint but painstakingly pleaded that the two agreements, along with one other that was based on the Municipal Swap Index, were evidenced by three simultaneous swap confirmations, with each confirmation providing that all three “together shall constitute one and the same instrument.” Thus, in the *Langford* Complaint, the SEC did not stake out a claim that LIBOR-based interest rate swap agreements are security-based swap agreements subject to the agency’s authority to police fraud.

³ At the same time, Section 2A of the Securities Act, 15 U.S.C. § 77b-1, and Section 3A of the Exchange Act, 15 U.S.C. § 78c-1, expressly state that: (1) security-based swap agreements are not securities as defined in Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act; (2) the SEC cannot register or require registration of any security-based swap agreement; and (3) the SEC cannot impose or specify reporting or recordkeeping requirements, standards or procedures to guard against fraud, manipulation or insider trading with respect to any security-based swap agreement. Notably, the *Langford* Complaint does not overreach and charge registration, reporting or recordkeeping or other securities-issuance specific violations against the defendants.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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