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District Court Holds That Rule 10b-5 Insider Trading Provisions Apply to Credit Default Swap (CDS) Contracts

BY THE WHITE COLLAR CRIME AND REGULATORY ENFORCEMENT GROUP

On June 25, 2010, a District Judge in the Southern District of New York held, in a case of first impression, that the federal insider trading laws apply to credit default swaps, but that, on the facts of the particular case before him, the defendants did not violate the law. The case, *Securities and Exchange Commission v. Rorech*, is the first enforcement action brought by the SEC alleging insider trading of credit default swaps in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. After a three-week bench trial, the court found that the SEC had failed to prove that the defendants, a hedge fund portfolio manager and a bond salesman for a major investment bank, had misappropriated material confidential information or acted with the requisite scienter. *Rorech* nonetheless could be an indication of how courts will apply the insider trading provisions to credit default swap transactions.

Background

A credit default swap ("CDS") is a contract whereby one party, the "credit protection buyer," pays the "credit protection seller" to take on the credit risk of a specified bond or other debt obligation of a specified corporation, government, or other legal entity. The specified debt obligation is known as the "reference obligation." If a payment default or other specified credit event occurs with respect to the reference obligation, the credit protection seller makes a credit protection payment to the credit protection buyer. The credit protection buyer need not own or have any other interest in the reference obligation. However, some CDS contracts provide for "physical settlement" upon the occurrence of a credit event. Physical settlement requires the credit protection buyer to physically deliver the reference obligation or another "deliverable obligation" to the credit protection seller, which then pays the credit protection buyer the "notional amount" of the reference obligation.

The Facts

Jon-Paul Rorech was a high-yield bond salesman at Deutsche Bank. In July 2006, he learned that his firm was considering recommending to its client, VNU, a Dutch media conglomerate, that it should issue bonds as part of a leveraged buyout. At the time, VNU CDS contracts trading in the market required that, in the case of a VNU credit event, the protection buyer would have to physically deliver VNU bonds in order to be entitled to the notional amount.

The U.S. Securities and Exchange Commission ("SEC") alleged that Rorech passed material, non-public information about the recommended VNU bond offering to Renato Negrin, a hedge fund manager, in violation of a duty of confidentiality that he owed to Deutsche Bank. The allegation was that Negrin used the information to purchase VNU CDS contracts shortly before the plan was announced and then subsequently sold them for a profit of $1.2 million. The evidence at trial established that market participants understood that the price of VNU CDS contracts was based at least in part on the price of VNU bonds that would have to be tendered or delivered upon a credit event.

The Court Finds That CDS Contracts Are "Securities-Based Swap Agreements" Subject to Rule 10b-5

Prior to *Rorech*, the SEC's authority to regulate insider trading in the CDS market had never been tested in court. The Commodity Futures Modernization Act ("CFMA"), enacted into law in 2000, extends Section 10(b) of the Securities Exchange Act and the corresponding rules to "securities-based swap agreements."[1] A "securities-based swap agreement," in turn, is defined by the Gramm-Leach-Bliley Act as "a swap agreement 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."[2] "Swap agreement" is defined to include a credit default swap.[3]

The defendants argued that the VNU CDS contracts Negrin purchased were not covered by the statutes because, according to their specific contract terms, the CDS price was not explicitly tied to the price, value or volatility of any particular security. The defendants conceded that the CDS contracts required that VNU bonds be delivered at the time of a credit event to trigger payment of the notional amount, but argued that the CFMA language requiring that a material term of the contract be "based on" the price, yield or value of a security should be interpreted to require a direct connection or exclusive relationship between the CDS and such a security. The defendants also argued that the VNU CDS prices were subject to change from a number of other factors, such as liquidity in the over-the-counter market and the general strength of the economy.

The court rejected the defendants' arguments, holding that to require a "direct, explicit relationship . . . be spelled out in the text of a CDS contract would allow traders to escape the ambit of section 10(b) and Rule 10b-5 through clever drafting," "no matter how closely tied to securities their material terms actually were."[4] The court also rejected the argument that the price of the CDS had to be exclusively based on the price, value or volatility of the underlying security.[5] Instead, the court looked to the plain meaning of the CFMA and held that, because "market analysts and experts considered CDS prices in general to be based on the price, yield, or value of the referenced entity's bonds," the CDS contracts at issue are securities-based credit swaps under the statute and are, therefore, subject to federal securities laws.[6]

Lack of Evidence of Misappropriation of Confidential Information

After finding that the transactions at issue were subject to section 10(b)'s antifraud provision, the court nonetheless dismissed the SEC's complaint, holding that the SEC failed to prove insider trading. Under the "misappropriation theory" of insider trading, an individual violates section 10(b) and Rule 10b-5 when he "misappropriates," by "secreting, stealing or purloining," "material non-public information in breach of an employer-based fiduciary duty of confidentiality."[7] The SEC's central allegation at trial was that the defendants, when discussing the likelihood that VNU would issue bonds, deliberately switched on two occasions from recorded landlines to their cell phones, suggesting that they knew what they were doing was wrong. For example, just prior to one of the unrecorded cell

phone conversations at issue and before Negrin had bought the VNU CDS contracts, the defendants had engaged in the following conversation on a Deutsche Bank recorded line:

Negrin: I wanted to talk a little bit more about the other situation.
Rorech: Yes.
Negrin: You know, ahh . . . so, I'll call --
Rorech: VNU.
Negrin: Yes . . . ahh . . .
Rorech: You're going to call my cell?
Negrin: Yeah . . .
Rorech: Alright, guy.
Negrin: Bye.
Rorech: Alright, bye.[8]

Then, days after Negrin had bought VNU CDS contracts and had realized a substantial profit, Negrin thanked Rorech for recommending the trades. Negrin said, "Great call. That's all I have to f---ing say." Rorech asked whether they would "go out soon or what?" Negrin replied, "Yeah, I'm going to have to take you out" and mentioned that he now owned 20 million Euros worth of VNU CDSs, which Rorech called "a nice little kiss."[9]

But because both Rorech and Negrin testified at trial that they could not recall the substance of the cell phone conversations at issue, the SEC had no evidence of what was actually said on those calls. In rejecting the SEC's argument that the circumstantial evidence surrounding the cell phone calls permitted the court to draw an inference of wrongdoing, the court focused on the fact that Rorech, as a salesman for the underwriter for the VNU transaction, was properly speaking to potential investors at the time about interest in a possible bond offering. Indeed, the evidence showed that Deutsche Bank salesmen were speaking openly with potential investors about a possible VNU bond offering, and that such conversations were necessary for the bank to gauge market interest and properly advise VNU about such an offering. In addition, the court found that, even if Rorech had shared his personal opinion with Negrin about whether Deutsche Bank would recommend the bond offering, this information would not have been material because the market was already aware that VNU might issue bonds and, regardless of whether Deutsche Bank made such a recommendation, it was still up to the sponsor, VNU, as to whether to approve the offering. Based on its finding that such "contingent or speculative" information was akin to a "generalized tip" that was "fairly obvious" to every market participant who was knowledgeable about the company or the particular instrument at issue, the court held that the defendants had not shared material non-public information.[10]

Aftermath

The district court took a broad reading of the CFMA, holding that traders should not be permitted to escape the reach of the securities antifraud provisions through the "clever drafting" of CDS contracts. Whether the reasoning of *Rorech* extending the reach of Rule 10b-5 to CDS agreements is accepted by other courts could have a significant effect on future enforcement actions and prosecutions.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Thomas P. O'Brien
213-683-6146
thomasobrien@paulhastings.com

William F. Sullivan
213-683-6252
williamsullivan@paulhastings.com

Thomas A. Zaccaro
213-683-6285
thomaszaccaro@paulhastings.com

New York

James R. Bliss
212-318-6626
jamesbliss@paulhastings.com

Kenneth M. Breen
212-318-6344
kennethbreen@paulhastings.com

Sean T. Haran
212-318-6094
seanharan@paulhastings.com

Douglas Koff
212-318-6772
douglaskoff@paulhastings.com

Keith W. Miller
212-318-6005
keithmiller@paulhastings.com

Barry G. Sher
212-318-6085
barrysher@paulhastings.com

Washington, D.C.

E. Lawrence Barcella, Jr.
202-551-1718
larrybarcella@paulhastings.com

Kirby D. Behre
202-551-1719
kirbybehre@paulhastings.com

Laura L. Flippin
202-551-1797
lauraflippin@paulhastings.com

Morgan J. Miller
202-551-1861
morganmiller@paulhastings.com

James D. Wareham
202-551-1728
jameswareham@paulhastings.com

[1] Commodity Futures Modernization Act, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

[2] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 206B, 113 Stat. 1138 (1999).

[3] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 206A, 113 Stat. 1138 (1999).

[4] *S.E.C. v. Rorech*, 2010 WL 2595111, at *40 (S.D.N.Y. Jun. 25, 2000).

[5] *Id.*, at *38.

[6] *Id.*, at *40.

[7] *Id.*, at *42.

[8] *Id.*, at *17.

[9] *Id.*, at *21.

[10] *Id.*, at *44.