



JONES DAY
COMMENTARY

SEC CHARGES HEDGE FUND MANAGER AND BOND SALESMAN IN FIRST INSIDER TRADING CASE INVOLVING CREDIT DEFAULT SWAPS

On May 5, 2009, the U.S. Securities and Exchange Commission (“SEC”) brought an action in the U.S. District Court for the Southern District of New York alleging the “the first insider trading enforcement action involving credit default swaps.”¹

Historically, the SEC has pursued enforcement actions focused primarily on violations of the antifraud provisions in the context of equity securities.² However, in the recent case of *SEC v. Barclays Bank PLC*,³ the SEC brought an enforcement action for violations of the insider trading laws involving debt securities. *SEC v. Rorech* may represent the next step in the extension of the insider trading laws.

In its complaint, the SEC alleges that Renato Negrin, a former portfolio manager employed by hedge fund investment adviser Millennium Partners L.P. (“Millennium”), and Jon-Paul Rorech, a bond and credit default swap (“CDS”) salesman at Deutsche Bank Securities Inc. (“DBSI”), engaged in insider

trading in CDSs of VNU N.V. (“VNU”), a Dutch media conglomerate.⁴

BACKGROUND

CDSs are derivatives, similar to insurance in the event an issuer defaults on a debt obligation, such as a bond. Accordingly, the price of a CDS generally increases when an issuer increases its outstanding debt obligations. These instruments have recently exploded into public prominence as a result of the U.S. government’s intervention in American International Group, Inc. (“AIG”), which was required partly because of the perception that a default by AIG on its CDS obligations may have wreaked havoc on the world’s financial system.

Despite the size of the CDS market, estimated at \$38.6 trillion traded value, CDSs are largely unregulated. Former SEC Chairman Christopher Cox has referred

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to the CDS market as a “regulatory hole” because under the current regulatory regimes “neither the SEC nor any regulator has authority over the CDS market.”⁵ In the late 1990s, the Commodities Futures Trading Commission attempted to regulate CDSs, but, in 2000, Congress passed the Commodity Futures Modernization Act, which made clear that these instruments were to remain unregulated.

The SEC lacks the general power to directly regulate CDSs because they fall outside the definition of a “security” under both the Securities Act of 1933, as amended (the “Securities Act”), and the Securities Exchange Act of 1934, as amended (the “Exchange Act”). However, the SEC’s Division of Enforcement does have specific authority over “securities-based swap agreements” (as defined in section 206B of the Gramm-Leach-Bliley Act) under the antifraud provisions in Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act.⁶ Thus, the SEC has jurisdiction over insider trading of CDSs linked to bonds. Although widely prevalent, CDSs linked to loans are beyond the SEC’s reach.

SEC v. RORECH

The SEC brought the action in *SEC v. Rorech* for alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. In its complaint, the SEC indicated that: “The CDSs at issue in this matter qualify as security-based swap agreements under the Gramm-Leach-Bliley Act of 2002 and are therefore subject to the antifraud provisions set forth in Section 10(b) of the Exchange Act and the rules promulgated thereunder.”⁷

The complaint alleges that Rorech, by virtue of his employment at DBSI, obtained confidential information concerning the restructuring of an upcoming bond offering by VNU, which was material to the market price of the separately traded CDSs that referenced VNU bonds. The complaint goes on to allege that, notwithstanding his duty to maintain the confidentiality of this material information, Rorech “tipped Negrin to the confidential information” regarding the bond offering by VNU.⁸ Thereafter, Negrin allegedly used this information to purchase €20 million of CDSs on VNU, on behalf of hedge funds advised by Millennium. Negrin later allegedly closed Millennium’s CDS position in VNU for a profit of approximately \$1.2 million.

IMPACT OF *SEC v. RORECH*

CDSs. In light of the role CDSs have played in the current financial crisis, the SEC will likely bring additional enforcement actions relating to “securities-based swap agreements.” In addition, legislators, regulators, practitioners, and academics may reexamine current legislation relating to CDSs, including “non-securities-based swap agreements.” It remains to be seen whether Congress will pursue legislation relating to the direct regulation of CDSs or antifraud regulation of non-securities-based swap agreements.

Hedge Funds. Since the U.S. Court of Appeals for the District of Columbia Circuit vacated the SEC’s attempt to directly regulate hedge funds in *Goldstein v. SEC*,⁹ the SEC has increased its antifraud enforcement efforts in the hedge fund industry. The SEC reportedly has at least 50 investigations involving derivatives underway.¹⁰ In light of the current financial crisis, increased scrutiny of transactions involving derivatives and hedge funds,¹¹ as well as calls for Congressional legislation authorizing direct regulation of hedge funds, are likely to continue.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our “Contact Us” form, which can be found at www.jonesday.com.

Harold K. Gordon

1.212.326.3740

hkgordon@jonesday.com

Ted Kamman

1.212.326.3906

tkamman@jonesday.com

Henry Klehm III

1.212.326.3706

hklehm@jonesday.com

Rory T. Hood

1.212.326.3814

rhood@jonesday.com

ENDNOTES

- 1 Press Release, U.S. Sec. & Exch. Comm'n, "SEC Charges Hedge Fund Manager and Bond Salesman in First Insider Trading Case Involving Credit Default Swaps" (May 5, 2009) (quoting Scott W. Friestad, Deputy Dir., U.S. Sec. & Exch. Comm'n Div. of Enforcement), available at <http://www.sec.gov/news/press/2009/2009-102.htm>.
- 2 See Stephen M. Bainbridge, "Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition," 52 *Wash. & Lee L. Rev.* 1189 (1995); Harvey L. Pitt & Karl A. Groskaufmanis, "A Tale of Two Instruments: Insider Trading in Non-Equity Securities," 49 *Bus. Law.* 187 (1993).
- 3 *Sec. & Exch. Comm'n v. Barclays Bank PLC*, No. 07 CV 4427 (S.D.N.Y. May 30, 2007). The topics of insider trading in debt and debt-linked derivatives, among others, are examined in an article that will appear in the spring 2009 issue of the *Columbia Business Law Review*. Ted Kamman & Rory T. Hood, "With the Spotlight on the Financial Crisis, Regulatory Loopholes and Hedge Funds, How Should Hedge Funds Comply with the Insider Trading Laws?" 2009 *Colum. Bus. L. Rev.* (forthcoming 2009). The views set forth in that article are the personal views of the authors and do not necessarily reflect those of the Firm.
- 4 Complaint, *Sec. and Exch. Comm'n v. Rorech*, No. 09civ4329 (S.D.N.Y. filed May 5, 2009), available at <http://www.sec.gov/litigation/complaints/2009/comp21023.pdf>.
- 5 "Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the Subcomm. on Banking, Housing and Urban Affairs," 109th Cong. (2008) (statement of Christopher Cox, Chairman, U.S. Securities and Exchange Commission), available at <http://www.sec.gov/news/testimony/2008/ts092308cc.htm>.
- 6 Securities Act of 1933, 15 U.S.C. § 77q(a) (2006); Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2006). Under these statutes, the SEC's antifraud authority, including its ability to prohibit insider trading, is limited to securities-based CDSs. If the swap agreement is "non-securities based," Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act do not apply. Section 206B of the Gramm-Leach-Bliley Act defines "security-based swap agreement" 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." Gramm-Leach-Bliley Act, 15 U.S.C. § 78c-1 (2006). Section 206C defines non-security-based swap agreement as "any swap agreement . . . that is not a security-based swap agreement." *Id.*
- 7 Complaint ¶ 49, *Sec. and Exch. Comm'n v. Rorech*, No. 09civ4329 (S.D.N.Y. filed May 5, 2009), available at <http://www.sec.gov/litigation/complaints/2009/comp21023.pdf>.
- 8 *Id.* at ¶ 32.
- 9 451 F.3d 873 (D.C. Cir. 2006).
- 10 Liz Rappaport, "As SEC Steps Up Vigilance, It's Policing Some New Beats," *The Wall Street Journal*, May 7, 2009, at C1.
- 11 Importantly, the SEC's press release announcing the filing of the complaint in *SEC v. Rorech* noted:

The case was handled by the SEC Enforcement Division's Hedge Fund Working Group, which is investigating fraud and market manipulation by hedge fund investment advisers. The SEC has brought more than 100 cases involving hedge funds in the past five years, including more than 20 this year alone. The SEC already has brought more enforcement actions involving hedge funds in the first four months of this year than all of last year.

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