SEWARD & KISSEL LLP

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First Credit Default Swap Insider Trading Case

Memorandum to Our Investment Management Clients and Friends

U.S. Securities and Exchange Commission v. Rorech is the first insider trading case the SEC has brought involving Credit Default Swaps ("CDSs"). On December 9, 2009, the Court in the matter denied the defendants' motions to dismiss, and the decision is important to those who trade or are otherwise involved with CDSs.

The background of the action is that on May 5, 2009, the SEC filed a Complaint against Jon-Paul Rorech, a bond salesman at Deutsche Bank Securities Inc., and Renato Negrin, a trader at Millennium Partners, L.P., for alleged insider trading in CDSs in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 .

The SEC alleges in its Complaint that in July 2006 Rorech, by virtue of his position at the bank, learned of changes in the restructuring of debt at VNU, N.V. ("VNU"), and shared that confidential information with Negrin. VNU is a Dutch media conglomerate that was taken private in May 2006 by a consortium of private equity companies. In order to finance the acquisition, VNU announced a proposed debt restructuring on July 10, 2006. The SEC alleges that one factor affecting the price of VNU CDSs in July 2006 was the limited supply of bonds covered by those CDSs. The SEC further alleges that Rorech was privy to discussions that VNU was going to change the restructuring such that the CDS would cover the new layer of bonds. On July 24, 2006, that change was publicly announced and the price of the CDSs increased. The Commission alleges that Negrin, on behalf of the Millennium fund he managed, bought VNU CDSs based on Rorech's tip and that his fund profited on the trade by approximately $1.2 million.

In August 2009, both Rorech and Negrin filed motions to dismiss the Complaint, essentially arguing that CDSs were not securities covered by the insider trading laws. Specifically, they argued that the SEC did not have the authority to regulate the CDSs at issue in the case because they are not "securities-based swap agreements" under Section 10(b) and 15 U.S.C. § 78j(b). A security-based swap agreement 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." The SEC argued that the prohibition on insider trading applies to the CDSs sold in this case because, among other reasons, the CDSs' price was "based on" the price, yield, value, or volatility of the underlying bonds. The defendants argued that while the price set in the CDS contracts may have been somewhat related to the characteristics of the underlying bonds, the pricing was not "based on" the characteristics of the bonds alone, but were affected by many factors, including the strength of the overall economy and the market's assessment of the referenced company's credit risk.

The Court held that whether CDSs were actually "securities-based" was a question of fact that it could not resolve at this early stage of the proceedings and it allowed the SEC to proceed with the case. The Court indicated that *CDSs appear to fall "into the heartland of the instruments Congress intended to govern under Section 10(b) and Rule 10b-5" especially where courts have historically determined whether novel financial instruments were securities by taking a "flexible approach and look[ing] to the 'economic reality' of the instruments and the public's expectations of their nature."*

Seward & Kissel will continue to monitor the litigation going forward. If you have any questions regarding this decision, please contact one of the following Litigation Partners:

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