Securities Litigation | Litigation

July 6, 2010

Court Scraps First Insider Trading Case Over Credit Default Swaps; Paves Way for Others

by David M. Furbush and Ranah L. Esmaili

On June 24, the U.S. District Court for the Southern District of New York dismissed the Securities and Exchange Commission's first-ever complaint against individuals allegedly involved in insider trading in credit derivatives. This decision, in SEC v. Rorech et al., *represents both a loss and a win for the SEC. While the court found the two defendants had not engaged in insider trading, and therefore dismissed the lawsuit, it also found the credit default swaps at issue to be "securities-based swap agreements" actionable under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.*

This holding in *Rorech* will likely prompt more securities lawsuits over the purchase or sale of credit default swaps. But future plaintiffs will not have an easy job as a result of the district court's analysis. First, the court based its decision on significant amounts of evidence on whether material terms of the swaps at issue were based on the price, yield, value or volatility of securities, including witness testimony and statistical analysis. This suggests future plaintiffs will face a similarly high hurdle in proving the applicability of section 10(b). Second, the outer limits of the court's ruling have not been defined. Are "securities-based swap agreements" limited to credit default swaps that reference securities? Or do they include swaps that reference non-security debt obligations so long as they fit the court's analysis? These issues will be tested in cases to follow.

Background

The SEC filed a lawsuit in May 2009 alleging that Renato Negrin, a portfolio manager at hedge fund Millenium Partners, L.P., and Jon-Paul Rorech, a high-yield bond salesman at Deutsche Bank Securities Inc., engaged in insider trading in the credit default swaps of VNU N.V., a Dutch media holding company.

Deutsche Bank was the lead underwriter for a bond offering by VNU subsidiaries in connection with a leveraged buy-out. In the course of marketing these bonds to sophisticated institutional customers, Mr. Rorech and others learned from market participants and through "chatter in the market place" that there was demand in the market for bonds issued by the VNU holding company because such bonds would be deliverable into existing VNU credit default swap agreements.

The SEC alleged that on July 14 and 17, 2006, Mr. Rorech tipped Mr. Negrin about Deutsche Bank's plans to recommend that the bonds be issued out of the holding company, and about a customer's order for holding company bonds. The evidence at trial showed that, during one call on a recorded line, Mr. Negrin asked Mr. Rorech to handicap the chances of a holding company issuance. Mr. Rorech responded: "you're listening to my silence right?" The men then ended their call, and Mr. Negrin called Mr. Rorech back on his non-recorded cell phone. Later that afternoon, Mr. Negrin purchased VNU credit default swaps on behalf of his hedge fund. He subsequently sold the swaps at a higher price following Deutsche Bank's July 24 announcement that the offering would include holding company bonds, realizing a profit for his hedge fund of approximately $1.2 million. These trades did not deviate from Mr. Negrin's historical trading pattern.

Defendants Are Not Liable for Insider Trading

Following a three-week bench trial, Judge Koeltl granted judgment to the defendants dismissing the SEC's complaint. This ruling was based on insufficient evidence proffered at trial that the defendants misappropriated material nonpublic information, or acted with the scienter and deception necessary for insider trading liability.

The court found no evidence that Deutsche Bank had actually decided to recommend that the sponsors issue holding company bonds, or that any such decision had been conveyed to Mr. Rorech at the time he allegedly tipped Mr. Negrin. It was approximately four hours after the last call when Mr. Rorech learned for the first time that Deutsche Bank, in fact, intended to make such a recommendation. Furthermore, there was no evidence that the wall Deutsche Bank had in place to control the flow of information between its investment banking and sales and trading businesses was ever breached during the marketing of this offering.

The information Mr. Rorech shared also was not material, in the court's view, given widespread market discussions regarding investor demand for VNU deliverable bonds. As an initial matter, "'[a] generalized confirmation of an event that is 'fairly obvious' to every market participant who was knowledgeable about the company or the particular instrument at issue is not material information.'" Moreover, any information Mr. Rorech allegedly shared with Mr. Negrin concerning Deutsche Bank's intention to recommend a holding company issuance "was speculative information that [did] not rise to the level of materiality," particularly where the ultimate decision as to how to structure the bond issuance belonged to the financial sponsors, not Deutsche Bank.

The court also held that Mr. Rorech did not breach any duty to Deutsche Bank. He did not possess confidential information regarding Deutsche Bank's recommendation at the time he shared information with Mr. Negrin. Indeed, it was "the custom and practice in the high yield bond market for Mr. Rorech, a salesperson, to share his ideas with Mr. Negrin, a prospective purchaser of the bonds." As for Mr. Rorech's customer who had submitted the order for holding company bonds, that customer testified that he had no expectation of confidentiality in his proposed order and expected that Deutsche Bank would discuss the order with other potential investors to generate additional demand for the issuance. Deutsche Bank's policy also permitted the sharing of information about such indications of interest with other potential investors in order to build market interest.

Finally, there was no evidence of "motive" by Mr. Rorech to provide Mr. Negrin with inside information, given that they had a purely professional working relationship, and were not personal friends. The evidence did not establish that Mr. Rorech obtained a quantifiable or direct financial benefit as a result of Mr. Negrin's trades. The court pointed out that this was "in stark contract to the typical insider trading case." Thus, the SEC failed to establish scienter.

Mr. Negrin's Credit Default Swaps Are "Securities-Based Swap Agreements"

Although the court dismissed the complaint against the defendants, it found in favor of the SEC on the issue of whether the credit default swaps at issue in this case were "securities-based swap agreements," and were therefore actionable under section 10(b) and Rule 10b-5.

In 2000, Congress passed the Commodity Futures Modernization Act, which expanded section 10(b) to encompass fraud, manipulation, and insider trading of "securities-based swap agreements." Under section 206B of the Gramm-Leach-Bliley Act, a "securities-based swap agreement" is defined 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."

In August 2009, the defendants filed a motion for judgment on the pleadings arguing that the VNU credit default swaps were not "securities-based swap agreements." The defendants argued that the court's analysis must be limited solely to the text of the credit default swap contracts. Because the swap's price terms were specified in basis points, and did not instead refer to the "price, yield, value or volatility of the VNU bonds," the price of the swaps could not be "based on" those characteristics of the bonds. The defendants further argued that the credit default swaps were not "based on" those characteristics of the bonds because they 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 denied the defendants' motion because it raised questions of fact that were not amenable to a motion for judgment on the pleadings.

Based upon substantial evidence submitted at trial, and extensive findings of fact, the court ruled in favor of the SEC on this issue. The court began its inquiry by considering, and rejecting, the defendants' definition of "based on" as requiring a direct or exclusive dependence. Instead, it found "based on" to mean "to use as the fundamental part or ingredient of, or principal component of, something." It observed that the defendants' interpretation of "based on" would "allow traders to escape the ambit of section 10(b) and Rule 10b-5 through clever drafting."

Applying this definition, the court found that the price of the VNU credit default swaps was based on the price, yield and value of VNU's bonds. The spread of deliverable VNU bonds was central to Mr. Negrin's decision to buy VNU credit defaults swaps. Moreover, Mr. Negrin and Mr. Rorech discussed the fact that the price of the swaps would increase if the value of deliverable bonds increased. Other market participants similarly believed that the price, yield and value of VNU's bonds were critical to the VNU credit default swap price. Finally, the fact that bond spreads and credit default swap prices can move in opposite directions on a daily basis was not dispositive, where the VNU credit default swaps purchased by Mr. Negrin in this case were based on the price, yield, value or volatility of the VNU bonds.

Impact of Decision on Future Securities Suits

At first blush, one might have assumed that, to determine whether a credit default swap is a "securities-based swap agreement," a court would merely have to determine whether the reference obligation (i.e., the obligation upon which protection is being purchased) is a security or non-security. But the court apparently did not regard the definition of "securities-based swap agreement" in the Gramm-Leach-Bliley Act to be this straightforward, which significantly complicated the analysis in *SEC v. Rorech*.

First, the court's opinion suggests that courts must take evidence on whether the defendants considered certain characteristics of securities when negotiating the material terms of the credit default swap. This issue will therefore be inappropriate for early resolution on the pleadings and will increase plaintiffs' burden of proof. Defendants may be able to escape the reach of the securities laws if they can prove that the parties did not consider certain characteristics of securities when negotiating the material terms of the swap agreements.

Second, the court's analysis raises a question as to whether evidence of a "correlation" between the price or spread of credit default swaps and a security is sufficient to bring it within the ambit of section 10(b). The court in *SEC v. Rorech* considered substantial evidence and made extensive findings of fact concerning the existence of such a correlation. But the court's definition of "based on" (i.e., "to use as the fundamental part or ingredient of, or principal component of, something") suggests that proof of correlation might support, but will not be sufficient for, a finding that a credit default swap is a "securities-based swap agreement."

Finally, it is unclear whether credit default swaps that reference debt obligations *other than* securities (e.g., a bank loan) could, under certain circumstances, qualify as "securities-based swap agreements." Suppose Bank A is deciding whether to hedge against the credit risk associated with Bank A's loan to Company B. Some of the factors Bank A considers when negotiating the price of the credit default swap are the price, value and volatility of Company B's common stock. Although the reference obligation for the credit default swap is not a security, query whether under the court's analysis in *SEC v. Rorech* it might qualify as a "securities-based swap agreement" if the price, value and volatility of a security was "used as the fundamental part" of determining how to price the credit default swap.

If you have any questions regarding the content of this alert, please contact the Pillsbury attorney with whom you work or the authors below.

David M. Furbush (bio)
Silicon Valley
+1.650.233.4623
david.furbush@pillsburylaw.com

Ranah L. Esmaili (bio)
New York
+ 212.858.1526
ranah.esmaili@pillsburylaw.com