

[Alerts and Updates]

SEC Files Credit Default Swap Insider-Trading Case

May 12, 2009

For the first time, the U.S. Securities and Exchange Commission ("SEC") filed an insider-trading case involving the purchase of a credit default swap ("CDS") based on confidential, nonpublic material information. A CDS is a financial product similar to an insurance policy that pays the purchaser of the CDS a negotiated amount upon the occurrence of certain triggers, typically events of default under a debt security. The trading price of a CDS fluctuates with changes in the perceived likelihood that the original issuer of the debt security will default on such debt security, thereby triggering payment under the CDS. As an issuer's perceived risk of defaulting rises, the value of the underlying CDS increases.

The SEC filed a complaint on May 5, 2009, alleging that Jon-Paul Rorech and Renato Negrin violated the antifraud prohibitions contained in Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 ("Exchange Act"). Rorech is a bond and CDS salesman employed by Deutsche Bank Securities Inc. ("DB"); and Negrin is a former portfolio manager employed by Millennium Partners, L.P. ("Millennium"), a hedge fund investment adviser. The SEC alleged that Rorech learned confidential, nonpublic material information from investment bankers at DB regarding a change to the structure of the proposed DB bond offering of VNU N.V. ("VNU"), a Dutch-based holding company that owns several media businesses, including television rating service Nielsen Media. The revision of the bond offering meant that VNU would be increasing its borrowings, likely making it a riskier borrower and increasing the value of underlying CDSs providing for payment in the event of a default by VNU under its outstanding debt ("VNU CDSs"). The complaint alleges that: (i) Rorech made a series of phone calls to Negrin - some of which were recorded - providing him with information about the structuring and encouraging him to purchase VNU CDSs before such information became public knowledge, and (ii) Negrin subsequently purchased VNU CDSs and later sold them for a profit of approximately \$1.2 million.

Attorneys for each of the defendants have indicated that the defendants plan to deny the allegations of wrongdoing and plan to argue, as a preliminary matter, that they fall outside of the provisions of Section 10(b) of the Exchange Act. In general, the SEC is prohibited from regulating the CDS market because of certain provisions contained in the Commodities Futures Modernization Act ("CFMA"). However, Section 10(b) of the Exchange Act specifically includes "any securities-based swap agreement" (defined in the CFMA) and, in the SEC's view, makes such swap agreements subject to the antifraud and insider-trading provisions of the Exchange Act. The CFMA defines a "securities-based swap agreement" as an 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 defendants' attorneys contend that the VNU CDSs fall outside of the scope of this definition. Even if the court finds that a material term of VNU CDSs were based on one of the factors of a security, the defendants' attorneys are likely to maintain that: (i) the SEC does not have jurisdiction over VNU CDSs because the security that the CDSs were based on was issued by a Dutch company, and (ii) the trades took place outside of the United States.

Trading volume of CDSs has grown exponentially over the past decade, and some have contended that they played a major role in the current economic downturn. In the past, the SEC has not focused its attention on complex financial products like CDSs, which are usually entered into and traded only by sophisticated institutional investors that are more likely to be capable of protecting their own interests than individuals purchasing and selling stock and other less-complex debt and equity securities. However, according to a recent interview with Kay Lackey, associate regional director of the SEC's New York office, the SEC is looking into a "broad array of financial products associated with the financial crisis." Now that the SEC is broadening the scope of transactions on which it

is focused, such as the CDS transaction described above, issuers, investors and the courts may have to deal with an array of novel issues, similar to the issues described in this Alert.

We will continue to monitor developments in the financial markets and provide updates on these developments as they occur.

For Further Information

If you have any questions regarding the proposed rules, including how they may affect your company, please contact one of the [members](#) of the [Securities Law Practice Group](#) or the lawyer with whom you are regularly in contact.