



---

Portfolio Media, Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | [www.law360.com](http://www.law360.com)  
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | [customerservice@portfoliomedia.com](mailto:customerservice@portfoliomedia.com)

---

## **An Analysis Of SEC V. Rorech**

*Law360, New York (August 12, 2009)* -- In a case that has attracted much attention, the U.S. Securities and Exchange Commission has attempted to expand the reach of its enforcement authority to include credit default swaps.

On May 5, 2009, the SEC charged Jon-Paul Rorech, a former salesman at an international investment bank, and Renato Negrin, a former portfolio manager at a large hedge fund, with insider trading in credit default swaps (CDSs).[1]

As the SEC recognized in its press release announcing the case, this is the first time the SEC has brought an insider trading enforcement action involving CDSs.[2]

However, for the case to proceed beyond a motion to dismiss, the court needs to find that CDSs are subject to SEC enforcement jurisdiction.

### **Background**

The complaint alleges that in July 2006 Rorech and Negrin engaged in insider trading relating to VNU N.V., a Dutch media conglomerate that owns Nielsen Media (among others).[3]

In May 2006, VNU was taken private.[4] On July 10, 2006, the equity owners of VNU announced a proposed financial restructuring of the company, including a bond offering, to finance the acquisition of Nielsen Media.[5]

Rorech's bank was the lead underwriter for the bond offering.[6] As part of the deal, the underwriters explored the idea of creating a new tranche of bonds that would be covered by the existing VNU-related CDSs.[7]

On July 24, 2006, it was publicly announced that VNU would be issuing this new tranche of bonds out of the holding company.[8]

The SEC alleges that Rorech tipped Negrin to the VNU restructuring plan prior to the July 24 public announcement, even though at the time the information was confidential and nonpublic.[9]

The SEC further alleges that Negrin, armed with that allegedly confidential information, subsequently purchased VNU-related CDSs and that upon the public announcement of the bond offering, when the value of a CDS on VNU's bonds increased significantly, Negrin sold his VNU-related CDSs allegedly for a \$1.2 million profit.[10]

The SEC complaint seeks (a) an injunction against both defendants, enjoining them from violating Section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act) and Rule 10b-5, (b) disgorgement of all unlawful trading profits, and prejudgment interest thereon, and (c) joint and several liability for the defendants.[11]

Although in some sense this is a garden variety insider trading case, the instrument involved here — credit default swaps — lends the case its novel twist. CDSs are derivative instruments by which investors (usually financial institutions and other businesses) manage their exposure to credit risk.

In simple terms, CDSs are a type of credit insurance contract in which one party (the buyer) pays another party (the seller) a premium to obtain protection from the risk of default on the debt instrument underlying the swap agreement. Then if a designated “credit event” occurs (e.g., a default on the debt instrument), the seller compensates the buyer for the loss.

CDSs are bilateral contracts that are not traded on registered exchanges. Further, CDSs may be, and usually are, traded separately from the debt obligations they reference, meaning that one can possess a CDS without owning the underlying debt obligation.

CDSs, themselves, are not securities. The definition of “security” in both the Securities Act of 1933 (the 1933 Act) and the 1934 Act does not include CDSs.[12]

In fact, in 2000, Congress passed the Commodities Futures Modernization Act (CFMA), which specifically barred the SEC from regulating the CDS market, except in one respect.[13]

The CFMA granted antifraud enforcement jurisdiction to the SEC over “security-based swap agreements.”[14] A “security-based swap agreement” is 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.”[15]

Thus, at the time of the alleged insider trading (and even today), CDSs as an asset class were not fully subject to regulation by the SEC.

As the former director of the SEC Division of Trading and Markets, Erik Sirri, has noted, many derivatives are designed specifically to come within the exclusion provided for under the securities laws.[16] The Rorech case will clarify certain issues relating to the jurisdiction of the SEC over these types of derivative contracts.

### **Defendants' Likely Arguments for Dismissal**

The central arguments of the Rorech defendants will likely relate to jurisdictional defects, that is, they will concentrate on arguing that Section 10(b) does not reach the defendants here, either because there is no jurisdiction over the securities themselves, or CDSs derived from them.

Further, the Rorech defendants are likely to point to the extra-territorial nature of the transactions and the absence of an explicit grant of extra-territorial jurisdiction to ask the court to conclude that the SEC lacks jurisdiction.

In particular, the defendants will likely argue that Section 10(b), which makes it unlawful to “use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered ... any manipulative or deceptive device ...” does not apply to these circumstances.[17]

The Rorech defendants will likely point out that the phrase “any security not so registered,” is ambiguous, and could mean securities traded within the United States, just not on a national exchange, and not foreign securities like the VNU bonds. (Indeed, the defendants may also argue that the VNU bonds may not be a security under even the expansive definition of the securities laws.)

Further, the defendants will likely argue that without explicit authority, the SEC cannot enforce the securities laws extraterritorially.[18]

Accordingly, the defendants will further likely argue that because VNU was not traded on a U.S. exchange, the SEC does not have jurisdiction over the securities themselves, and therefore cannot reasonably have jurisdiction over CDSs derived from those securities. As the complaint fails to allege the location of the actual CDS trades, the jurisdiction question is made even murkier.

### **The Commission's Likely Counter-Arguments**

The SEC also will also likely rely on the language of Section 10(b) and Rule 10b-5. Section 10(b) makes it unlawful to use or employ any manipulative or deceptive device in connection with the purchase or sale of any securities-based swap agreement, as defined in section 206B of the GLBA.

Section 10(b) further states that any rules promulgated thereunder that prohibit fraud, manipulation, or insider trading shall apply to security-based swap agreements to the same extent as they apply to securities. [19]

To the extent that Rule 10b-5 prohibits insider trading in securities, the commission will likely argue, it similarly applies to security-based swap agreements.

In general, the commission will probably argue that Section 10(b) and Rule 10b-5 are broadly worded to encompass a variety of instruments, as well as to further the public policy goals of stopping fraud and policing the markets.[20]

The commission will argue this is of particular importance here because of the growth of CDSs and their susceptibility to abuse. For example, the use of CDSs has been implicated in the current economic situation.[21]

While it is worth noting that the definition of “security-based swap agreement” has never be litigated in this context (a point the defendants are likely to stress), the commission will likely argue that CDSs are security-based swaps subject to the SEC’s antifraud jurisdiction.

Under the GLBA, a “swap agreement” is “any individually negotiated contract, agreement, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices or other assets ...”[22]

In other words, “an OTC derivative is ‘securities-related’ when the reference is to an entity that is an issuer of securities (such as a public company), to a security itself (or a related event such as a dividend payment), to a group or index of securities or issuers, or based on related aspects of a security or group or index of securities or issuers, such as price, yield, volatility, dividend payments or value.”[23]

The SEC will likely argue that the VNU-related CDSs referenced bonds issued by the VNU holding company, and that such bonds are securities, therefore, the CDSs are “security-based.”

The SEC will likely support this argument by citing to section 206B of the GLBA, which does not have the “national exchange” language in Section 10(b) and argue that this supports its jurisdiction over security-based swaps in these circumstances.

The SEC will also likely argue that because there is a close relationship between the securities markets and derivatives such as CDSs, the court should recognize CDSs as security-based swaps, regardless of where the underlying securities trade.[24]

SEC Chairman Mary Schapiro has testified that “[b]ecause market participants can readily use securities-related OTC derivatives to serve as synthetic substitutes for securities, the markets for these OTC derivatives directly and powerfully implicate the policy objectives of capital markets that Congress has set forth in the federal securities laws.”[25]

Schapiro further testified that “[f]rom an economic viewpoint, the interchangeability of securities and securities-related OTC derivatives means that they are driven by the same economic forces and are linked by common participants, trading strategies and hedging activities.”[26]

The SEC will attempt to persuade the court to recognize that CDSs and the obligations they reference are so interrelated, that a finding against them would cause of anomalous result of permitting the SEC to pursue insider trading actions involving derivatives based on domestically traded securities but not those based on securities traded elsewhere, especially where derivative transactions might have effects in the United States.

The commission will likely point to other “long-arm” cases it has brought (and won) to convince the court that the defendants should be subjected to the commission’s enforcement jurisdiction.

This is not the first time the SEC has claimed jurisdiction over transactions that merely impact markets in the United States, allegedly, though the transactions take place elsewhere.

The Second Circuit has developed two jurisdictional tests to deal with such extraterritorial application of the securities laws. One test focuses on the conduct of foreign persons within the United States; the other focuses on the effects within the United States of conduct occurring in foreign nations.[27]

The SEC will likely argue that the court should apply the effects test to find that the purchase and sale of the VNU-related CDSs affected the integrity of the United States markets.[28] The SEC may be able to convince the court to extend the Commission’s reach to cover the allegations presented in the complaint.

## **Conclusion**

While other issues will no doubt be presented by the parties, the above is meant to summarize what may prove to be the thorniest legal questions presented by Rorech. By bringing this case, the SEC has sought to expand the breadth of its enforcement authority. It remains to be seen whether its effort will be successful.

--By Daniel A. Goldfried, Bank of America Merrill Lynch, and Gerald J. Russello and Sima G. Fried, Bingham McCutchen LLP

*Daniel Goldfried is director and assistant general counsel at Bank of America Merrill Lynch. Gerald Russello is of counsel in the New York office of Bingham McCutchen. Sima Fried, an associate at Bingham, assisted in the preparation of this article.*

*The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.*

[1] See generally Compl., SEC v. Rorech, et al., 09–CV–4329 (May 5, 2009 S.D.N.Y.) (hereinafter “SEC Compl.”), available at [www.sec.gov/litigation/complaints/2009/comp21023.pdf](http://www.sec.gov/litigation/complaints/2009/comp21023.pdf); see also SEC Press Release 2009–102, SEC Charges Hedge Fund Manager and Bond Salesman in First Insider Trading Case Involving Credit Default Swaps (May 5, 2009) (hereinafter “SEC Press Release”), available at [www.sec.gov/news/press/2009/2009-102.htm](http://www.sec.gov/news/press/2009/2009-102.htm).

[2] SEC Press Release 2009–102.

[3] SEC Compl. ¶¶ 2, 10. After the acquisition of Nielsen Media, VNU changed its name and is now known as Nielsen Media.

[4] Id. at ¶ 10.

[5] Id.

[6] Id. at ¶ 11.

[7] Id. at ¶¶ 16-18.

[8] Id. at ¶ 20.

[9] Id. at ¶¶ 2, 23-41.

[10] Id. at ¶¶ 2, 42-44.

[11] Id. at ¶ 53.

[12] See Securities Act of 1933, § 2(a)(1), 15 U.S.C. § 77b(a)(1). The 1934 Act provides a similar definition of security in Section 3(a)(10). See Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10).

[13] See Commodity Futures Modernization Act of 2000, P.L. 106–554, App’x E, §§ 302(a), 303(a), 114 Stat. 2763A–365, 451-53 (2000) (hereinafter “CFMA”). Section 2A(a) of the 1933 Act now excludes “non-security-based swaps.” 15 U.S.C. § 77–1(a) (The definition of “security” in section 2(a)(1) does not include any non-security-based swap agreement (as defined in section 206C of the Gramm-Leach-Bliley Act).) (See Section 3A(a) in the 1934 Act.) Section 2A(b)(1) similarly excludes “security-based swaps”. 15 U.S.C. § 77–1(b)(1).

[14] See CFMA, § 303, 114 Stat. at 453–54. Section 10(b) now states that the SEC rules prohibiting “fraud, manipulation or insider trading, shall apply to security-based swap agreements [ . . . ] to the same extent as they apply to securities”. 15 U.S.C. § 78j(b).

[15] Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106–102, § 206(b), 113 Stat. 1338, 1394 (1999) (hereinafter “GLBA”) (current version at 15 U.S.C. § 78c Note).

[16] See Erik Sirri, Testimony Concerning Credit Default Swaps before the House Committee on Agriculture (Nov. 20, 2008), available at [www.sec.gov/news/testimony/2008/ts112008ers.htm](http://www.sec.gov/news/testimony/2008/ts112008ers.htm).

[17] 1934 Act, § 10(b), 15 U.S.C. § 78j(b).

[18] See, e.g., *Morrison v. Nat’l Australia Bank Ltd.*, 547 F.3d 167, 174 (2d Cir. Oct. 23 2008) (noting that there is a general “presumption” against the extraterritorial application of American laws).

[19] See 1934 Act, § 10(b), 15 U.S.C. § 78j(b).

[20] See *SEC v. Zandford*, 535 U.S. 813, 821 (2002) (noting statute’s broad language and interpretation); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972) (noting statutes broad language accords with Congress’ “fundamental purpose ... to achieve a high standard of business ethics in the securities industry”) (internal quotation marks omitted).

[21] For example, the implosion of AIG is often attributed to CDSs. See e.g., Adam Davidson, *How AIG Fell Apart* (Ed. Thomson Reuters Sept. 18, 2008), available at [www.reuters.com/article/newsOne/idUSMAR85972720080918?sp=true](http://www.reuters.com/article/newsOne/idUSMAR85972720080918?sp=true).

[22] Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, § 206(b), 113 Stat. 1338, 1394 (1999) (current version at 15 U.S.C. § 78c Note).

[23] Chairman Mary L. Schapiro, Testimony Concerning Regulation of Over-the-Counter Derivatives before Senate Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing and Urban Affairs (June 22, 2009), available at [www.sec.gov/news/testimony/2009/ts062209mls.htm](http://www.sec.gov/news/testimony/2009/ts062209mls.htm) (“Schapiro Testimony”).

[24] See *id.*

[25] *Id.*

[26] *Id.*

[27] See *SEC v. Berger*, 322 F.3d 187, 192-93 (2d Cir. 2003); see also *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1972) (creating and applying the “conduct test”); *Schoenbaum v. Firstbrook*, 405 F.2d 200 (2d Cir. 1968) (creating and applying the “effects test”).

[28] United States courts have subject matter jurisdiction when illegal activity abroad causes a “substantial effect” within the United States. *Alfadda v. Fenn*, 935 F.2d 475,

478 (2d Cir. 1991). However, the Rorech defendants will likely stress that neither Negrin's purchase nor sale of the VNU-related CDSs affected the market of the underlying bonds.