

SEC Jurisdiction Over Credit Default Swaps

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The U.S. District Court for the Southern District of New York recently dismissed an action commenced by the Securities and Exchange Commission (“SEC”) alleging insider trading with respect to credit default swaps (“CDSs”). This was the first case to address the SEC’s anti-fraud jurisdiction over CDSs. Credit-default swaps are bilateral contracts, not exchange traded, that provide for the transfer of credit risk with respect to a reference security from one party to another. They are akin to portfolio insurance, as the buyer is afforded protection against specified “credit events” (e.g., default, restructuring, credit downgrade). Although the court ruled in favor of defendants, the court affirmed SEC jurisdiction over the CDSs at issue.

In *SEC v. Jon-Paul Rorech, et. al.*, the SEC alleged that the defendants engaged in insider trading in CDSs that provided protection against the credit risk of VNU N.V., a Dutch media holding company. The SEC maintained that a high-yield bond salesperson at an international investment bank (“Banker”) supplied confidential information to a hedge fund portfolio manager (“Manager”) in connection with a proposed restructuring of VNU, including a bond offering. The SEC alleged that Banker disclosed confidential information regarding the investment bank’s recommendations to the holding company, as well as information about customer orders for the holding company’s bonds. Manager bought VNU CDSs on behalf of his hedge fund prior to the public announcement that the bond offering would be amended to include a tranche issued by the holding company (which were deliverable into the existing CDSs of VNU). The value of the VNU CDSs increased substantially after the public announcement, and Manager sold the CDSs for a profit of \$1.2 million.

During the three-week bench trial, the court found no evidence to support the SEC's theory of insider trading. Recognizing that it is common in the high yield market to disclose information about potential structural changes in a bond offering with prospective investors, as bond deals in the high yield market are not presented on a take-it-or-leave-it-basis, the court held that the information at issue was not material and the SEC had failed to prove Banker's actions showed any intent to deceive, manipulate, or defraud.

Although the SEC failed to establish insider trading in this case, it succeeded in establishing jurisdiction over CDSs. The SEC argued that the prohibition in Section 10(b) of the Securities Exchange Act and Rule 10b-5 against insider trading applied to the VNU CDSs because their price was "based on" VNU bonds. The Commodity Futures Modernization Act had amended Section 10(b) to include "securities-based swap agreements." (Covered swaps are defined in section 206B of 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 of index securities, or any interest therein.") Although not explicitly tied to VNU bonds in the CDS contracts, the court accepted the SEC's argument that the "material terms of the VNU CDSs were based on the price, yield, value, or volatility of VNU securities," and that Congress intended Rule 10b-5's anti-fraud rules to govern CDSs like those in this case.

The District Court's decision broadly construes that the swaps were "based on" securities and therefore strengthens the SEC's aegis. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act just signed into law, the SEC will retain jurisdiction over "security-based swaps" while the CFTC and the SEC, in consultation with the Federal Reserve, will have joint rulemaking authority of "mixed swaps" that contain both swap and security-based swap characteristics. The parameters of "mixed swaps" (and the continuing vitality of the determination that the CDSs in *Rorech* were security-based swaps subject to SEC aegis) now await the rulemaking process.

*Author: **Charles E. Dropkin***

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- **Christopher M. Wells**