E-ALERT | Securities Litigation

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SEC TRIAL LOSS SENDS AGENCY BACK TO THE DRAWING BOARD ON PROSECUTING INSIDER TRADING IN CDS

On June 24, 2010, following a three-week bench trial, a federal judge in the Southern District of New York dismissed the SEC's first-ever insider trading case based on trading in credit default swaps (CDS). The agency's loss is a significant setback to its program to expand its enforcement activities into nontraditional markets, especially those associated with the current financial crisis. While clients should expect the SEC to continue to bring cases in new areas, the court's decision strongly suggests that the Enforcement Division and its new specialized units need to redouble their ongoing efforts to deepen the Division's expertise in credit derivatives and other complex products and markets.

The SEC filed the case, *SEC v. Rorech*, in May 2009. Senior agency officials heralded it as "strategically important"[1] and an example of its new priority focus on "cross-market conduct—that is, utilizing two or more of the equity, fixed income and derivatives markets to engage in wrongdoing."[2] In brief, the complaint alleged that a portfolio manager made an unlawful profit of approximately $1.2 million for his hedge fund by trading in CDS on the basis of material, nonpublic information about the structure of a proposed high-yield bond offering provided to him by a Deutsche Bank salesman, in supposed breach of the salesman's duty to keep the information confidential. Both the salesman and the portfolio manager were charged with securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.

In his 122-page decision, U.S. District Judge John G. Koeltl rejected the SEC's proof across the board, finding that the information at issue was neither material nor confidential; that in conveying it the salesman did not breach any duty to Deutsche Bank; and that neither defendant acted with an intent to deceive. Most strikingly, the decision gives the impression that the SEC did not appreciate that, during the marketing of a high-yield bond issue, issuers, investment bankers, and institutional investors routinely exchange information about the potential structure of the offering and indications of interest, and do not regard it as confidential. That standard industry custom and practice, as confirmed by several trial witnesses, would appear to have been a fatal flaw in the case from the outset.

The only silver lining for the SEC is that Judge Koeltl rejected the defendants' jurisdictional challenge by broadly construing the definition of "security-based swap agreements" in Section 10(b) to include the CDS at issue. Yet even that ruling may prove to be of limited prospective utility to the SEC, depending on whether the Dodd-Frank Wall Street Reform and Consumer Protection Act is enacted in its current form and, if so, how the relevant 1934 Act amendments are interpreted. But despite

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[1] SEC Chairman Mary L. Schapiro, Testimony Before the House Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, Jul. 14, 2009, *available at* http://www.sec.gov/news/testimony/2009/ts071409mls.htm.

[2] SEC Enforcement Director Robert Khuzami, Remarks Before the New York City Bar, Aug. 5, 2009, *available at http://www.sec.gov/news/speech/2009/spch080509rk.htm*.

the uncertainty of those provisions and the SEC's trial loss in *Rorech*, one thing is clear: the SEC won't give up on policing insider trading in CDS.

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