Emerging Regulatory and Criminal Enforcement of Credit Default Swaps

By Pravin B. Rao

Credit Default Swaps ("CDS") constitute a multi-trillion dollar segment of the financial services industry that until recently has encountered almost no direct regulation by the U.S. Government. The current financial crisis, however, has resulted in a push by prosecutors, politicians, and regulatory agencies alike for reform of the financial sector and, in particular, the market for over-the-counter (OTC) derivatives. This reinvigorated environment of enforcement is expected to result in more regulatory oversight and increased civil and criminal enforcement actions involving the financial sector. Recent enforcement actions brought by the Securities and Exchange Commission illustrate that the Commission may be attempting to expand its jurisdiction over insider trading involving CDS. This may be a stepping stone to similar actions by criminal law enforcement authorities. For example, the Department of Justice's Antitrust Division announced in July 2009 that it had begun investigating whether certain providers of CDS trading data engaged in anticompetitive behavior. This raises the possibility that the DOJ will use antitrust laws to bring criminal charges against certain individuals for having unfair access to CDS price information. This article will focus on possible civil and criminal liability for insider trading involving CDS and suggest pre-emptive measures to prepare for such enforcement.

Background of CDS Regulation

Derivatives are sophisticated financial instruments intended to increase or decrease risk. The market for trading in these products has grown to over $600 trillion in value. CDS are the most common type of credit derivatives, insurance-like contracts that promise to cover losses on certain securities in the event of a default. Sold by banks, hedge funds, and other financial institutions, CDS typically apply to municipal bonds, corporate debt, and mortgage backed securities. With CDS, the buyer pays a periodic fee to the seller, who is obligated to make a settlement payment if the specified reference company experiences a specified "Credit Event." Although the primary function of CDS is to protect investors against losses on bonds or loans, they are more frequently used as a tool to speculate on a company's ability to repay debt. Such speculation involves investors, hedge funds, and others who buy and sell CDS instruments from the sidelines without having any direct relationship with the underlying investment. While CDS were initially an obscure corner of the credit market, they rapidly grew, from a $100 billion market in 2000 to a world-wide business that had recently mushroomed to $62 trillion. Much of this rapid growth occurred during the housing boom when CDS were used to protect against defaults on mortgage-backed securities.

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Historically, CDS have not been regulated as insurance, securities or futures. The Commodity Futures Modernization Act of 2000 (CFMA), signed into law on December 21, 2000, also generally excludes CDS from regulation as "futures" under the Commodity Exchange Act. In fact, the CFMA describes CDS as "swap agreements" that are not "securities" for purposes of the Securities Act of 1933 or the Securities Exchange Act of 1934. Although the CFMA provides for CDS to be subject to the anti-fraud and anti-manipulation provisions of the 1933 Act and 1934 Act as "security-based swap agreements," it prohibits the SEC from taking preventative measures against fraud or manipulation involving CDS. In testimony before the Senate in September 2008, former SEC Chairman Christopher Cox pointed out: "Neither the SEC nor any regulator has authority over the CDS market, even to require minimal disclosure to the market." Chairman Cox called for giving the SEC the authority to regulate CDS, telling Congress that "the $58 trillion national market in credit default swaps — double the amount outstanding in 2006 – is regulated by no one."

Reinvigorated Regulation and Enforcement Focus on CDS

The days of CDS being unregulated appear to be over, as the reinvigorated enforcement of the financial markets pulls many products onto the Government's radar. The derivatives markets are heavily blamed for the current financial crisis. Specifically, many believe the lack of transparency found in CDS transactions contributed to the credit crisis in 2008. AIG, which was the country's biggest insurance company, was bailed out by the Government after it defaulted on $14 billion worth of CDS.

In response to an outcry for regulating derivatives, the Obama administration recently detailed plans to give the

SEC and the Commodity Futures Trading Commission the authority to police and prevent fraud in the derivatives market, in addition to new record-keeping and reporting requirements for all OTC derivatives. The proposal would require that all standardized OTC derivative transactions be executed in regulated and transparent venues and centrally cleared through exchanges. Furthermore, while trading OTC customized products would still be permissible, regulators would have the authority to collect data on these trades for the first time. Finally, the proposal recommends allowing the CFTC to set position limits on OTC derivatives if they help set market prices. As new regulations are implemented, there will necessarily be more referrals between the regulatory and enforcement arms of the SEC and the CFTC, which, in turn, could lead to more investigations and criminal referrals. Also, as regulators get access to more trading data and can analyze trading patterns, they will have the tools to look for signs of trading that violate insider trading laws.

Recently, Congress has joined the fray by considering steps to curb speculation in the CDS market. The new regulations under consideration could prohibit investors from speculating on a borrower's credit quality, including a ban on so-called "naked" CDS, where a trader does not hold the underlying asset being insured (such as a bond) and a requirement that derivative dealers and investment advisers that manage in excess of $100 million report their short interests in CDS to the appropriate regulator. As with the Obama Administration's proposal, this derivatives bill is part of a broad overhaul of U.S. financial regulation sought by the White House and Congressional lawmakers. Concerned about increased scrutiny from regulators, Wall Street firms are bracing themselves to be more heavily-policed in the future.

CDS-Related Enforcement Actions by the SEC and DOJ

As the increased regulatory scrutiny engenders apprehension on Wall Street, it is only further exacerbated by the SEC and DOJ recently initiating separate investigations into CDS and related markets (and in the SEC's case, already bringing a case).

A. Civil Liability for Insider Trading of CDS: An Expansion of SEC Jurisdiction?

Academic and financial experts have repeatedly claimed that insider trading in CDS is rampant. These experts have supported this conclusion by pointing to instances where CDS prices moved before major market announcements, demonstrating that CDS investors obtained information before it was publicly available and consequently traded on it. Although the SEC has been investigating cases of suspected CDS insider trading since 2007, it has never brought an enforcement action pertaining to CDS until recently.

On May 5, 2009, the SEC brought its first insider trading suit in this area. The SEC charged Jon-Paul Rorech, a Deutsche Bank bond and CDS salesman, with allegedly passing information to hedge-fund money manager Renato Negrin on a bond sale. The SEC complaint alleges that Rorech provided material insider information about the bond offering to his client Negrin, who used this information to buy CDS and sell them a week later after the bond offering was publicly-announced and profited about $1.2 million. As in traditional insider trading cases, a buyer of CDS may be liable for insider trading if the buyer possesses material non-public information, and uses such information to trade and receive a "windfall."

The vigor with which the SEC has pursued this CDS insider trading case highlights its clear political will to exercise more oversight over these markets that could, in turn, signal a new wave of investigations in this area. As the SEC stated in its press release to the Rorech complaint: "CDS may still be obscure to the average individual investor, but there is nothing obscure about fraudulently trading with an unfair advantage. Although CDS market participants tend to be experienced professionals, there must be a level playing field with even the most sophisticated financial instruments." The SEC does not bring this case without some risk, however. Before reaching the merits of its insider trading allegations, the SEC will likely first need to establish that it has jurisdiction to bring such a suit. Rorech has contested the SEC's jurisdiction, arguing that the underlying Dutch bonds are not subject to regulation in the United States. In response, the SEC has asserted jurisdiction based on the swaps at issue being security-based swaps and the defendants being based in the United States. The Commission's goal to assert jurisdiction over CDS trading, even though they are not publicly-traded securities, could be thwarted if it gets a bad precedent in the Rorech case.

B. Criminal Liability for Insider Trading of CDS: Taking a New Tack?

A natural outgrowth of increased SEC insider trading enforcement actions could be parallel criminal proceedings. The most frequently-used criminal statutes to prosecute insider trading— mail fraud, wire fraud, and securities fraud— could just as well be used in CDS insider-trading cases. Since insider trading enforcement has typically fallen under the purview of civil enforcement by the SEC, the DOJ has sparingly exercised its authority to bring parallel criminal proceedings. Nonetheless, CDS insider trading might spur the DOJ to assert itself more in these cases

where both the elevated need for deterrence and high level of culpability associated with these trades (widely held to be the cause of the last year's credit markets' collapse) make it an attractive target for criminal prosecution. The perceived deterrent value of criminal prosecution, in addition to the egregiousness of the story surrounding alleged unlawful CDS trading, could be sufficient for such enforcement. As in other insider trading cases, criminal CDS insider trading will be difficult to prove where prosecutors have to establish willfulness with largely circumstantial evidence. And the intricacies of CDS transactions add another level of complexity, when compared to traditional trading in equities, that makes it difficult to bring criminal cases in this area.

Federal prosecutors, however, are not prone to turn away from pursuing cases in an area because of its complexity. The DOJ may turn to criminal enforcement of CDS through a new angle: antitrust laws. Broadly speaking, antitrust laws are designed to promote fair competition and to protect consumers and businesses from anti-competitive business practices. The harm in antitrust law is done to an entire market, and not a particular business or consumer. Two principal offenses that the DOJ pursues under the Sherman Antitrust Act are "monopolization" and "conspiracy to restrain trade."

Insider trading of CDS arguably falls under the "conspiracy to restrain trade" category, as set forth in Section 1 of the Sherman Act. ("Every contract, combination, in the form of trust or otherwise, or conspiracy, in restrain of trade or commerce among the several States, or with foreign nations, is declared to be illegal.") To prove such an offense, the DOJ would need to establish "the relevant product and geographic market" in which the conspiracy to restrain trade has been allegedly undertaken. Furthermore, the conspiracy merely needs to be a tacit understanding. While certain kinds of trade restraints are deemed *per se* violations (e.g., price-fixing, bid-rigging, horizontal market allocation), others will be found to violate antitrust laws only if they are proven to be unreasonable. Insider trading of CDS might be classified as a *per se* violation because having access to material non-public information on CDS prices is "unambiguously harmful" activity that does not have any "plausible offsetting benefit to consumers."

The DOJ's recent activity may indicate that it is taking this route with CDS. On July 15, 2009, the DOJ's Antitrust Division notified Markit Group Holdings Ltd. that it would be conducting an inquiry into the CDS market. Markit serves as a collector of pricing information from the largest players in the derivatives industry and passes on the gathered information to more than 300 financial firms that use the information to determine the prices of similar contracts in their own books. Markit has thus far been cooperating with the DOJ's inquiry, stating that it would "provide any information requested" and strive to "enhance transparency and efficiency in the credit derivatives market." While the scope of the DOJ's inquiry was initially unclear, it now appears that the DOJ is examining whether Markit's shareholders had an advantage as owners and providers of trading data for CDS.

Market participants have also speculated that the DOJ may be requesting information from Markit to gather evidence of possible dealer involvement in manipulating prices. The DOJ later confirmed the investigation, issuing a statement that "[t]he antitrust division is investigating the possibility of anticompetitive practice in the credit derivatives clearing, trading, and information services industries." In addition to Markit, the DOJ is conducting similar inquiries at several banks to determine if there are industry-wide improper practices through which participants receive unfair access to pricing information.

If the DOJ does find particularly egregious antitrust violations, it may also bring criminal charges under the Sherman Act against officers and directors of a corporation in their personal capacity. If convictions are obtained, these individuals face steep fines and possible jail time, in addition to a likely onslaught of civil claims. While the DOJ may have opened an investigation on Markit due to the gravity of the wrongdoing, it also appears to be in part a response to the changing political climate under the Obama administration, which seems determined to hold those involved in CDS schemes criminally accountable for their actions.

Anticipatory Measures for Heightened Scrutiny

While courts have yet to determine whether the SEC has jurisdiction to bring CDS insider trading cases or whether criminal enforcement actions could also succeed, there is every reason to believe that civil regulators and prosecutors are serious about policing this long unfettered market. Rather than wait for the final word, the better course is for companies to prepare themselves for heightened scrutiny in this area. Companies may be able to reduce the risk of potential civil and criminal prosecutions by following the suggestions set forth below, with the first four recommendations being most relevant to CDS insider trading, while the remaining ones are mainstays of any effective insider trading prevention program:

- Maintain physically and functionally separate departments for trading and lending.

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it is clear that counsel should, at a minimum, make some form of contemporaneous record that a warning has been provided. It is ideal if employees sign a document providing the text of the warning and indicating that the employee has read the warning, understands it and is willing to be interviewed. Without documentation, there is a risk of a court finding, as did the Court in *Ruehle*, that no *Upjohn* warning was given at all.

6. Be especially vigilant about the risks associated with joint representation. While joint representation of a corporation and one of its employees is possible if there are no conflicts of interest, be aware that joint representation creates additional risks, as should be clear from the *Ruehle* opinion. If it appears at all likely that a conflict of interest may arise, decline the joint representation. If such representation is undertaken, make sure to advise the employee (as well as the corporation) in writing of the terms of the joint representation and to include *Upjohn* warnings in that communication.

Endnotes

1. *Upjohn v. United States*, 449 U.S. 383 (1981).
2. 583 F.3d 600 (9th Cir. 2009).
3. *Id.* at 602-03.
4. *Id.* at 602-04, 609-11.
5. *Id.*
6. *Id.* at 603, n.2.
7. *Id.* at 604.
8. *Id.* at 604 n.3, 605.
9. *Id.* at 604.
10. *Id.* at 605-06, n.4.
11. *Id.* at 605.
12. *Id.* at 606.
13. *Id.* at 613-14.
14. *Id.* at 607, 609.
15. *Id.* at 609-12.
16. 415 F.3d 333 (4th Cir. 2005).
17. *Id.* at 335-36.
18. *Id.* at 336.
19. *Id.* at 337.
20. *Id.* at 339-40.

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- Establish walls within a firm to prevent the department engaging in credit derivative trading from learning material non-public information from the lending department.
- Appoint a compliance officer who understands the new regulatory landscape and its intersection with CDS.
- Monitor trading activities of employees and look for large spikes in the purchase of credit derivatives in the period before a big corporate announcement is made.
- Abstain from selective disclosures to analysts in financial firms trading in credit derivatives and ensure that every communication is a wide dissemination of information.
- Utilize restricted lists and watch lists for companies that are being insured by CDS.
- Adopt and enforce procedures designed to eliminate insider trading in CDS and programs designed to educate on the potential dangers of insider trading.
- Require officers, directors, and majority shareholders to disclose their holdings on certain events at certain intervals.
- Impose a blackout period where CDS trading is restricted within a certain period of time, such as before corporate announcements or buy backs are made.
- Convey significant insider activity and corporate disclosure in a uniform publicly-accessible means to the public and to the appropriate exchange.

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