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Should Insider Trading in Credit Default Swap Markets be Regulated? The Landmark Significance of SEC v. Rorech

Adam Reiser*

INTRODUCTION

On May 4th, 2009 the United States Securities and Exchange Commission (SEC) brought suit against Jon-Paul Rorech and Renato Negrin for alleged insider trading with credit default swaps (CDSs) in violation of Section 10(b) of the Securities Exchange Act of 1934. SEC v. Rorech is unique among SEC enforcement actions because it is the first case involving insider trading in credit derivatives. This paper analyzes Rorech by examining insider trading in CDS markets. Until the recent passage of the Dodd-Frank Act, lawmakers left CDS markets largely unregulated, consequently making them a fertile ground for insider trading. While insider trading in securities markets has repeatedly been judicially condemned, some scholars have defended the practice as an effective mechanism to promote market efficiency and productivity. This paper asks whether the insider trading regulations currently imposed on securities markets should be similarly imposed upon CDS markets.

Part I overviews insider trading in securities markets. Part II reviews the CDS market, notes empirical evidence of CDS insider trad-

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2. Credit default swaps are the most widely used kind of credit derivative. See Steven L. Schwarcz, Systemic Risk, 97 GEO. L.J. 193, 220 (2008).
6. CDSs and securities are highly similar. Both involve (1) wagering on the financial future of an entity largely outside of one's control; (2) securing an increased return if one's wager is accurate; (3) receiving a return that is correlated to the financial history of the entity on which one wagers (i.e. those who invest with financially unproven firms reap larger rewards if the firm is
ing, and concludes by discussing Rorech, the latest chapter in insider trading regulation. Part III analyzes whether insider trading in CDS markets should be permitted; it also discusses the lessons Rorech teaches and what it signifies in the future of financial regulation.

I. An Overview of Insider Trading

Because this paper operates on the assumption that insider trading in securities markets is the most analogous model for insider trading in CDS markets, this Part briefly describes insider trading in securities markets. Defined simply, insider trading is engaging in a securities transaction with the aid of material, non-public information. Insider trading in securities markets has long puzzled courts, lawmakers, and commentators. The difficulty of solving the insider trading dilemma centers on pinning down exactly why the practice is culpable at all. Bargaining with asymmetrical information, the core premise of insider trading, is practiced in negotiation and contract arenas with little regulatory interference. The parties themselves regulate the conduct of their counterparties, employing judicial assistance at their own expense.

The dynamic changes, however, when parties move their transactions from one-on-one, in-person transactions to a public security exchange. Securities transactions, which at their core are financial contracts, are regulated in part because the unique asymmetries that exist between publicly traded companies and their investors make contract law insufficient to provide adequate remedies for injured investors. In other words, at some point the advantage one party gains as a result of asymmetrical information becomes significant enough for the law to intervene and punish the party for exploiting that advantage.

No federal statute or regulation explicitly provides a sweeping prohibition on insider trading. Rather, two provisions of the 1934 Ex-

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7. See supra note 6 for explanation of this assumption.
8. Stephen Bainbridge, Securities Law: Insider Trading 1 (2d ed. 2007) (“[T]he phrase insider trading thus includes ... individuals who trade ... on the basis of material information unknown by the investing public at large.”).
9. Prior to the passage of the 1934 Exchange Act, insider trading was not only lawful, but appears to have been encouraged. See Nasser Arshadi & Thomas H. Esyssell, The Law and Finance of Corporate Insider Trading 43 (1993) (noting how, prior to the Exchange Act, insider trading was regarded as a “perquisite granted to corporate insiders”).
change Act and two SEC rules combine to regulate the three areas of insider trading lawmakers and regulators have deemed most harmful. Section 16(b) of the Exchange Act, commonly known as the “short swing provision,” regulates trading by corporate insiders but only within a narrow time frame. Whenever insiders sell and purchase company stock within a six-month time frame, 16(b) holds them strictly liable for any profits gained or losses avoided irrespective of whether the insider actually used material, non-public information to make her decision. The SEC crafted Rule 14e-3 to regulate trading on material, non-public information but the rule only applies to tender offers.

Finally, section 10(b) of the Exchange Act is undoubtedly the strongest and farthest reaching weapon available to curb insider trading, and the rule most resembling a “catchall” provision applicable to insider trading. Section 10(b) makes it unlawful for any person “[to] use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.”

The SEC in turn promulgated Rule 10(b)(5), which makes it unlawful “to (a) employ any device, scheme, or artifice to defraud . . . or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.” From 10(b)(5) emerged three judicially crafted theories of insider trading liability: The Equal Access Model of Liability, the Fiduciary Duty Model of Liability, and the Misappropriation Model of Liability. While each model's scope of liability varies, each succeeds in condemning the practice of trading with the aid of material, non-public information. Part III discusses these theories in detail.

10(b)(5) and its judicial progeny apply only to securities and, by virtue of a subsequent amendment, “securities-based swap agreements.” Financial instruments such as CDSs, unless they are classified as securities or securities-based swap agreements, are thus free from 10(b)(5)'s reach. Part II transitions into an overview of the CDS

12. Id.
15. 17 C.F.R § 240.10b-5 (2010).
market which, combined with Part I, lays an analytic foundation upon which Part III's discussion of CDS insider trading regulation builds.

II. CREDIT DEFAULT SWAPS

The lending arena entered an era of transformation in the early 1990s. Creditors recognized they were needlessly assuming all the risk of debtor default. The idea of spreading lending risk among parties besides the creditor emerged as a viable, legal, win-win alternative and credit default swaps were the vehicle that made the idea a reality.

A credit default swap is a type of credit derivative\textsuperscript{17} that spreads risk among parties in ways similar to insurance contracts. In a CDS, a "protection buyer" contracts with a "protection seller," who agrees to compensate the protection buyer if a designated reference asset experiences a "credit triggering event." The credit triggering event is usually the default of the reference asset. For example, protection buyer X, wanting to hedge some of the risk it assumes by lending to Y, transacts a CDS with protection seller Z. If the credit triggering event occurs, Z must compensate X for all or part of its loss, depending on the terms of the CDS. In exchange for assuming this risk, Z receives a periodically paid premium from X.\textsuperscript{18}

A. The Value CDSs Provide

Shortly after their inception in the early 1990s, CDSs rapidly blossomed into an immensely popular financial instrument, exceeding $450 trillion in notional value by mid-2009.\textsuperscript{19} CDSs benefit individual market participants because they "increase[ ] the range of financial products available to corporations and investors and foster[ ] more

\textsuperscript{17} Some types of credit derivatives are considered over-the-counter (OTC) derivatives. A derivative is labeled OTC when it is not traded on any centralized exchange. As part of its response to the financial crisis, the SEC sought to reduce some of the risks and harms associated with OTC trading by approving designated entities (e.g., Chicago Mercantile Exchange) to serve as central counterparties (CCPs) for credit derivatives. CCPs help reduce some of the risk of OTC trading by providing some of the functions a centralized exchange provides, such as substituting the liquidity of the CCP for the liquidity of the counterparties to a CDS. Nevertheless, as of the date of this paper's submission, no true centralized exchange for credit derivatives yet exists. See Granting Temporary Exemptions, Exchange Act Release No. 34-59578, 2009 SEC LEXIS 737 (Mar. 13, 2009), available at http://www.sec.gov/rules/exorders/2009/34-59578.pdf.


precise ways of understanding, quantifying and managing risk.”

CDSs mitigate the sudden and intense blows of debtor default that often push lenders into failure. By enabling lenders to spread the debtor’s default risk among several parties, rather than shouldering that risk alone, CDSs permit lenders to make more loans.

CDSs also benefit the market collectively because they reduce systemic risk. Systemic risk is the notion that “a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences—sometimes referred to as a domino effect.” Systemic risk theory posits that these domino effects, if not contained

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20. The President’s Working Group on Financial Markets Report on Over-the-Counter Derivatives Markets and the Commodity Exchange Act: Before the S. Comm. on Risk Mgmt., Research and Specialty Crops on the H. Comm. on Agric., 106th Cong. 15 (2000) (statement of Lee Sachs, Assistant Secretary for the Financial Markets, U.S. Department of Treasury), available at http://commdocs.house.gov/committees/ag/hag10643.000/hag10643_0f.htm; see generally John D. Finnerty & Mark S. Brown, An Overview of Derivatives Litigation, 1994 to 2000, 7 FORDHAM J. CORP. & FIN. L. 131, 146 (2001); Lily Tjoe, Note, Credit Derivatives: Regulatory Challenges in an Exploding Industry, 26 ANN. REV. BANKING & FIN. L. 387, 394 (2007) (“[C]redit derivatives allow different parties in the market to calibrate their portfolios to accommodate varying appetites for credit risk.”). To illustrate: suppose a market participant enters into a financial transaction where the risk could be anywhere from twenty to thirty units (arbitrary numbers). The highly customized nature of the CDS allows the trader to know with much greater certainty the exact level of risk she is assuming (say twenty-eight units). The trader can now seek out specific ways to hedge a risk of twenty-eight units. This certainty increases the chances that the trader will hedge the CDS risk correctly, which in turn decreases the risk involved with the initial CDS transaction.

21. See infra note 26 (describing how CDSs reduce the burden lenders shoulder when a default does occur). The CDS’s ability to decrease the overall risk a lender assumes for any given loan enables the lender to make more loans.

22. Schwarcz, supra note 2, at 220 (“Derivatives used for hedging . . . actually reduce the potential for systemic risk . . . . The most widely used derivative instrument for this purpose is the credit-default swap.”).


24. Schwarcz, supra note 2, at 198.

The classic example of systemic risk in this context is a “bank run,” in which the inability of a bank to satisfy withdrawal-demands causes its failure, in turn causing other banks or their creditors to fail. The original failure can occur when depositors panic, converging on the bank to quickly withdraw their monies. Because banks keep only a small fraction of their deposits on hand as cash reserves, a bank may have insufficient cash to pay all withdrawal-demands, causing it to default and ultimately fail. The chain of subsequent failures can occur because banks are closely intertwined financially. They lend to and borrow from each other, hold deposit balances with each other . . . . Because of this interconnectedness, one bank’s default on an obligation to another may adversely affect that other bank’s ability to meet its obligation to yet other banks, and “so on down chain of banks and beyond.”

Id. at 199 (citation omitted).
early, may put entire markets at risk of collapse.\textsuperscript{25} Former Federal Reserve Chairman Alan Greenspan noted,

Historically, banks have been at the forefront of financial intermediation, in part because their ability to leverage offered an efficient source of funding. But too often in periods of severe financial stress, such leverage brought down numerous, previously vaunted banking institutions, and precipitated a financial crisis that led to recession or worse. But recent regulatory reform coupled with innovative technologies has spawned rapidly growing markets... credit default swaps... The new instruments of risk dispersal have enabled the largest and most sophisticated banks in their credit-granting role to divest themselves of much credit risk by passing it to institutions with far less leverage.\textsuperscript{26}

B. The CDS Market's Vulnerability to Insider Trading and Associated Harms

While they provide significant value to the market, CDSs are also highly susceptible of insider trading\textsuperscript{27} and associated harms. Specifically, if protection buyer X has material, non-public information about reference asset Y, or can itself influence Y's credit triggering event, X has incentive to exploit this information to the detriment of less-informed protection sellers. Similarly, loan officers of a bank may pass on information to protection buyers who are not themselves creditors to the reference asset, arguably defrauding the CDS counterparties of these protection buyers. For at least three reasons, CDS markets are ripe for insider trading and other associated harms deserving special attention: (1) Most of the players in the CDS market are insiders; (2) CDSs create moral hazards that increase the damage caused by insider trading; and (3) the CDS market is highly opaque and CDSs only recently have been traded on regulated exchanges. The next sections discuss each in turn.

\textsuperscript{25} See id.


Firms using both debt and equity financing tend to maintain closer relationships with their lenders than with their investors.\(^{28}\) Lending relationships often require borrowers to provide to their lenders material information, including revenue projections, merger and acquisition plans, and other price-sensitive information well before the public obtains that information.\(^ {29}\) Lenders use this information to quote CDS prices to potential protection sellers, a responsibility which often falls on the lender's trading desk.\(^ {30}\) As Professors Acharya and Johnson note, "[I]n the absence of perfect 'Chinese walls' within banks, the credit derivatives market provides the trading desks...a trading mechanism through which the information possessed by loan officers about a firm can be exploited, and, in turn, transmitted in public markets."\(^ {31}\)

Further lubricating the insider trading wheels is the fact that nearly all CDSs on the market are held by a very small number of large institutional traders. The same ten lenders are participating in nearly two-thirds of all CDS transactions,\(^ {32}\) and each of these lenders has access to material, non-public information for each of their CDSs. CDS markets break with securities markets in this aspect. Unlike securities markets, in which few market players have access to inside information, nearly every CDS player has access to inside information.

2. CDS Moral Hazards Increase Harms Caused by Insider Trading

At their core, CDSs are insurance contracts; like all insurance contracts, CDSs create moral hazards.\(^ {33}\) A CDS's ability to compensate a lender for the loss it incurs as a result of borrower default causes that borrower to reevaluate its interests as the lending relationship progresses. In some scenarios, lenders may find it more financially advantageous to collect from the protection seller than from the borrower,\(^ {34}\) and so may actually hope for the lender's default.\(^ {35}\) Thus,

\(^{28}\) See id. at 3.
\(^{29}\) See id.
\(^{30}\) See id.
\(^{31}\) See id.
\(^{32}\) Tijoe, supra note 20, at 404 n.146–49.
\(^{34}\) See Gregory Plotko, The Impact of Credit Default Swaps on the Chapter 11 Process, 18 J. BANKR. L. & PRACT. 1 (2009) ("The Bankruptcy Code contemplates that creditors will act in their own self-interest to participate constructively and rationally in the restructuring process and will
in some scenarios, CDSs are incentivizing creditors and other protection buyers to destroy value in reference entities.\textsuperscript{36}

In an example describing the most extreme version of CDS moral hazard, Pacific Investment Management Co. (PIMCO), the largest bond investor in the U.S., recorded several cases of CDS insider trading exploiting large firms such as Household International Inc., AT&T Wireless, and Sprint. Indeed, when used unethically, credit default swaps become "a mechanism with which friendly commercial bankers . . . can profit by betraying and destroying their clients through the use of inside information," and "firms with large lending departments would always come in and buy protection at exactly the right moment."\textsuperscript{37}

A less extreme example of CDS moral hazard involved a 2004 lending arrangement with J.P. Morgan Chase, Morgan Stanley, and several hedge funds serving as creditors for a $580 million loan to Tower Automotive (Tower).\textsuperscript{38} As Tower's financial position declined, it sought to refinance and asked for additional loans to free up collateral.\textsuperscript{39} Although J.P. Morgan Chase and Morgan Stanley cooperated, presumably doing so to help Tower avoid default, the hedge funds flatly rejected the request.\textsuperscript{40}

Wall Street rumor currents suggested the hedge funds had short-sold Tower's stock.\textsuperscript{41} Sophisticated financial models created a scenario where the profits Tower would gain from the shorted stock were greater than those they would gain from a continued lending relationship with Tower.\textsuperscript{42} CDS trading records are too inaccessible to confirm that the hedge funds had purchased CDS protection for their favor a bankruptcy filing only if they expect to receive more in a bankruptcy than in an out-of-court workout.") (citation omitted).

35. See Henry T. C. Hu & Bernard Black, \textit{Equity and Debt Decoupling and Empty Voting II: Importance and Extensions}, 156 U. PA. L. REV. 625, 732 (2008) (describing how CDS-backed creditors no longer have the same incentives to work toward their borrowers' reorganization and may even contribute to a borrower's decline); see also Eamonn K. Moran, \textit{Wall Street Meets Main Street: Understanding the Financial Crisis}, 13 N.C. BANKING INST. 5, 42 (2009) ("[T]he underlying sentiment [of lenders] was why worry about the possibility of loan defaults if credit-default swaps were available.").


38. See Partnoy & Skeel, Jr., supra note 26, at 1034.

39. See id.

40. See id.

41. See id. at 1034-35.

42. See id.
Tower loans.\(^4^3\) However, if they did, the incentive to destroy Tower's value may have been irresistible.\(^4^4\) Not only would the hedge funds have profited from their short sale, they would have received additional compensation from their CDS. With such a reward hinging upon its borrower's decline, some market players might take affirmative measures to accelerate it.

Still less extreme examples of CDS moral hazard involve CDS-hedged lenders who, though not taking affirmative steps to destroy a borrower, disregard implied, but unenforced, duties to assist in their borrower's revival. Such was the case when Enron defaulted in 2001. Market watchers noted that its lenders were mysteriously uninvolved and seemingly uninterested in Enron's decline.\(^4^5\) Observers later learned Enron's creditors had effectively used CDSs to hedge themselves against Enron's failure; thus the creditors had little interest in Enron's survival or assisting in its restructure, as creditors typically do and should.\(^4^6\)

CDS insider trading is an issue ripe for discussion because of the CDS market's opacity, its absence of regulation, and the significant flow of material, non-public information that occurs in lending relationships. CDS moral hazards further the discussion by illustrating that, regardless of whether CDS insider trading is itself a harmful practice, it incentivizes additional market-destroying behavior. When a creditor receives compensation for the default of its borrowers, and the creditor possesses inside information about the borrower's financial situation, the creditor may at times have incentive to use that inside information to contribute manipulatively to the borrower's decline.

3. CDS Markets are Highly Opaque and Have Only Recently Been Traded on Regulated Exchanges.

To promote product innovation and growth, Congress explicitly excluded OTC derivatives from the securities regulatory framework in the Commodity Futures Modernization Act of 2000.\(^4^7\) A recent study of CDSs by the Government Accountability Office found that "comprehensive and consistent data on the overall market have not been

\(^4^3\) See id.
\(^4^4\) For protection buyers who are not simultaneously serving as the lender to the reference asset, the moral hazard may reach still higher levels.
\(^4^5\) See Partnoy & Skeel, Jr., supra note 26.
\(^4^6\) See id.
readily available,” that “authoritative information about the actual size of the market is generally not available” and that regulators are currently unable to monitor activities across the market. An absence of regulation allows CDS market players to exploit informational advantages in a way prohibited in securities markets.

C. SEC v. Rorech

The facts giving rise to SEC v. Rorech began when VNU, a Dutch media holding company, employed Deutsche Bank Securities Inc. (DBSI) as an underwriter for its public bond offerings. VNU regularly offered CDSs that used VNU bonds as the reference asset. From July 12th to July 24th, 2006, DBSI allegedly encouraged VNU to issue additional bonds, leading to VNU’s announcement of an additional public bond issuance on July 24th, 2006.

In Rorech, the SEC alleged that the issuance of these new bonds materially affected the price of previously issued VNU CDSs. According to the SEC, a trader in possession of VNU CDSs before the July 24th announcement enjoyed a significant price and value increase in her CDSs after the announcement. Surely enough, the price of VNU CDSs did significantly increase after the July 24th announcement.

DBSI employed Paul Rorech as a bond and CDS salesman. The SEC alleged that between July 14th and July 17th, 2006, Rorech tipped off Renato Negrin, a manager for a hedge fund investment advisor, about the upcoming VNU bond issuance. On July 17th and July 18th, 2006, Negrin purchased two VNU CDSs, allegedly basing his purchase decision on Rorech’s tip. Sometime after the July 24th announcement, Negrin sold his CDS for a profit of approximately $1.2 million.

On May 11th, 2009, the SEC brought suit in United States District Court, Southern District of New York, against both Rorech and

49. VNU is the actual name of the company and is not an acronym.
51. Id. at 378.
52. Id. at 382.
53. Id. at 387.
54. Id. at 383.
55. Rorech, 720 F. Supp. 2d at 387.
56. Id. at 383.
Negrin. The SEC’s complaint accused both Rorech and Negrin of violating Section 10(b) of the Securities Act. Both defendants argued that their trades were outside of the 10(b) scope because they were not securities-based swap agreements; the SEC therefore lacked subject matter jurisdiction to pursue the case. Rorech further argued that even if he traded on material, non-public information, he still was not in violation of 10(b)’s insider trading proscription because he had no duty to keep information about the VNU bonds confidential.

*Rorech* provides the first judicial response to CDS insider trading and, in doing so, breaks ground on what promises to be a fruitful new area of judicial and scholarly analysis. The *Rorech* court had three primary options in deciding the case. First, it could have ruled that a CDS is not a securities-based swap agreement. Such a holding would have dismissed the SEC’s complaint because, in the pre-Dodd-Frank regulatory landscape, the only viable avenue for regulating CDS was through 10(b); and 10(b) is only operative in securities-based swap agreements.

A second option available to the court was to rule that CDSs are securities-based swap agreements, while also holding that CDS traders are nevertheless free from 10(b) liability because they possess no fiduciary duty to either disclose material, non-public information or refrain from trading. Again, such a holding would have dismissed the SEC’s complaint. Absent a fiduciary duty to disclose material, non-public information, 10(b)’s reach would not extend to CDS insider trading.

The *Rorech* court chose the third and most analysis-rich option by holding that CDSs are security-based swap agreements while also holding that CDS traders have a fiduciary duty to disclose material, non-public information or refrain from trading. Because the court found that neither Rorech nor Negrin possessed the necessary inside information to qualify as true “insiders,” both defendants escaped liability entirely. The court’s holding nevertheless sweeps CDS insider trading into SEC jurisdiction. It also requires courts, Congress, and administrative agencies to craft a new rule of exactly what the fiduciary duty in CDS markets entails.

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57. *Id.* at 370.
58. *Id.* at 404.
59. *Id.* at 408–13.
61. If the history of insider trading in securities markets is any predictor, defining a fiduciary duty in CDS markets will be no easy task. The most recent Supreme Court case dealing with fiduciary duties in securities markets was *United States v. O’Hagan*, 521 U.S. 642 (1997). The rule set forth in *O’Hagan* has been highly criticized. See, e.g., M. Breen Haire, *The Uneasy Doctrinal*
III. SHOULD INSIDER TRADING IN CDS MARKETS BE REGULATED?

As described in Part I, scholars, market participants, and lawmakers alike have hotly contested insider trading regulation in securities markets. A congressional reluctance to statutorily ban all trading on material, non-public information has led to three separate eras of judicially created insider trading regulation, each producing a unique collection of awkward, inconsistent results.\textsuperscript{62} With Rorech, the CDS market now embarks on its own journey through the puzzling world of insider trading regulation, and undoubtedly will face many of the same challenges securities markets have faced. Part III assesses whether CDS insider trading should be regulated. It first analyzes how arguments that favor insider trading in securities markets apply to CDS markets. It then argues why an insider trading prohibition in CDS markets, as in securities markets, is sound policy.

A. Weighing Insider Trading Deregulation Arguments in Securities Markets and Analyzing their Applicability to CDSs

Deregulators (those who oppose insider trading regulation) have set forth the following arguments: (1) Insider trading increases pricing efficiency;\textsuperscript{63} (2) those suffering losses from trading with insiders would have suffered the same losses had inside trading regulations been in place;\textsuperscript{64} (3) insider trading improves the agent/principal relationship.\textsuperscript{65}

1. Increased Pricing Efficiency

Deregulators argue that insider trading leads to greater pricing efficiency in securities markets by bringing the security's price closer to the price it would be if the inside information was publicly known.\textsuperscript{66} More accurate pricing leads to more efficient allocation of resources. Assuming the argument is cogent\textsuperscript{67} it is likely even more persuasive in CDS markets.


\textsuperscript{62} Part III(C) analyzes each of these eras in detail.

\textsuperscript{63} See Carlton & Fischel, \textit{supra} note 5, at 866-68.

\textsuperscript{64} See DONALD C. LANGEVVOORT, INSIDER TRADING REGULATION 41(1991 ed.).

\textsuperscript{65} See Manne, \textit{supra} note 5, at 111-58.

\textsuperscript{66} See Carlton & Fischel, \textit{supra} note 5, at 866-68.

As noted above, parties disclose more material, non-public information in lending relationships than in equity relationships. Additionally, the CDS market is highly institutionally concentrated. These facts combine to make the CDS market much more “inside” than securities markets. Most of the players in the CDS market are insiders with ready access to inside information. Thus, at an even greater pace than in securities markets, trading in the CDS market with material, non-public information arguably leads to increased pricing efficiency.

2. Those Suffering Losses from Trading with Insiders Would Have Suffered the Same Losses Had Insider Trading Regulation Been in Place

Perhaps the most oft used argument by regulators (those favoring insider trading regulation), and discussed more below, is the fundamental unfairness of trading with asymmetric information. Absent regulation, insiders inevitably will profit at the expense of less-informed outsiders. However, if regulation’s goal is to protect the outside trader, a ban on insider trading is not necessarily an effective means of accomplishing this goal. Had regulations barred the insider from trading, the outsider who would have traded with that insider will find another outsider with whom to make its intended trade, and subsequently suffer the same loss it would have suffered had it traded with the insider.

This argument assumes, however, that the absence of inside traders would not affect the outsider’s trading decision. If there are a sufficient number of insiders who would have traded with material, non-public information, but who are now regulatorily barred from making those trades, there will be fewer traders of that security, thus changing its price. The changed price may affect the less-informed trader’s decision.

As noted above, insider trading activity in CDS markets creates even greater price shifts because insiders make up a greater portion of total traders than insiders in securities markets. Unlike in securities markets, there are fewer CDS outsiders whose trading activity can di-

68. As Tijoe notes, The “$12.4 trillion market for credit derivatives is dominated by too few banks, making it vulnerable to a crisis if one of them fails to pay on contracts that insure creditors from companies defaulting.” Ten of the top firms on Wall Street hold more than two-thirds of credit default swaps. A default in a major dealer or investment manager in the credit derivatives market may harm the market overall and worsen credit derivatives’ liquidity.

Tijoe, supra note 20, at 404 (citations omitted).

69. See infra note 86, for further discussion.
lute the price-changing effects of insiders' trading activity. Thus, the argument that those suffering losses by trading with insiders would have suffered the same loss in the absence of insider trading loses some of its steam in the CDS market. In the CDS market, it is less certain that outsiders would have made their same ill-fated trades with insider trading regulations in place.

Decreased liquidity in CDS markets further weakens the argument. As noted in Part II(A) & (B), CDSs are highly customized and have only recently been traded on centralized exchanges; this in turn poses liquidity problems. Unlike in public securities markets, where traders are generally able to immediately find a counterparty for their desired trade, CDS traders are not always so fortunate.

To illustrate how decreased liquidity is relevant in this context, consider the following example: CDS trader X intends to use material, non-public information and enter into a CDS transaction with counterparty Y. Because of its informational advantage, X will likely profit at Y's expense. However, if regulation prohibits X from entering into the transaction, deregulators would argue that Y will find another counterparty and make the same transaction it would have made with X. However, the decreased liquidity in the CDS market might prevent Y from finding that counterparty. In such case, the insider trading ban effectively prevented Y's loss.

3. Agency Arguments

Commentators have set forth several arguments asserting that insider trading improves the principal/agent relationship. None of these arguments applies to CDSs because no principal/agent relationship is currently recognized in a CDS transaction. None of the parties in a CDS transaction—protection buyer, protection seller, reference asset—serves in any formally recognized agency capacity.

70. In Part III(B)(2) below, I argue that a CDS insider trading prohibition would benefit the CDS market by increasing its liquidity. Such increased liquidity, I recognize, would return some of the force of the deregulators' argument in III(A)(2). Public policy is a battle of tradeoffs. I do not believe the added force that increased liquidity would provide to III(A)(2)'s deregulation argument sufficiently trumps the other benefits of increased liquidity a CDS insider trading prohibition would engender.

71. See MANNE, supra note 5, at 111–58.

72. In Section III(D) I argue that a principal/agent relationship should exist between a borrower and a protection buyer; however, I also argue that CDS insider trading by a protection buyer constitutes an egregious breach of this fiduciary relationship—nothing like the improvements the deregulators claim would occur in the securities markets if the insider trading prohibition was lifted.
B. Why an Insider Trading Prohibition in CDS Markets is Sound Policy

Similar to securities markets, an insider trading prohibition in CDS markets would (1) promote confidence in financial markets; (2) increase liquidity and (3) decrease the moral hazard associated with insider trading.

1. Promoting Confidence in Financial Markets

Confidence in financial markets is low. Fairness is a fundamental precept of a financial market in which the public can have confidence. Momentarily placing economic and legal arguments aside, something simply “feels” wrong about corporate insiders profiting at the expense of those who do not have, and cannot obtain, the same information the insider has. Though the author is unaware of any empirical study proving that insider trading deters market participation, the anecdotal evidence is arguably sufficient. Human nature is to avoid games where one’s opponent has stacked the deck unevenly in one’s favor. Because CDSs are of great economic benefit, a public perception of CDS market fairness is of great import.

Similar to a fair marketplace, a consistent marketplace earns public respect and confidence. Consistency is highly applicable to CDSs because, while CDS insider trading is similar to securities insider trading, only the latter is regulated. SEC Chairman Mary Schapiro recently commented on the undesirability of inconsistently regulating similar financial products and practices: “A basic tenet of functional regulation . . . is to have a regulatory regime under which similar products and activities should be subject to similar regulations and oversight.”

“[R]egulatory arbitrage[] possibilities abound when economically equivalent alternatives are subject to different regulatory regimes. An


individual market participant can have incentives to migrate to products that are subject to lighter regulatory oversight."

2. Achieving Increased Liquidity

Public confidence in the market, and the increased market participation that occurs as a result, leads to increased liquidity. Currently, the CDS market suffers from institutional concentration, a term that refers to a small number of participants dominating a specific market. Institutional concentration can cause significant liquidity problems. Because the CDS market participants share liabilities, security and derivative ownership, and other financial dealings with one another, each participant's success in part hinges on the success of the other players. If one participant begins to fail, each of the other market participants becomes vulnerable as well.

With so few institutions dominating the market, the failure of even one significantly affects the liquidity of the market collectively. Several institutional failures in a short period of time can lead to a liquidity crisis of market-destroying magnitude. The risk of such phenomena occurring is referred to as "systemic risk"—the concept that "a trigger event," such as an economic shock or institutional failure, causes a chain of bad economic consequences—sometimes referred to as a "domino effect."

The role American International Group (AIG) played in the 2008 financial crisis illustrates these principles in action. AIG had entered into complex webs of CDSs that it used to hedge the risks of $441 billion worth of mortgage-backed securities, $58 billion of which involved sub-prime loans. As the value of these sub-prime loans tumbled, AIG's credit rating was downgraded, causing many of its

77. See supra note 68.
78. See Tjoe, supra note 20, at 404 nn.146-49.
79. "Trigger event" in this context does not necessarily mean triggering events in relation to a CDS. Though a CDS triggering event can be the start of systemic collapse, there are many other triggering events that could also play this role.
80. Schwarcz, supra note 2, at 198.
81. A mortgage-backed-security (MBS) is a type of asset-backed security that is secured by a mortgage or a collection of mortgages. Investing in MBSs is essentially lending money to a home buyer or business and betting on the borrower paying it off, for which the investor will then reap a return.
counterparties to demand it to post collateral.\textsuperscript{83} Obtaining that collateral in the complex web of CDSs in which AIG had entangled itself caused a liquidity crisis that, but for a federal bailout, would likely have led to its bankruptcy.\textsuperscript{84}

Preventing AIG’s failure, of itself, was not likely a sufficient reason to expend hundreds of millions of taxpayer dollars. Rather, the heightened liquidity problems and the accompanying systemic risk the remainder of the market would have borne had AIG failed led government decision-makers to conclude its bailout was justified.\textsuperscript{85} Reducing institutional concentration in the CDS market is one preventative to liquidity and systemic crises. More widely spread participation in any market increases its liquidity. To at least some degree, increased participation in the CDS market depends on public perceptions of its fairness and consistency. Regulating CDS insider trading is one way to increase fairness and consistency, thereby broadening CDS market participation and preventing the liquidity and systemic catastrophes like those of September 2008.

3. Reducing Moral Hazards

Insider trading in securities markets creates a moral hazard by allowing managers to profit from their firm’s decline.\textsuperscript{86} Managers trad-
ing with material, non-public information have incentive to destroy value in their firms and reap personal gain by short selling the firm's stock. CDSs suffer from a similar moral hazard, which Part II(B)(2) introduced and this Part readdresses. Consider the following straightforward example: Creditor X learns material, non-public information about the financial condition of one of its borrowers, Y. Because the information is negative, X seeks CDS protection and enters into a CDS transaction with protection seller Z.

As Y's financial condition declines, X may find the payout of the CDS more favorable than the payout of a continued lending relationship with Y. X may subsequently take measures to ensure Y’s failure, most likely by refusing to assist in or by manipulating Y’s restructuring. In an action closely resembling securities market moral hazard, X may even short Y’s stock in effort to manipulatively drive its price down, further facilitating Y’s downward slide.

A ban on CDS insider trading would shrink the CDS moral hazard. If regulations barred X from trading with material, non-public information, it would have been unable to purchase the CDS protection at the time it did because the purchase utilized material, non-public information. If X desires CDS protection for its loan to Y, regulation would force X to purchase this protection without the assistance of material, non-public information in its possession. A CDS insider trading ban thus forces X to bargain with symmetrical information or not come to the bargaining table at all. Being unable to lawfully purchase a CDS, X loses its incentive to destroy value in Y and instead returns to the traditional, more constructive role of assisting in Y’s revival.

Notably, an insider trading ban would not abolish X’s incentive to destroy value in all circumstances. X may still purchase CDSs, so long as the exchange occurs with symmetrical information. Once in possession of a CDS, X’s incentive to destroy Y’s value returns. The insider trading ban makes this scenario less likely, however, because it ensures X bargains with symmetrical information. When Z possesses the same information X possesses, Z likely will not sell protection to X unless Y is in good financial health. The insider trading ban would thus prevent those scenarios mentioned in Part II(B)(2) in which a protection buyer, utilizing insider information, sabotages its reference asset and buys CDS protection at just the right time. But whenever a protection buyer succeeds in purchasing protection, from that point forward an insider trading ban’s ability to curb CDS moral hazards is exhausted.
C. The Case Law Governing Insider Trading in Securities Markets

Turning now from insider trading regulation policy arguments, this subsection analyzes CDS insider trading regulation through case law already established in securities markets. Courts have struggled to craft rules that sufficiently capture the harms of insider trading while not intruding upon the efficient function of securities markets. Indeed, the notion that one can obtain and then use information other market participants may not possess is a driving force in investment professions.\(^\text{87}\) To determine which kind of asymmetrical information use is permissible, courts have constructed three major rules of insider trading regulation: The Equal Access Model of Liability, the Fiduciary Model of Liability, and the Misappropriation Model of liability. This subpart explains each model in turn.


The Equal Access Model originated in the Second Circuit case \textit{SEC v. Texas Gulf Sulfur}.\(^\text{88}\) In that case, a mining company discovered a copper-rich field in Canada. The company was silent about the findings in its quarterly reports, however, while company insiders purchased high volumes of the firm’s stock.\(^\text{89}\) Surely enough, the value of the stock soared after the company disclosed the discovery publicly, and the insiders reaped huge capital gains.\(^\text{90}\)

\textit{Texas Gulf Sulfur} stood for the proposition that the Exchange Act required parity of information access among all traders in public securities markets. While not all traders must actually possess the same information, they must have equal access to it.\(^\text{91}\) One commentator has argued that “the logic of the disclose-or-refrain rule theory precludes exploitation of an informational advantage that the public is unable lawfully to overcome or offset.”\(^\text{92}\) The Equal Access Model never gained serious credibility, making it no surprise when the Su-
preme Court overruled it and ushered in a new era of insider trading law.


In the late 1970s, Vincent Chiarella, as part of his duties as an employee of the prominent financial printing firm Pandick Press, was responsible for readying for print news releases for which financial firms had retained Pandick to distribute publicly. Sensing the value of the information passing through his hands each day, Chiarella began to study the releases and soon learned to identify firms that were targeted for mergers and acquisitions. Chiarella purchased stock in these firms before the news of the merger or acquisition became public, and reaped lucrative gains as a result. Shortly thereafter, the SEC charged Chiarella with seventeen counts of violating sections 10(b) and rule 10(b)(5) and successfully convicted him on each of them. Adhering strictly to the Equal Access Model of liability, the Second Circuit affirmed.

In its first case directly confronting the Equal Access Model, the Supreme Court reversed all seventeen counts of Chiarella's convictions. Writing for the majority, Justice Powell emphasized that 10(b) is foremost an antifraud provision, and "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so." That duty, Justice Powell continued, only arises when "the other [party] is entitled to know [the information] because of a fiduciary duty or other similar relation of trust and confidence between them.”

Chiarella, who, as an employee of Pandick, owed no fiduciary duty to the shareholders of the companies targeted for merger and acquisition, could not have defrauded them. Justice Blackmun's dissent, which argued on behalf of the equal access theory, was promptly dismissed by the majority as an attempt to recognize "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.” The majority further reasoned that

[f]ormulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship be-

94. Id.
95. Id. at 225.
96. United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978).
98. Id. at 228.
99. Id. (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).
between two parties... should not be undertaken absent some explicit evidence of congressional intent... Neither Congress nor the Commission ever has adopted a parity-of-information rule.\textsuperscript{100}

3. The Misappropriation Model of Liability (1998-present)

While the rule set forth in \textit{Chiarella} was based on sound fiduciary reasoning, it produced illogical results. Absent some other provision imposing liability, those who obtain inside information, but who are not fiduciaries in the firm (e.g. officers and others with similar control over the firm’s functions) to whom the inside information pertains, may lawfully trade with that information. However, had those same traders been fiduciaries in the firm, they would be squarely in violation of Section 10(b). Is there any meaningful distinction between the two scenarios? The Misappropriation Model,\textsuperscript{101} adopted in the 1997 case \textit{United States v. O’Hagan},\textsuperscript{102} declares there is not and continues to govern insider trading regulation in securities markets today.

\textit{O’Hagan} dealt with an attorney, defendant O’Hagan, who worked for a law firm retained by Grand Met PLC to assist with an upcoming acquisition of the Pillsbury Company.\textsuperscript{103} Although O’Hagan was not part of the legal team working on the acquisition, he learned of the matter before it was disclosed publicly, and profited $4 million by using that knowledge in strategically timed trades of large volumes of Pillsbury stock.\textsuperscript{104}

In a 6-3 decision, the Supreme Court reversed the Eighth Circuit and convicted O’Hagan on fifty-seven counts of mail fraud, money laundering and securities fraud.\textsuperscript{105} The \textit{O’Hagan} Court broke sharply with \textit{Chiarella} reasoning by accepting the government’s argument that O’Hagan breached a fiduciary duty he owed to the source of the information, rather than to the person with whom he traded.\textsuperscript{106} By expanding the scope of a trader’s fiduciary duty to include the source from which he obtained the information, the Court was able to catch O’Hagan within 10(b)’s net, a ruling not possible under strict \textit{Chiarella} reasoning. Post-\textit{O’Hagan}, 10(b) thus condemns “insiders” trading

\begin{itemize}
  \item \textsuperscript{100} Id. at 233.
  \item \textsuperscript{101} \textit{Chiarella}, 445 U.S. at 240 (1980) (Burger, C.J., dissenting). Chief Justice Burger laid the foundation for the Misappropriation Model of Liability. Condemning Chiarella’s actions as violations of 10(b)’s antifraud provisions, Burger asserted that any trader who obtains material, non-public information “not by superior experience, foresight, or industry” has acted unlawfully. \textit{Id.}
  \item \textsuperscript{102} \textit{United States v. O’Hagan}, 521 U.S. 642 (1997).
  \item \textsuperscript{103} \textit{United States v. O’Hagan}, 92 F.3d 612, 614 (8th Cir. 1996).
  \item \textsuperscript{104} \textit{Id.}
  \item \textsuperscript{105} \textit{O’Hagan}, 521 U.S. 642 (1997).
  \item \textsuperscript{106} \textit{Id.} at 651.
\end{itemize}
with inside information because the insider breached a fiduciary duty to shareholders; it also condemns "outsiders" trading with inside information because the outsider breached a fiduciary duty to the source of the information.\footnote{107}

D. Applying Insider Trading Case Law in Securities Markets to CDSs

Several principles from the three models described above are applicable to CDS insider trading regulation. Perhaps foremost, the judicial distaste and accompanying congressional acquiescence for the Equal Access Model make it unlikely that it or any other "duty-less" model will survive as a CDS insider trading regulatory mechanism. Thus, effective CDS regulation will attach some kind of fiduciary duty to users of material, non-public information in CDS markets.

However, on first glance, the policy argument for imposing fiduciary duties into CDS markets is not particularly strong. Repeat transactions govern institutionally concentrated markets like the current CDS market. As one commentator has noted, "when parties expect to have repeated transactions, the risk of self-dealing by one party is constrained by the threat that the other party will punish the cheating party in the future."\footnote{108} Protection buyers who abuse their counterparties will find that such actions come back to haunt them when they wish to enter into future CDS transactions.

On the other hand, the institutional concentration currently present in the CDS market, which facilitates the repeat transactions that incentivize fair play, is also undesirable in the systemically endangering ways described in detail in section III(B)(2). CDS insider trading policy should be set with an active aspiration for the future ideal rather than a submissive acceptance of the current reality. It is true that broader participation in the CDS market weakens traders' incentive

\footnote{107} Id. at 651-52. An important distinction should be noted between the Misappropriation Model and the Equal Access Model. Misappropriation theory holds that outsiders who gain access to material, non-public information from an insider owe a duty to that insider not to trade with that information. Because the insider cannot lawfully trade with the information, any to whom they entrust the information and who subsequently trade with that information breaches a duty to the insider (and the same duty applies to any additional outsiders who obtain information in a way that can be reasonably traced to the insider). See id. Those who trade with material, non-public information obtained by applying "superior experience, foresight, or industry," rather than through simply having access to the information because of one's position within the firm (or being tipped about such information in a way that can be traced to a source who obtained the information because of her position in the firm) do not do so unlawfully; such practice drives the investment profession and was the essence of the Equal Access Model's dismissal. Chiarella, 445 U.S. at 240.

\footnote{108} See Bainbridge, supra note 8, at 97.
to play fairly because a greater pool of potential counterparties reduces traders' interest in protecting future trading relationships decreases. However, regulation can compensate for this weakened incentive by attaching a fiduciary duty to protection sellers.

To keep with the public interest of maintaining consistent financial regulation, CDS regulation should also, as securities regulation has, extend its fiduciary duty to include misappropriation. Fortunately, the policy argument is quite strong for implementing a Misappropriation Model into CDS markets similar to the model that currently exists in securities markets. The Misappropriation Model only requires that a user of inside information breach a duty to the source of that information. Surely a protection buyer breaches a duty to its borrower when it uses the borrower's confidential information to dupe an unsuspecting protection seller into a poor bargain.

The breach is especially egregious because the borrower has strong interests in the protection seller bargaining with symmetrical information. A protection buyer bargaining with asymmetrical information is likely to use that advantage to the detriment of the borrower. Knowing that the borrower's financial condition is in decline, the furtherance of which will not hurt and may even help the protection buyer because of its CDSs, the protection buyer will neglect its implied responsibilities to assist in the borrower's revival, perhaps even to the point of sabotage.

When the protection buyer is forced to bargain with symmetrical information, the parties will transact CDSs on terms more favorable to the protection seller. Because the interests of protection sellers and borrowers are aligned, protection sellers will bargain in ways favorable to borrowers. Better-informed protection sellers are thus better advocates for borrowers, making the protection buyer's use of asymmetrical information about the borrower a breach of duty to that borrower.

CONCLUSION: INSIDER TRADING IN CDS MARKETS SHOULD BE REGULATED

Credit default swaps have revolutionized lending policy and transformed the financial marketplace. The 2008 market crash frighteningly revealed that CDSs also possess systemically dangerous attributes. CDS regulation should proceed cautiously to further CDS development and channel CDS power to market-building uses. SEC v. Rorech is the most significant regulatory challenge CDSs have con-
fronted in a court of law. A comparison to securities market regulation suggests that *Roroch* may be the first step in a disjointed CDS insider trading regulation path.

However, CDS regulation certainly will build upon lessons learned from securities regulation, allowing it to carve out a more workable regulatory landscape with much less hassle. For example, this paper described how the fiduciary duty and misappropriation principles currently present in securities regulation would similarly provide CDS regulators with both a legal justification and a sensible framework to enforce CDS insider trading laws and regulations. When a protection buyer misappropriates the confidential information of its borrowers to engage in practices adverse—or with reasonable potential to become adverse—to that borrower, the law should view the protection buyer’s action as a breach of duty to the borrower.

To determine if CDS insider trading regulation is worth its burdens, this paper also reviewed policy arguments relating to insider trading in securities markets and applied them to CDS markets. The analysis revealed that while insider trading in CDS markets may increase pricing efficiency, such a benefit—if it in fact exists—does not outweigh the significant harms insider trading imposes into the CDS market. Other arguments deregulators have previously posed in securities regulation analysis at best weakly apply to CDS markets.

A prohibition on insider trading will help contain the moral hazards that currently plague the CDS market. More importantly, insider trading regulation will promote confidence in CDS markets, a timely benefit given the waning public confidence in financial markets generally. Restored public confidence would in turn invite increased liquidity into the CDS market, helping to cure the undesirable and systemically endangering institutional concentration from which CDSs currently suffer. In short, enacting CDS insider trading regulation is one intelligent step in the ongoing effort to revive the financial marketplace.