



Hedge Fund Returns

2010 No.6

Hedge Fund Returns is published by Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +212-310-8000.

Weil Gotshal's multidisciplinary hedge fund practice group spans the United States, Europe and Asia. We represent blue chip hedge fund managers around the globe as well as investors in hedge funds.

We provide seamless service and unparalleled transactional advice to hedge fund managers. Our hedge fund manager clients benefit from our substantial expertise and reputation in fund formation, mergers & acquisitions, leveraged finance, real estate and structured finance transactions as well as our pre-eminent restructuring practice.

Our representation frequently includes the following:

- establishing hedge funds, hybrid funds, special situation funds and distressed debt funds and seeding new hedge fund managers
- strategic transactions involving hedge fund managers, including the acquisition or sale of controlling and minority stakes in hedge fund managers
- control and non-control acquisitions and dispositions and investments in senior and subordinated debt and structured products
- leveraged lending transactions and debtor-in-possession financing
- advice with respect to the management of CLOs and CDOs
- out of court and in court workouts and restructurings of debt

The members of our hedge fund practice group are listed on the last page of this publication.

Court Confirms that Insider Trading Laws Apply to Credit Default Swaps

By Bronwen Pyle (bronwen.pyle@weil.com)

On June 24, 2010, the United States District Court, Southern District of New York (the "Court") dismissed an action brought by the Securities and Exchange Commission (the "SEC") alleging unlawful insider trading by Jon-Paul Rorech, a high yield bond salesman at Deutsche Bank Securities, Inc. ("Deutsche Bank") and Renato Negrin, a portfolio manager at Millennium Partners, L.P. ("Millennium"). *SEC v. Rorech* (2010 WL 2595111 (S.D.N.Y.)). In its complaint, the SEC alleged that Rorech, in two unrecorded cell phone conversations, unlawfully provided Negrin with confidential information concerning contemplated changes in the structure of a bond offering by VNU N.V. (now known as Nielsen Company, "VNU") that would lead to an increase in the market value of certain credit default swaps ("CDSs") on VNU bonds. The SEC further alleged that, on the basis of that confidential information, Negrin purchased CDSs on behalf of Millennium and closed Millennium's position for a profit of \$1.2 million after the bond offering was announced with the contemplated changes.

The decision is notable as the SEC contended and the Court accepted that the CDSs at issue in the proceeding qualified as "security-based swap agreements" under the Gramm-Leach-Bliley Act of 2002 (the "GLB Act") and were therefore subject to the antifraud provisions set forth in Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"). This is the first reported decision to consider and confirm that the insider trading provisions set forth in Section 10(b) of the Exchange Act apply to CDSs.

Congress amended Section 10(b) of the Exchange Act in 2000 as part of Commodity Futures Modernization Act, with the amendments extending the application of the insider trading provisions to "securities-based swap agreements" (as such term is defined in Section 206B of the GLB Act). Section 206B of the GLB Act defines a "security-based swap agreement" as a swap 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.

The SEC submitted that the price term (or spread) of the two VNU CDSs were based on the price, yield, value or volatility of the VNU bonds and, therefore, that the CDSs were security-based swap agreements. Seeking to avoid the application of the insider trading laws, Rorech and Negrin argued that the term "based on" should be interpreted to require a direct or exclusive dependence. The defendants argued that the spread of the CDSs may have related to VNU bonds but were not "based on" those characteristics of the bonds because the price of the VNU CDSs was a negotiated term and was based on many factors and not just the value of the underlying VNU bonds.

The Court determined that the CDSs at issue were “security-based swap agreements” under Section 206B of the GLB Act. In reaching its conclusion, the Court determined that the plain meaning of “based on” does not imply an exclusive dependent relationship. The Court also noted that Congress extended the provisions of Section 10(b) of the Exchange Act to security-based swap agreements and not other types of swap agreements (such as interest rate swaps, currency swaps or weather swaps) that were clearly not based on securities, and this appeared to bring CDSs like those in issue in this case into the heartland of the swap agreements Congress intended to govern to enhance protection for investors and for the financial markets.

The Court rejected Rorech and Negrin’s arguments regarding the interpretation of the Exchange Act and GLB

Act on the basis that if their view were accepted, so long as the material terms of CDSs did not make reference to the price or value of securities, the CDSs would not be “security-based” no matter how closely tied to securities their materials terms actually were. The Court concluded that whilst Negrin may have considered other factors when determining the price at which he would purchase the VNU CDSs, it was clear from the evidence that a fundamental part of his decision was the spread or yield of VNU bonds and the value of VNU bonds. Further, the Court noted the importance of the underlying VNU bonds given provisions in the master agreement governing the CDSs at issue (and incorporated by reference) that allowed for settlement of the swap taking into account the value of the underlying VNU bonds that would be deliverable under the CDS agreement.

The SEC’s case ultimately failed however as the Court determined that the SEC had failed to produce evidence that Deutsche Bank had actually decided to recommend the contemplated bond offering changes to VNU at the time of Rorech’s conversations with Negrin, that the alleged information conveyed by Rorech to Negrin was material, that the alleged information was in fact confidential and that Rorech had acted in a deceitful manner contrary to his employment obligations or custom and practice in the industry. However, the favorable determination by the Court regarding the applicability of Section 10(b) of the Exchange Act to the CDSs in issue clears the way for the SEC to pursue insider trading actions against hedge funds and others in respect of CDSs and other derivative securities.

Back Issues of Hedge Fund Returns are available online at www.weil.com

Recent Articles:

- Congress Moves Forward on Hedge Fund Regulation
- Break-Up Fees – Not Necessarily Guaranteed for Stalking Horse Bidders
- Time for Investment Advisers to Engage in Regulatory and Compliance Review
- Court Issues a Favorable Decision for Secondary Loan Market Participants
- EU Proposals To Regulate Alternative Investment Fund Managers: An Update
- IMO Carwash Scheme of Arrangement: Mezzanine Creditors Take a Soaking
- No “Ordinary Course” For You – The SEC Issues a Warning to Hedge Fund Managers
- Fed Expands TALF to Include Legacy CMBS
- EU Proposal to Regulate Alternative Investment Fund Managers
- Warning Shot by the SEC to Hedge Fund Managers
- Changes to FSA Regime on Disclosure of Contracts for Differences
- Public-Private Investment Program – Potential Opportunities for Investors
- Update: Participating in TALF – Pros and Cons for Investors
- Are DIP Loans Worth the Investment?

- BEIJING
- BOSTON
- BUDAPEST
- DALLAS
- DUBAI
- FRANKFURT
- HOUSTON
- HONG KONG
- LONDON
- MIAMI
- MUNICH
- NEW YORK
- PARIS
- PRAGUE
- PROVIDENCE
- SHANGHAI
- SILICON VALLEY
- WARSAW
- WASHINGTON, DC
- WILMINGTON

Hedge Fund Practice Group Members

(all lawyers based in New York except where otherwise noted)

Capital Markets

- Todd Chandler
- James Cole – London
- Alex Lynch
- David Meredith – Hong Kong
- Peter Schwartz – London

Fund Formation

- John Fadely – Hong Kong
- Shukie Grossman
- Jeffrey Hitt – Dallas
- David Kreisler – Boston
- Jonathon Soler
- Jeffrey Tabak
- David Wohl
- Barry Wolf

Leveraged Finance

- Dan Dokos
- Michael Nicklin – London
- Elaine Stangland
- Doug Urquhart

Mergers & Acquisitions

- Craig Adas – Silicon Valley
- David Akin – Paris
- Joe Basile – Boston
- David Dederick – Budapest
- Peter Feist – Hong Kong
- Michael Francies – London
- Jeffrey Hitt – Dallas
- Jane McDonald
- Karel Muzikar – Prague
- Henry Ong – Hong Kong
- Gerhard Schmidt – Frankfurt
- Joe Tortorici – Dubai
- Doug Warner
- Glenn West – Dallas
- James Westra – Boston
- Michael Weisser
- Artur Zawadowski – Warsaw

Real Estate

- Philip Rosen

Restructuring

- Philippe Druon – Paris
- Lori Fife
- Marcia Goldstein
- Uwe Hartmann – Frankfurt
- Gary Holtzer
- Stephen Karotkin

**Structured Finance/
Derivatives**

- Conrad Bahlke
- Robert Chiperfield
- Jacky Kelly – London
- Frank Nocco

Tax

- Juergen Boerst – Frankfurt
- Robert Frastai
- Joseph Newberg – Boston
- Martin Pollack
- Sarah Priestley – London
- Stan Ramsay

Editors: Doug Warner (doug.warner@weil.com), +1-212-310-8751
 Joe Basile (joseph.basile@weil.com), +1-617-772-8834

©2010. All rights reserved. Quotation with attribution is permitted. This publication provides general information and should not be used or taken as legal advice for specific situations that depend on the evaluation of precise factual circumstances. The views expressed in these articles reflect those of the authors and not necessarily the views of Weil, Gotshal & Manges LLP. If you would like to add a colleague to our mailing list or if you need to change or remove your name from our mailing list, please log on to <http://www.weil.com/weil/subscribe.html> or e-mail subscriptions@weil.com.