Should Insider Trading in Credit Default Swap Markets Be Regulated? The Landmark Significance of S.E.C. v. Rorech

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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 1934.¹ SEC v. Rorech (“Rorech”) is unique among SEC enforcement actions because it is the first case involving insider trading in credit derivatives.² This paper analyzes Rorech by examining insider trading in CDS markets. Until the recent passage of the Dodd-Frank Act, CDS markets were left largely unregulated,³ and consequently provided a welcoming atmosphere for insider trading. While insider trading in securities markets has repeatedly been judicially condemned,⁴ some scholars have defended the practice as an effective mechanism to promote market efficiency and productivity.⁵ This paper asks whether the insider trading regulations currently imposed on securities markets should be similarly imposed upon CDS markets.

Section I overviews insider trading in securities markets.⁶ Section II reviews the CDS market, notes empirical evidence of CDS insider trading, and concludes by discussing Rorech,

² Credit default swaps are the most widely used kind of credit derivative.
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 successful; similarly, those willing to sell CDS
the latest chapter in insider trading regulation. Section 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 Section briefly overviews 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 are left to regulate the conduct of their counterparties, employing judicial assistance at their own expense.

The dynamic changes, however, when the transactions are moved 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

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7 See id. for explanation of this assumption.
8 Stephen Bainbridge, *SEcurities LAW: INSIDER TRADING* 11 (2d ed. 2007) (“The insider trading laws thus capture...individuals who trade...on the basis of material information unknown by the [] 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”).

remedies for injured investors.\textsuperscript{10} 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 Exchange 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.\textsuperscript{11} 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.\textsuperscript{12} The SEC crafted Rule 14e-3 to regulate trading on material, non-public information but the rule only applies to tender offers.\textsuperscript{13}

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

\begin{quote}
“[to] use or employ, in connection with the purchase or sale of any security…any manipulative or deceptive or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest of for the protection of investors.”\textsuperscript{14}
\end{quote}

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) to 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

\textsuperscript{10} See John Mahoney, \textit{An Overview of Securities Regulation in the United States}, \textit{JOURNAL OF ACCOUNTING RESEARCH} 325 (2009).
\textsuperscript{12} Id.
\textsuperscript{13} See 17 C.F.R § 240.14e-3 (2010).
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. These theories are discussed in detail in Section III.

10(b)(5) and its judicial progeny apply only to securities and, by virtue of a subsequent amendment, “securities-based swaps 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. Section II transitions into an overview of the CDS market which, combined with Section I, lays an analytic foundation upon which Section 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 that spreads risk among parties in ways similar to insurance contracts. In a CDS, a “protection buyer” contracts with a “protection

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15 17 C.F.R § 240.10b-5 (2010).
16 These theories are discussed in detail in Section III.
18 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
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.19

A. The Value CDSs Provide

Shortly after their inception in the early 1990’s, CDSs rapidly blossomed into an immensely popular financial instrument, exceeding $450 trillion in notional value by mid 2009.20 CDSs benefit individual market participants because they “increase[] the range of financial products available to corporations and investors and foster[] more precise ways of understanding, quantifying, and managing risk.”21 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

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21 Report of President’s Working Group on Financial Markets, November 1999 at 3, available at http://www.ustreas.gov/press/releases/reports/otcact.pdf; John D. Finnerty & Mark S. Brown, An Overview of Derivatives Litigation, 7 FORDHAM J. CORP. & FIN. L. 131, 146 (2001); Lily Tijoe, 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 20-30 units (arbitrary numbers). The highly customized nature of CDSs allows the trader to know with much greater certainty the exact level of risk she is assuming (say 28 units). The trader can now seek out specific ways to hedge a risk of 28 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.
several parties, rather than shouldering that risk alone, CDSs permit lenders to make more loans.\textsuperscript{22}

CDSs also benefit the market collectively because they reduce systemic risk.\textsuperscript{23} Systemic risk\textsuperscript{24} is the notion that “a trigger event,\textsuperscript{25} such as an economic shock or institutional failure causes a chain of bad economic consequences [such as a sudden string of corporate defaults], sometimes referred to as a domino effect.”\textsuperscript{26} Systemic risk theory posits that these domino effects, if not contained early, may put entire markets at risk of collapse.\textsuperscript{27}

Former Federal Reserve Chairman Alan Greenspan noted:

Historically, banks have been at the forefront of financial intermediation, in part because of their ability to leverage off an efficient source of funding. But in periods of severe financial stress, such leverage too often brought down banking institutions and, in some cases, precipitated financial crises that led to recession or worse. But recent regulatory reform, coupled with innovative technologies, has stimulated the development of financial products, such as…credit default swaps that facilitate the dispersion of risk. The new instruments of risk dispersal have enabled the largest and most sophisticated banks, in their credit-granting role, to

\textsuperscript{22} See Greenspan, infra note 33(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.

\textsuperscript{23} Steven L. Schwarz, Systemic Risk, 97 GEO. L.J. 193, 220 (2008) (“Derivatives used for hedging actually reduce the potential for systemic risk…[t]he most widely used derivative for this purpose is the credit default swap.”).

\textsuperscript{24} AIG’s bailout is widely believed to be a governmental effort to reduce systemic risk. See Gretchen Morgenson, Behind Insurer’s Crisis: Blind Eye to a Web of Risk available at http://www.nytimes.com/2008/09/28/business/28melt.html.

\textsuperscript{25} “Trigger event” in this context does not necessarily mean the credit triggering event in relation to a CDS. Though a CDS triggering event could be the start of systemic collapse, there are many other triggering events that could also play this role.

\textsuperscript{26} A classic example of dangers associated with systemic risk 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…[b]ecause 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.’” Schwarz, supra note 23, at 198-99.

\textsuperscript{27} See id.
divest themselves of much credit risk by passing it to institutions with far less leverage.\textsuperscript{28}

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 to insider trading\textsuperscript{29} 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 only recent have been traded on regulated exchanges. Each is discussed in turn.

1. More Material, Non-public Information is Disclosed in Lending Relationships than in Equity Relationships

Firms using both debt and equity financing tend to maintain closer relationships with their lenders than with their investors.\textsuperscript{30} Lending relationships often require borrowers to provide to their lenders material information, including revenue projections, merger and acquisition

\textsuperscript{28} Practicing Law Institute, PLI Order No. 11333. Credit Derivatives: Usage, Practice and Issues at 354 (October 16-17, 2007). As an example of the concept described above, Greenspan noted that credit derivatives served as a shock absorber during Enron and WorldCom crises. Because their creditors had so effectively hedged themselves through CDSs, Enron and WorldCom’s colossal bankruptcies did not overly disrupt the market. See Frank A. Partnoy & David A. Skeel, Jr., Debt as a Lever of Control: The Promise and Peril of Credit Derivatives, 75 U. Cin. L. Rev. 1019, 1024 (2007).


\textsuperscript{30} See Acharya and Johnson, supra note 34, at 3.
plans, and other price-sensitive information well before that information is publicly disclosed.31 Lenders use this information to quote CDS prices to potential protection sellers, a responsibility which often falls on the lender’s trading desk.32 As Professors Acharya and Johnson note, “in the absence of perfect “Chinese walls” within banks, the credit derivatives market provides these 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.”33

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,34 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, where 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.35 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,36 and so may actually hope for the lender’s

31 See id.
32 See id.
33 See id.
34 Tijoe, supra note 21, at 404 n. 146-9.
36 See Gregory Plotko, The Impact of Credit Default Swaps on the Chapter 11 Process, NORTON JOURNAL OF BANKRUPTCY LAW AND PRACTICE 1, 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 favor a bankruptcy filing only if they expect to receive more in a bankruptcy than in an out of court proceeding.”).
default. Thus, in some scenarios, CDSs are incentivizing creditors and other protection buyers to destroy value in reference entities.

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.”

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

Wall Street rumor currents suggested the hedge funds had short sold Tower’s stock. 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

37 See Henry T.C. Hu & Bernard Black, 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, Wall Street Meets Main Street: Understanding the Financial Crisis, NORTH CAROLINA BANKING INSTITUTE 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 Stephen J. Lubben, Credit Derivatives and the Future of Chapter 11, 81 AMER. BANK. L.J. 405, 419 (Fall 2007).
40 See Partnoy & Skeel, supra note 28, at 1034.
41 See id.
42 See id.
43 See id. at 1034-35.
Tower.\footnote{See id.} CDS trading records are too inaccessible to confirm that the hedge funds had purchased CDS protection for their Tower loans. However, if they did, the incentive to destroy Tower’s value would have been irresistible.\footnote{For protection buyers who are not simultaneously serving as the lender to the reference asset, the moral hazard may reach still higher levels.} 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, few market players would not 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.\footnote{See Partnoy & Skeel, supra note 28, at 1024.} 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.\footnote{See id.}

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 is compensated 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 manipulatively contribute to the borrower’s decline.

\footnote{See id.}
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.\(^48\) A recent study of CDSs by the Government Accountability Office found that “comprehensive and consistent data on the overall market have not been readily available,” that “authoritative information about the actual size of the CDS market is not generally available” and that regulators are currently “unable to monitor activities across the market.”\(^49\) 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 (“Rorech”) began when VNU,\(^50\) a Dutch media holding company, employed Deutsche Bank Securities Inc. (“DBSI”) as an underwriter for its public bond offerings.\(^51\) VNU regularly offered CDSs that use VNU bonds as the reference asset.\(^52\) From July 12, 2006 to July 24, 2006, DBSI allegedly encouraged VNU to issue additional bonds, leading to VNU’s announcement of an additional public bond issuance on July 24\(^{th}\), 2006.\(^53\)

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 24\(^{th}\) announcement enjoyed a significant price and value increase in her

\(^{50}\) VNU is the actual name of the company and is not an acronym.
\(^{52}\) Id.
\(^{53}\) Id.
CDSs after the announcement. Surely enough, the price of VNU CDSs did significantly increase after the July 24th announcement.\textsuperscript{54}

Paul Rorech was employed by DBSI as a bond and CDS salesman. The SEC alleged that between July 14th, 2006 and July 17th, 2006, Rorech tipped off Renato Negrin, a manager for a hedge fund investment advisor, about the upcoming VNU bond issuance.\textsuperscript{55} On July 17th and July 18th, 2006, Negrin purchased two VNU CDSs, allegedly basing his purchase decision on Rorech’s tip.\textsuperscript{56} Sometime after the July 24th announcement, Negrin sold his CDSs for a profit of approximately $1.2 million.\textsuperscript{57}

On May 11th, 2009, the SEC brought suit in United States District Court, Southern District of New York, against both Rorech and Negrin. The SEC’s complaint accused both Rorech and Negrin of violating Section 10(b) of the Securities Act.\textsuperscript{58} Both defendants argued that their trades are outside of the 10(b) scope because they are not securities-based swap agreements; the SEC therefore lacks subject matter jurisdiction to pursue the case.\textsuperscript{59} Rorech further argued that even if he traded on material, non-public information, he still is not in violation of 10(b)’s insider trading proscription because he had no duty to keep information about the VNU bonds confidential.\textsuperscript{60}

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

\textsuperscript{54} Id.
\textsuperscript{55} Id.
\textsuperscript{56} Id.
\textsuperscript{57} Id.
\textsuperscript{58} Id. at 367.
\textsuperscript{59} Id.
\textsuperscript{60} Id.
complaint because, in the pre-Dodd-Frank regulatory landscape, the only viable avenue for regulating CDSs 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 does 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 be held liable for insider trading, both defendants escaped liability entirely. The court’s holding nevertheless sweeps CDS insider trading into SEC jurisdiction. It also requires courts, Congress, or administrative agencies to craft a new rule of exactly what the fiduciary duty in CDS markets entails.

**III. Should Insider Trading in CDS Markets be Regulated?**

As described in Section I, insider trading regulation in securities markets has been hotly contested. 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

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62 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 U.S. v. O’Hagan, supra note 3. The rule set forth in *O’Hagan* has been highly criticized. See e.g., M. Breen Haire, *The Uneasy Doctrinal Compromise of the Misappropriation Theory of Insider Trading Liability*, 73 N.Y.U. L. REV. 1251 (1998); Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491 (1999). See section III(D)(3) for further discussion.
producing a unique collection of awkward, inconsistent results. 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. Section 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;\(^6^4\) 2) those suffering losses from trading with insiders would have suffered the same losses had inside trading regulations been in place;\(^6^5\) 3) insider trading improves the agent/principal relationship.\(^6^6\) Each argument is briefly explained and then applied to CDS markets.

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.\(^6^7\) More accurate pricing leads to more efficient allocation of resources. Assuming the argument is legitimate,\(^6^8\) it is likely even more persuasive in CDS markets.

As noted above, more material, non-public information is disclosed in lending relationships than in equity relationships. Additionally, the CDS market is highly institutionally

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\(^6^3\) Section III analyzes each of these eras in detail.

\(^6^4\) See Carlton & Fischel, *supra* note 7, at 866-68.

\(^6^5\) See Donald C. Langevoort, _INSIDER TRADING REGULATION_ 41(1991 ed.).

\(^6^6\) See Manne, *supra* note 7, at 111-58.

\(^6^7\) See Carlton & Fischel, *supra* note 7, at 866-68.

\(^6^8\) Professor Lynn Stout thoroughly criticizes this argument in his article, _The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation_, _87 MICH. L. REV._ 613 (1988).
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 the insider been barred from trading, the outsider who would have traded with that insider will find another outsider with whom to make her intended trade, and subsequently suffer the same loss she would have suffered had she 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 regulatory 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 trading 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.

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69 See Tijoe, supra note 21, at 404 n. 146-9 ("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.")

70 See note 81, infra for further discussion.
Unlike in securities markets, there are fewer CDS outsiders whose trading activity can dilute 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 the outsider would have made his same ill-fated trade with insider trading regulations in place.

Decreased liquidity in CDS markets further weakens the argument.71 As noted in Section II(a), 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, CDSs 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 her 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 he 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.

71 In sub-section II(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 II(A)(2). Public policy is a battle of tradeoffs. I do not believe the added force that increased liquidity would provide to II(A)(2)’s deregulation argument sufficiently trumps the other benefits of increased liquidity a CDS insider trading prohibition would engender.
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.

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. Each is further explained below.

1. Promoting Confidence in Financial Markets

Confidence in financial markets is at historical lows. 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 enough. Human nature is to avoid
games where one’s opponent has stacked the deck unevenly in her favor. Because CDSs are of
great economic benefit, a public perception of CDS market fairness is of great import.

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72 These arguments were conceived in Henry Manne’s landmark book INSIDER TRADING AND THE STOCK MARKET; see Manne, supra note 5, at 111-58.
73 In Section III(E) 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.
Exchange Act [is] to insure honest securities markets and thereby promote investor confidence); Roy A.
1425, 1439 (1967) (expounding upon fairness as paramount priority in a functional financial market)
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 [are] subject to similar regulations and oversight…regulatory 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.  

1. 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 each other, 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 become 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


76 See Tijoe, supra note 26, at 404 n. 146-9 (“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.”)

77 See id.
time can lead to a liquidity crisis of market destroying magnitude. The risk of such a phenomena occurring is referred to as “systemic risk”—the concept that “a trigger event,\textsuperscript{78} such as an economic shock or institutional failure causes a chain of bad economic consequences, sometimes referred to as a domino effect.”\textsuperscript{79}

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 were used to hedge the risks of $441 billion worth of mortgage-backed securities,\textsuperscript{80} $58 billion of which involved sub-prime loans.\textsuperscript{81} As the value of these sub-prime loans tumbled, AIG’s credit rating was downgraded, causing many of its counterparties to demand it post collateral.\textsuperscript{82} Obtaining that collateral in the complex web of CDSs in which AIG was entangled caused a liquidity crisis that, but for a federal bailout, would likely have led to its bankruptcy.\textsuperscript{83}

Preventing AIG’s failure, of itself, was not likely a sufficient enough 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 bear had AIG failed led government decision-makers to conclude its bailout was justified.\textsuperscript{84} Reducing institutional

\textsuperscript{78}“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.

\textsuperscript{79}Schwarz, supra note 28, at 198.

\textsuperscript{80}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.


\textsuperscript{82}Collateral refers to properties or assets that are offered to secure a loan or other credit. Collateral becomes subject to seizure on default; upon learning that a debtor has experienced significant financial decline, creditors may demand debtors to “post” collateral, or offer evidence to the creditor of the assets the debtor has available should it default.

\textsuperscript{83}See Morgenson, supra note 81.

\textsuperscript{84}The following excerpt depicts the scene surrounding AIG’s near collapse and justification for its bailout “As the group, led by Treasury Secretary Henry Paulson, pondered the collapse of one of America’s oldest investment banks, Lehman Brothers, a more dangerous threat emerged: American International Group, the world’s largest insurer, was teetering. AIG needed billions of dollars to right itself and had suddenly
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.

2. Reducing Moral Hazards

Insider trading in securities markets creates a moral hazard by allowing managers to profit from their firm’s decline. Managers trading 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 was introduced in section II(b)(3) and readdressed here. 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 manipulating Y’s restructuring. In an

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beggged for help. One of the Wall Street chief executives participating in the meeting was Lloyd Blankfien of Goldman Sachs, Mr. Paulson’s former firm. Mr. Blankfein had particular reason for concern. Although it was not widely known, Goldman, a Wall Street stalwart that had seemed immune to its rivals’ woes, was AIG’s largest trading partner, according to six people close to the insurer who requested anonymity because of confidentiality agreements. A collapse of the insurer threatened to leave a hole of as much as $20 billion in Goldman’s side, several of these people said. Days later, federal officials, who had let Lehman die and initially balked at tossing a lifeline to AIG, ended up bailing out the insurer for $85 billion. Their message was simple: Lehman was expendable. But if AIG unspooled, so could some of the mightiest enterprises in the world.” Gretchen Morgenson, Behind Insurer’s Crisis: Blind Eye to a Web of Risk, N.Y. TIMES, Sept. 27, 2008 available at http://www.nytimes.com/2008/09/28/business/28melt.html

action closely resembling securities market moral hazard, X may even short Y’s stock in effort to manipulatively drive its price down, further lubricating Y’s downward slide.

A ban on CDS insider trading would shrink the CDS moral hazard. If X was barred 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, it would be forced 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 section II(b)(3) where 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.

D. 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.\footnote{See Charles C. Cox & Kevin Fogarty, \textit{Bases of Insider Trading Law}, 49 \textit{Ohio St. L.J.} 353, 354 (1988) ("A prohibition that discourages the use other than that already discovered necessarily discourages the discovery of new information and inhibits the use of information whose public or nonpublic status is uncertain."); M. Breen Haire, The Uneasy Doctrinal Compromise of the Misappropriation Theory of Insider Trading Liability, 73 \textit{N.Y.U. L. Rev.} 1251, 1261 (1998) (noting that a rule that requires all nonpublic information to be disclosed or not traded upon may “stifle the efforts of financial analysts to bring information to the markets.”).} 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 subsection explains each model in turn.


The Equal Access Model originated in the Second Circuit case \textit{SEC v. Texas Gulf Sulfur}.\footnote{401 F.2d 833 (2d Cir. 1968) (en banc).} 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.\footnote{\textit{Id.} at 846-47.} Surely enough, the value of the stock soared after the discovery was publicly disclosed, and the insiders reaped huge capital gains.\footnote{\textit{Id.}}

\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.\footnote{\textit{Id.} at 848.} 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.” The equal access theory never gained serious credibility with scholars, was never endorsed by the Supreme Court, and in fact was overruled by the Court in 1980 when it ushered 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 in violation of sections 10(b) and rule 10(b)(5) and he was subsequently convicted on each of them. Adhering strictly to equal access theory liability, the Second Circuit affirmed.

In its first case directly confronting equal access theory, the Supreme Court stunned the securities regulation world by reversing 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

93 Id.
94 Id.
95 United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978).
97 Id. at 228.
information] because of a fiduciary duty or other similar relation of trust and confidence between them.\footnote{Id. (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).}

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. Formulation of such a broad duty, which departs radically from the established doctrine that arises from a specific relationship between two parties…should not be undertaken absent some explicit evidence of congressional intent…neither Congress nor the SEC has adopted a parity-of-information rule.\footnote{Id. at 233.}

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

While the rule set forth in 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, directors, and others with similar control over the firm’s functions) to whom the inside information pertains, may lawfully trade with that information. However, had that same trader been a fiduciary in the firm, she would be squarely in violation of Section 10(b). Is there any meaningful distinction between the two scenarios? The Misappropriation Model,\footnote{In his dissent in Chiarella, 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. Chiarella v. U.S., 445 U.S. 222, 240 (1980) (C.J. Burger Dissenting).} adopted in the 1997 case United States v. O’Hagan,\footnote{United States v. O’Hagan, 117 S. Ct. 2199 (1997).} declares there is not and continues to govern insider trading regulation in securities markets today.

\footnote{United States v. O’Hagan, 117 S. Ct. 2199 (1997).}
U.S. v. 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{102} 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{103}

In a 6-3 decision, the Supreme Court reversed the Eighth Circuit and convicted O’Hagan on 57 counts of mail fraud, money laundering and securities fraud.\textsuperscript{104} The O’Hagan Court broke sharply with 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{105} 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 Chiarella reasoning. Post-O’Hagan 10(b) now condemns both “insiders” trading with inside information because the insider breached a fiduciary duty to shareholders as well as “outsiders” trading with inside information because the outsider breached a fiduciary duty to the source of the information.\textsuperscript{106}

\begin{footnotes}
\footnote{102} United States v. O’Hagan, 92 F.3d 612, 614 (8th Cir. 1996).
\footnote{103} Id.
\footnote{105} Id. at 2207.
\footnote{106} Id. at 2207-08. 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 trades 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). \textit{See id.} Those who trade with material, non-public information obtained by applying “superior experience, foresight, or industry” (see FN 105), 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.
\end{footnotes}
E. 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 require that some kind of fiduciary duty be attached 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. Institutionally concentrated markets like the current CDS market are governed by repeat transactions. 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.” 107 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. Though more broadly spread participation in the CDS market weakens traders’ incentive to play fairly,108 regulation can compensate for this weakened incentive. Attaching a fiduciary duty to protection sellers is one way to compensate for this negative consequence of a less institutionally concentrated CDS market.

107 See Bainbridge, supra note 8, at 97.
108 This is because, with a greater pool of potential counterparties, traders’ interest in protecting future trading relationships decreases.
To keep with the public interest of maintaining consistent financial regulation, CDS regulation should also, as securities regulation has, extend its fiduciary duty reach 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, CDSs will be transacted 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: Should Insider Trading in CDS Markets 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

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109 See remarks of SEC Chairman Mary Schapiro, supra note 82.
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 confronted in a court of law. A comparison to securities market regulation suggests that *Rorech* 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 the CDS market with both a legal justification and a sensible framework through which CDS insider laws and regulations would be enforced. 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.