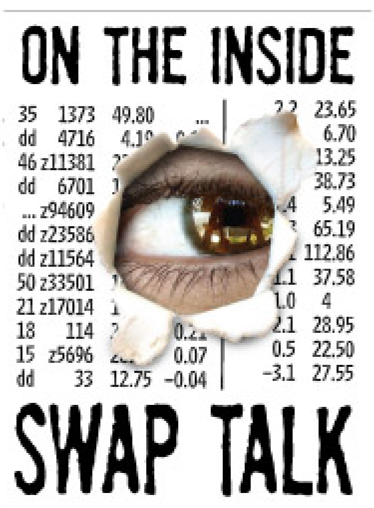
THE WALL STREET JOURNAL.
WSJ.com
MARCH 31, 2010

Trader's 'Nice Little Kiss' Tests Reach of Regulators

A series of phone calls between a Deutsche Bank AG bond salesman and a hedge-fund trader has landed the two men at the center of a courtroom test of how far federal regulators can go in pursuing insider trading.

Jon-Paul Rorech, the salesman, was teeing up buyers for a bond offering for a unit of Dutch publisher VNU. In a call to portfolio manager Renato Negrin, he suggested that derivatives contracts based on the bonds could soar in value, regulators say. Mr. Negrin, they say, bought a huge trading position, reaping a $1.2 million profit.



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"Great call. That's all I have to f------ say," Mr. Negrin later told the salesman, according to a recording of a phone call transcribed by regulators. Mr. Rorech told Mr. Negrin that the trading tip was a "nice little kiss," the regulators say.

Those 2006 conversations triggered a major civil insider-trading case that is slated to go to trial next week in a New York federal court. The S ecurities and Exchange Commission has accused the two men of improperly using nonpublic information, and are seeking disgorgement of profits and civil penalties. They deny the charges. Details about the conversations have trickled out in recent days in court filings.

Neither Deutsche Bank nor the hedge fund, Millennium Partners LP, has been accused of wrongdoing. Millennium says it cooperated with the investigation and has a "zero-tolerance policy" for insider trading. Deutsche Bank declined to comment.

The case has triggered a broader debate: Can federal securities regulators pursue insider-trading charges in the unregulated market for "credit-default swaps," financial contracts that provide insurance against debt defaults. Banks, hedge funds and traders use them to bet on the likelihood of bonds or loans going bad. The SEC

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says it has purview over policing the market.

The defendants in the New York case argue, among other things, that swaps aren't securities, but private contracts between financial players outside the SEC's jurisdiction. Unlike most stocks, bonds and options, swaps aren't traded on an exchange.

The case will test the SEC's authority at a critical time. In recent months, regulators have launched high-profile cases alleging insider trading by hedge fund Galleon Group and several technology executives. Just last week, the U.K.'s Financial Services Authority arrested seven people as part of what they say is a large insider-trading ring. The defendants have denied wrongdoing.

Insider trading occurs when someone makes an investment decision based on material information not available to the general public, and knows that information is coming from a person who has a responsibility to keep it private. The SEC traditionally has pursued insider-trading cases involving stocks, options and other securities. But as swaps have exploded in popularity in recent years, regulators have grown concerned that investors have been using inside information in trading them.

"What is at stake is the jurisdictional boundary of the SEC," says Frank Partnoy, a law and finance professor at the University of San Diego and a former Morgan Stanley derivatives salesman.

Bloomberg News

A Deutsche Bank bond trader's 2006 conversations with a hedge-fund trader triggered a major civil insider-trading case that is slated to go to trial next week. Neither the bank nor the hedge fund have been accused of wrongdoing. Above, Deutsche Bank headquarters in Frankfurt, Germany.

Mr. Rorech's sales call to Mr. Negrin involved a $1.6 billion bond offering for the Nielsen TV-ratings unit of Dutch publisher VNU, which has since been renamed Nielsen Co. Mr. Rorech, 39 years old, wanted to know whether Mr. Negrin was interested in buying the Nielsen bonds or credit-default swaps insuring against a default of VNU, according to papers filed by the SEC in the case.

Mr. Negrin, 46, balked, according to the SEC. Mr. Rorech told him there were possible "upsides" to buying VNU swaps, the SEC says. He indicated, among other things, that parent VNU—not just its Nielsen unit—could also issue more debt, the SEC says.

An increase in VNU's debt would heighten the company's risk of default, making the insurance on its debt more expensive. Information about an additional VNU debt offering wasn't known to the market, the SEC says.

"How do we define the odds?" Mr. Negrin asked, according to a recorded call transcribed by the SEC.

"I think they're very good," Mr. Rorech told him.

"Give me something to grab onto that they're very good," Mr. Negrin said.

"You're listening to my silence, right?" asked Mr. Rorech before they hung up.

Mr. Negrin called Mr. Rorech back on his cell phone where they spoke for three minutes, a voiding the recorded phone line, the SEC says.

A few days later, they talked again over cellphones about VNU. Three hours after the second call, on July 17, 2006, Mr. Negrin placed the first of two orders totaling €20 million (then about $27

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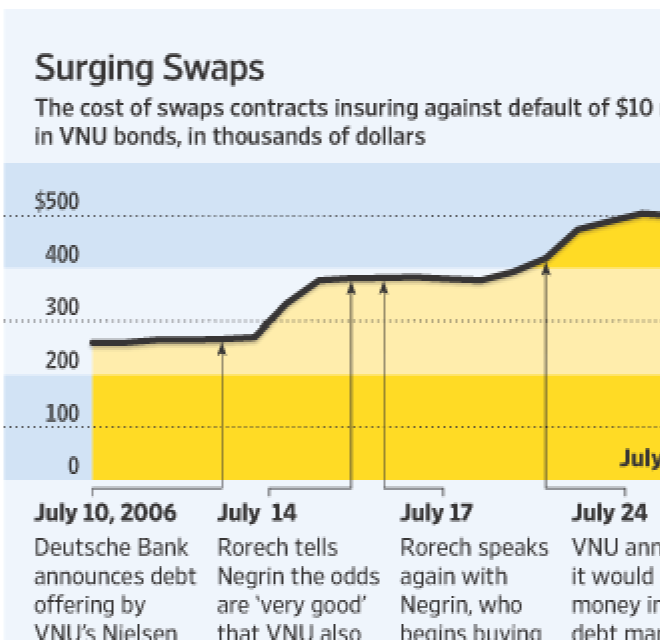
million) for credit-default swaps on VNU debt, double the size of any VNU swaps position he previously held.

One week later, a deal involving VNU's Nielsen unit was announced that included VNU also issuing bonds. The move sent prices of VNU credit default swaps—the cost to insure against a default—surging.

Mr. Negrin later sold all his VNU swaps, for a profit of about $1.2 million, based on the e xchange rate at the time, according to the SEC.

Lawyers for Mr. Rorech, who currently is on leave from Deutsche Bank, say the information wasn't confidential and he simply was generating interest in the bond offering to ensure it went off without a hitch, and that he never knew with certainty that VNU also would issue more debt. Lawyers for Mr. Negrin, who no longer works for Millennium, say he did nothing wrong.



In court documents, lawyers for Messrs. Rorech and Negrin argue that traders discuss potential deal terms "routinely" in marketing bond offerings. "If the Commission now believes that information flow in high yield bond deals creates a problem as it relates to credit default swaps," it needs to "develop rules to address potential abuses."

The SEC argues that the activity was insider trading and that it currently has jurisdiction over swaps because they're based on the value of VNU securities. The defendants say swaps are private contracts traded between dealers outside the SEC's purview.

When VNU's swap prices rose suddenly in the wake of the announcement of the additional debt offering, some traders unrelated to the case were frustrated, the SEC says. Paul Causer, a trader and Deutsche Bank client in London, suggested to a Deutsche salesman that some hedge funds had gotten early word of the bond deal, according to the SEC. According to a recorded line transcribed by the SEC, Mr. Causer said: "Has it got to the point where it can be as blatant as that?"

The Deutsche salesman, Sean Hunt, responded: "Is that insider trading or is that just you sort of having an interactive…"

Mr. Causer cut him off, according to the recorded call, saying: "It's insider trading. The whole market doesn't know, Sean. The people that are in the know, know, right?"

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