Can Anyone Police the Swaps?

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Unusual trading in a relatively new corner of the bond market illustrates how the rise of increasingly sophisticated financial instruments is potentially outpacing the ability of regulators to police them.

In recent months, there have been spikes in the prices of so-called credit-default swaps, which are a kind of default insurance on debt, popular among banks, hedge funds and other big investors. In some prominent cases recently -- including deals involving hospital operator HCA Inc. and energy company Anadarko Petroleum Corp. -- prices of the swaps climbed in the weeks before news of major acquisitions became public.

That raises the possibility that some traders might have acted on inside information.

There is no evidence at this point that improper inside information was leaked. Proving insider trading has always been a challenge for regulators, even in traditional securities. But the recent activities raise questions as to which regulator, if any, is policing the market, and how they will go about it as these exotic instruments spread.

A credit-default swap is an insurance contract tied to, say, corporate bonds. A buyer will pay a sum annually for such a derivative. If a bond defaults, the losses will be covered by the seller of the contract. The cost of protection rises if investors feel the underlying debt is getting riskier.

The credit-default swap market has ballooned to more than $17 trillion in recent years -- meaning such agreements have been written on trillions of dollars of debt -- and trading volumes in this market now exceed trading volumes in the debt itself. But it is a difficult market to track. Credit-default swaps trade away from exchanges in the "over-the-counter" market, and tend to be negotiated privately and over the phone. They are typically traded in trxs of $5 million, making them the exclusive domain of large investors that are active in the debt markets. Moreover, they aren't even clearly securities, because they are often likened to insurance contracts.

These instruments are one example of a large and growing array of financial products that have cropped up in recent years that don't easily fit the definitions of securities with which regulators have traditionally dealt. These newfangled instruments were mostly created by banks and others to manage their risks, and many observers say they have helped to make the financial markets more resilient to shocks.

But worries are growing. Last year regulators demanded that banks become more efficient at processing everyday trades in these fast-growing contracts. Another concern: Credit-default swaps have become popular with some investors, namely hedge funds, which are barely regulated themselves.

"All it's going to take is somebody from the bank talking to his friend who works at a hedge fund" for inside information to spread, said Michael Piazza, a former enforcement attorney with the Securities and Exchange Commission who is now a partner at Dorsey & Whitney LLP.

Adding to the regulatory challenge, the growth in cross-border finance and deregulation means these transactions sometimes fall either under multiple jurisdictions, or no clear jurisdiction.

Prices on credit-default swaps for HCA rose by a third in the weeks before reports appeared saying the company was in talks to be sold to a group of private investors.

An investor who wanted to be sheltered from a default of $10 million in HCA bonds over five years had to pay around $130,000 annually for such coverage in June.

That price climbed to around $170,000 in the days before news of a possible deal, and then soared to more than $400,000 after one was unveiled.

A similar pattern occurred before Anadarko's $21 billion cash offer in June for two companies, Kerr-McGee Corp. and Western Gas Resources Inc. In both the HCA and Anadarko transactions, the deals increased the acquiring company's financial risk and thus made the swaps more valuable.

HCA declined to comment. An Anadarko spokeswoman said: "The credit-default swap market operates independent of Anadarko and we cannot speculate on the nature or cause of fluctuation and spreads in that market."

Other cases appear to have cropped up. A 2005 study by two London Business School researchers examined credit-default swap prices of around 80 U.S. companies from 2001 to 2004.

The researchers, Viral Acharya and Timothy Johnson, said they found evidence "consistent with insider trading" in these instruments. In Europe, some investors complained last month that the credit-default swaps of Dutch media company VNU NV had become significantly more expensive ahead of an announcement that the company's bond issue was being restructured.

A spokesman for VNU's owners didn't return calls.

British regulators have also received an increasing number of complaints from investors about the market. "We have intensified our surveillance of this market," says Diwyn Griffiths, head of Market Monitoring at the United Kingdom's Financial Services Authority.

In the U.K., regulation is a bit simpler. The U.S. has two principal market regulators, the SEC and

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the Commodity Futures Trading Commission, in addition to bank regulators. In the U.K., "we are a single regulator, which is important, so there are no questions on whose jurisdiction this is," says Mr. Griffiths.

Turf is only one complication for regulators. It is notoriously difficult to distinguish cases of insider trading from the sort of trading on rumors that is common -- and legal -- in financial markets. Some scholars have even argued that prosecuting such cases is pointless because information moves so quickly in today's markets and because it is hard to find actual victims to such crimes of high finance.

In the cases of both HCA and Anadarko, the SEC is scrutinizing stock-option trading associated with both deals, but there is no evidence the agency is examining the rise in the credit-default swap trades.

The International Swaps and Derivatives Association, an industry trade group, says the SEC has no jurisdiction because the swaps are private contracts that don't trade on traditional exchanges.

The SEC hasn't brought a case in this area, though it hasn't ruled out its ability to do so. The CFTC, which oversees futures contracts, says it has no oversight.

While some big investors in swaps -- like banks, mutual funds and insurance companies -- are closely regulated, others, most notably hedge funds, are less regulated.

One reason "people are worried about hedge funds is not only are hedge funds lightly regulated but they deal to a large measure in unregulated transactions," says Michael Greenberger, a former director of the CFTC's division of trading and markets and now a professor at the University of Maryland School of Law. "It's a daisy chain of risk."

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