

SEC APPROVES CREDIT DEFAULT SWAP EXEMPTIONS

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ALL THREE ACTIONS ARE TEMPORARY ISSUANCES TO GIVE THE SEC THE OPPORTUNITY TO EVALUATE THE CONDITIONS IMPOSED UNDER THE ORDERS AND DETERMINE WHETHER MODIFICATIONS ARE NECESSARY.

The Securities and Exchange Commission (SEC) recently issued exemptive orders and interim final rules designed to facilitate the operation of clearinghouses for credit default swaps (CDS).¹ One order, issued under section 36 of the Securities Exchange Act of 1934 (“Exchange Act”), generally exempts exchanges that effect transactions in

certain CDS from exchange registration requirements and brokers and dealers that effect CDS transactions on these exchanges from the prohibition on trading on unregistered exchanges. Separate orders grant specific exemptions from the Exchange Act clearing agency registration requirements to (1) LIFFE Administration and Management (LIFFE) and LCH.Clearnet Ltd. (LCH) and (2) ICE US Trust, LLC (“ICE Trust”)² to permit those organizations to clear certain CDS products. Finally, the SEC has adopted interim final rules that exempt “eligible credit default swaps” from all provisions of the Securities Act of 1933 (“Securities Act”) other than the anti-fraud provisions. Each of the above has been issued on a temporary basis to provide the SEC the opportunity to evaluate the conditions imposed under the orders and determine whether modifications are necessary.

BACKGROUND

A CDS is a bilateral contract between two counterparties pursuant to which one party pays a premium to the other for protection against the occurrence of certain credit events. A CDS may be based on the underlying obligations of a single entity; a particular security or other debt obligation; or a group of entities, securities, or obligations. The requirement to make a payment under a CDS is triggered on the occurrence of a specified credit event relating to the underlying entity, security, or obligation. The SEC has limited authority over “security-based swap agreements” as defined

by section 206A of the Gramm-Leach-Bliley Act (enacted as part of the Commodity Futures Modernization Act of 2000 (CFMA)), which requires that the material terms of the transaction, other than price and quantity, be “subject to individual negotiation.”

As a practical matter, a clearinghouse or other central counterparty (CCP) can accept CDS or other products for clearing only if they are standardized. Standardizing CDS or other swaps for clearing, therefore, has the effect of removing them from the “swap agreement” definition and potentially rendering them subject to regulation as “securities” under the federal securities laws. The SEC’s recent actions (described below) grant relief from the exchange, broker-dealer, and clearing agency registration provisions of the Exchange Act and the securities offering provisions of the Securities Act that might otherwise apply to CDS contracts that are not security-based swap agreements (“non-excluded CDS”).

EXCHANGE AND BROKER-DEALER EXEMPTIVE ORDER

This order provides a temporary exemption to (1) any exchange that effects or reports transactions in non-excluded CDS if that exchange is not otherwise required to be registered with the SEC as a national securities exchange, and (2) any broker or dealer that effects or reports transactions in non-excluded CDS on such an exempt exchange.³ The order contains several conditions regarding the availability of the relief to CDS exchanges, which generally

¹ The actual scope and extent of the SEC’s authority over these instruments is a complicated and somewhat unresolved issue. In November 2008, the President’s Working Group on Financial Markets called for the immediate implementation of central counterparties (CCPs) for the exclusively over-the-counter CDS market. In response, the Federal Re-

serve Board, the SEC, and the Commodity Futures Trading Commission (CFTC) entered into a Memorandum of Understanding that established a framework for consultation on issues related to CCPs for CDS. The SEC actions discussed herein are part of that initiative and are designed to remove existing regulatory barriers under the securities laws (if

any) that have, up to this point, impeded the development of centralized CDS clearing.

² The application for ICE Trust was submitted by the IntercontinentalExchange, Inc. and The Clearing Corporation.

³ See SEC Release No. 34-59165 (December 24, 2008), available at www.sec.gov/rules/ex-orders/2008/34-59165.pdf.

mirror those applicable to alternative trading systems (broker-dealer operated systems that are exempt from exchange registration pursuant to SEC Regulation ATS):

1 The temporary relief is available only with respect to transactions in non-excluded CDS.

2 A CDS exchange must not adopt rules governing the conduct of subscribers (other than conduct related to trading on the exchange) and must not discipline subscribers (other than by exclusion from trading) or otherwise exercise self-regulatory authority over them.

3 A CDS exchange must comply with recordkeeping requirements relating to the CDS exchange's operations (including transaction, order, and subscriber information); disclose information to the SEC on an initial and on ongoing basis; establish procedures to ensure confidential treatment of trading information; and provide access to the SEC for inspections and investigations.

LIFFE-LCH ORDER

In a companion order, the SEC temporarily exempted LCH from the requirement to be registered as a clearing agency under section 17A of the Exchange Act in connection with the clearance and settlement of CDS transactions based on certain CDS indices through LIFFE's OTC derivatives processing service ("Bclear"). Under the order, the Bclear service may be offered to certain qualified U.S. market participants for index-based CDS. Absent an exemption, LCH's role as a CCP for non-excluded CDS in the United States would require clearing agency registration with the SEC.

The SEC granted LCH's request for exemption from clearing agency registration, subject to the following conditions (among others):

1 LIFFE's rules ensure that the Bclear service is offered to U.S. persons solely by LIFFE members that are regulated by appropriate regulatory authorities.

2 LCH meets the principles set forth in the Recommendations for Central Counterparties (RCCP).⁴

3 At least 80% of the weighting of index-based CDS contracts are attributable to reference entities or reference securities that satisfy certain conditions relating to the availability of information about these entities or securities.

4 LCH makes publicly available on fair and reasonable terms (a) all end-of-day settlement prices and any other prices with respect to the cleared Index CDS that LCH may establish to calculate mark-to-market margin requirements for LCH or LIFFE participants, and (b) any other pricing or valuation information with respect to the cleared Index CDS published or distributed by LCH or LIFFE.

The order also includes exemptions from certain Exchange Act provisions for three specific categories of expected market users. The exemptions in general operate to ensure that transactions in non-excluded CDS effected on LIFFE and cleared by LCH are subject to the same substantive Exchange Act requirements as those that currently apply to transactions in non-cleared OTC credit default swaps. Further, the exemptions generally ensure that the qualifying categories of participants are not required to seek fur-

ther registration under the U.S. securities laws to effect Index CDS transactions on the LIFFE and LCH systems.

The first category of exemption applies to persons or entities that qualify as eligible contract participants (ECPs),⁵ other than (1) ECPs that receive or hold funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Index CDS positions for other persons; (2) ECPs that are self-regulatory organizations; and (3) ECPs that are registered brokers or dealers. Market participants that are excluded from these three categories may, however, qualify for one of the other two exemptions described below.

The second category applies to those members of LIFFE that receive or hold funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Index CDS positions for other persons. This exemption is conditioned on the LIFFE member's material compliance with LIFFE rules (and, if applicable, LCH rules) with respect to non-excluded CDS. Further, to the extent that this category of exempted persons receives or holds funds or securities of U.S. ECPs in connection with non-excluded CDS, the exemption is conditioned on (1) the U.S. person being a natural person, (2) the LIFFE member segregating the U.S. person's funds from its own assets, and (3) the LIFFE member providing certain specified disclosure to the U.S. person.

The third category of participant-based exemption applies to registered broker-dealers. This exemption, however, specifically does not extend to several Exchange Act fi-

⁴ RCCP was produced by a joint task force composed of representative members of the International Organization of Securities Commissions and the Committee on Payment and Settlement Systems.

⁵ This term is defined in section 1a(12) of the Commodity Exchange Act to include, among

others, banks, broker-dealers, and entities with at least \$10 million in assets.

financial responsibility and associated recordkeeping provisions, namely, sections 7(c), 15(c)(3), 17(a), and 17(b); Rules 15c3-1, 15c3-3, 17a-3 through 17a-5, and 17a-13; and the Federal Reserve Board's Regulation T. Thus, these provisions will continue to apply to the activities of a registered broker-dealer effecting transactions in Index CDS through the Bclear system.

ICE TRUST ORDER

Most recently, in a separate order, the SEC granted similar temporary and conditional exemptions to ICE Trust to enable it to clear and settle certain OTC CDS transactions without being registered as a clearing agency. Under the order, ICE Trust will act as CCP for matched CDS transactions accepted for clearing via The Depository Trust & Clearing Corporation's Deriv/SERV infrastructure.

The conditions imposed by the SEC are similar to those found in the LIFFE-LCH Order including, among other things, that ICE Trust meet the principles set forth in the RCCP; that at least 80% of the weighting of non-excluded index-based CDS be composed of reference entities or reference securities that satisfy informational conditions; and that ICE Trust make certain settlement and pricing information publicly available. In addition, as in the LIFFE-LCH Order, the SEC

provided temporary Exchange Act exemptions to certain categories of qualifying market users to ensure that, from a trading perspective, the non-excluded CDS transactions cleared by ICE Trust are subject to the same substantive Exchange Act requirements that currently apply to transactions in non-cleared OTC credit default swaps.

ICE Trust will calculate an end-of-day settlement price based on prices submitted by its participants. To validate the accuracy of these submissions, ICE Trust will periodically require participants to execute CDS trades at the end-of-day settlement price. To permit ICE Trust to use this validation mechanism, the SEC temporarily exempted ICE Trust from the registration requirements of section 5 of the Exchange Act and exempted participants from section 6 of the Exchange Act solely in connection with this process.

INTERIM FINAL RULES

The SEC adopted interim final rules that, among other things, provide conditional exemptions under the Securities Act for "eligible credit default swaps" ("Eligible CDS") to encourage market participants to clear qualifying CDS through CCPs.⁶ The definition of Eligible CDS under the interim final rules limits this term to certain standardized, bilateral executory derivative

contracts involving credit-related events.

The interim final rules exempt Eligible CDS from all provisions of the Securities Act, other than the anti-fraud provisions of section 17(a), and the Exchange Act's registration provisions. Thus, offers and sales of Eligible CDS will not be required to comply with the registration requirements of section 5 of the Securities Act. This relief is conditioned on the following:

1 The Eligible CDS must be issued or cleared by an SEC-registered securities clearing agency or an exempt CDS CCP (such as LCH and ICE Trust).

2 The Eligible CDS must be offered and sold only to ECPs as defined in section 1(a)(12) of the Commodity Exchange Act (and must not be offered and sold to those persons who are included in the ECP definition solely due to regulatory action by the CFTC).

The interim final rules also include a temporary amendment to Securities Act Rule 146 to clarify that ECPs that are buyers of Eligible CDS will be treated as "qualified purchasers" under the Securities Act, thereby ensuring that qualifying Eligible CDS are treated as "covered securities" under the Securities Act and are correspondingly exempted from state, blue sky laws.

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⁶ The interim final rules also include related exemptions from the Exchange Act and the

Trust Indenture Act to facilitate the operation of centralized CDS clearing.