

Client Advisory

SEC Approves Credit Default Swap Exemptions

January 16, 2009

Executive Summary

The Securities and Exchange Commission (“SEC”) has issued two exemptive orders and interim final rules designed to facilitate the operation of one or more clearinghouses for credit default swaps (“CDS”).¹ The first order, issued under Section 36 of the Securities Exchange Act of 1934 (the “Exchange Act”), exempts exchanges that effect transactions in certain CDS from exchange registration requirements and exempts brokers and dealers that effect CDS transactions on such exchanges from the prohibition on trading on unregistered exchanges. The second order grants exemptions to LIFFE Administration and Management (“LIFFE”) and LCH.Clearnet Ltd. (“LCH”) to permit the clearing of certain CDS products without either LIFFE or LCH registering as a “clearing agency” under the Exchange Act.² The second order also provides exemptions from certain provisions of the Exchange Act to certain CDS market participants. Finally, the interim final rules exempt “eligible credit default swaps” from all provisions of the Securities Act of 1933 (the “Securities Act”) other than the anti-fraud provisions. All three actions were 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, on a particular security or other debt obligation, or on a group of entities, securities or obligations. The requirement to make a payment under a CDS is triggered upon 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 in more detail 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”).

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 Reserve 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 in time impeded the development of centralized CDS clearing.

² A number of market participants have announced their intention to establish CDS exchanges and clearinghouses. In addition to the LIFFE-LCH effort, groups involving the Intercontinental Exchange and The Clearing Corporation, and the Chicago Mercantile Exchange and Citadel Investment Group, are in various stages of preparation.

The 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 a number of conditions with respect to the availability of the relief to CDS exchanges, which generally mirror those applicable to alternative trading systems (broker-dealer operated systems that are exempt from exchange registration pursuant to SEC Regulation ATS):

- The temporary relief is available only with respect to transactions in non-excluded CDS.
- 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 its subscribers.
- 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 ongoing basis; establish procedures to ensure confidential treatment of trading information; and provide access to the SEC for the purpose of inspections and investigations.

The LIFFE-LCH Order

In the 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 credit default swap indices through LIFFE's OTC derivatives processing service ("Bclear").⁴

Under the terms of the order, the Bclear service may be offered to certain qualified U.S. market participants for index-based CDS.⁵ 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):

- LIFFE's rules ensure that the Bclear service was offered to U.S. persons solely by LIFFE members that are regulated by appropriate regulatory authorities.
- LCH meets the principles set forth in the Recommendations for Central Counterparties ("RCCP").⁶
- At least 80 percent 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 such entities or securities.
- LCH makes publicly available on fair and reasonable terms: (i) 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 (ii) 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 further registration under the U.S. securities laws in order to effect Index CDS transactions on the LIFFE and LCH systems.

³ See SEC Release No. 34-59165 (December 24, 2008).

⁴ In contrast to the SEC's generally applicable exemptive order relating to exchange and broker-dealer registration, the SEC's order for LIFFE and LCH is specific to their proposal and cannot be relied on by others.

⁵ LIFFE is a recognized investment exchange and LCH is a recognized clearinghouse in the UK. LCH is also registered with the CFTC as a derivatives clearing organization.

⁶ 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.

The first category of exemption applies to persons or entities that qualify as eligible contract participants (“ECPs”),⁷ excluding three subsets of ECPs: (i) ECPs that receive or hold funds or securities for the purpose of purchasing, selling, clearing, settling or holding Index CDS positions for other persons; (ii) ECPs that are self-regulatory organizations; and (iii) ECPs that are registered brokers or dealers. Users of the LIFFE-LCH system who 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 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 (i) the U.S. person not being a natural person; (ii) the LIFFE member segregating the U.S. person’s funds from its own assets; and (iii) the LIFFE member disclosing to the U.S. person that the LIFFE member is not regulated by the SEC and that Exchange Act segregation requirements and the Securities Investor Protection Act do not apply to funds or securities held by the LIFFE member.

The third category of participant-based exemption applies to registered broker-dealers. This exemption, however, specifically does not extend to a number of Exchange Act financial responsibility and associated recordkeeping provisions, namely, Sections 7(c), 15(c)(3), 17(a), 17(b), Rules 15c3-1, 15c3-3, 17a-3 through 17a-5, 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 trades in Index CDS on the LIFFE-LCH system.

The 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.⁸ 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 upon the following:

- The Eligible CDS must be issued or cleared by an SEC-registered securities clearing agency or an exempt CDS CCP (such as LCH).
- The Eligible CDS must be offered and sold only to ECPs as defined by 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 make clear that ECPs that are buyers of Eligible CDS will be considered 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.

Note: Katten Muchin Rosenman LLP represented LIFFE Administration and Management and LCH.Clearent Ltd. before the Securities and Exchange Commission in connection with these matters.

⁷ 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.

⁸ The interim final rules also included related exemptions from the Exchange Act and the Trust Indenture Act to facilitate the operation of centralized CDS clearing.

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