

**SEC GRANTS EXEMPTIONS FOR CREDIT DEFAULT SWAP  
EXCHANGES AND CENTRAL COUNTERPARTY**

On December 24, 2008, the U.S. Securities and Exchange Commission (“SEC”) published two orders (“Orders”) establishing conditional exemptions from provisions of the Securities Exchange Act of 1934 (“Exchange Act”) to facilitate exchange trading and central counterparty (“CCP”)<sup>1</sup> activities with respect to the market for certain credit default swaps (“CDS”).<sup>2</sup> The SEC has also approved interim final temporary rules providing related exemptions under the Securities Act of 1933 and the Exchange Act, but the rules have not yet been released.

The SEC’s action is intended to help stabilize financial markets by reducing counterparty risk and promoting efficiency in the CDS market.<sup>3</sup> The SEC is seeking comments on the exemptions, which expire on September 25, 2009.<sup>4</sup>

Exchange and Broker-Dealer Exemption

The SEC is providing a temporary exemption from the requirement to register as a national securities exchange to any exchange that effects or reports transactions in non-excluded CDS<sup>5</sup>

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<sup>1</sup> A CCP is an entity that interposes itself between counterparties to contracts traded on one or more financial markets, becoming the buyer to every seller and the seller to every buyer.

<sup>2</sup> The SEC issued the following orders pursuant to Exchange Act Section 36:

- “Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions from Sections 5 and 6 of the Exchange Act for Broker-Dealers and Exchanges Effecting Transactions in Credit Default Swaps” (“Exchange and Broker-Dealer Exemption”); and
- “Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection with Request of LIFFE Administration and Management and LCH.Clearnet Ltd. Related to Central Clearing of Credit Default Swaps, and Request for Comments” (“CCP Exemption”).

SEC Release No. 34-59165 (Dec. 24, 2008) and SEC Release No. 34-59164 (Dec. 24, 2008).

<sup>3</sup> SEC Press Release 2008-303 (Dec. 23, 2008) (“SEC Press Release”). In developing the exemptions, the SEC consulted with the Federal Reserve Board and the Commodity Futures Trading Commission (“CFTC”) pursuant to the Memorandum of Understanding cited in the Orders. *See* SEC Press Release; Releases 34-59164 n.7 and 59165 n.7. The CFTC has approved clearing of over-the-counter (“OTC”) CDS by several derivatives clearing organizations subject to the CFTC’s jurisdiction, including the Chicago Mercantile Exchange, Inc.

<sup>4</sup> The SEC has not specified any deadline for submission of comments.

<sup>5</sup> The SEC appears to take the position that security-based swaps that are exchange-traded or centrally cleared and novated are “non-excluded CDS” that do not fall within the Gramm-Leach-Bliley Act’s limitation of the SEC’s authority over the OTC market for CDS and the general exclusion of swap agreements in Section 3A of the Exchange Act. With respect to these “excluded swaps” the SEC’s authority is generally confined to certain antifraud and insider trading provisions in the Exchange Act.

and is not otherwise subject to the requirements under Sections 5 and 6 of the Exchange Act.<sup>6</sup> The exemption is subject to certain conditions, which generally mirror those applicable to alternative trading systems pursuant to Regulation ATS.<sup>7</sup>

Specifically, the exemption includes the following conditions:

- The exempt exchange must not (1) set rules governing the conduct of subscribers other than the conduct of such subscribers trading on such exchange, or (2) discipline subscribers other than by exclusion from trading.
- The exempt exchange must make and keep preserved for a period of not less than three years (1) a record of subscribers in the exchange, (2) daily summaries of trading including information that identifies the CDS and information regarding transaction volume, and (3) time-sequenced records of order information.
- The exchange must, within five days of commencing operation, submit a notice to the SEC detailing its official name, its ownership structure, a contact person, and a description of what CDS are traded and how the exchange operates.
- The exempt exchange must report to the SEC detailed information regarding trading activity and subscribers within 30 days of the end of each quarter.
- The exempt exchange must establish adequate safeguards and procedures to protect subscribers' confidential trading information, including (1) limiting access to such confidential trading information, (2) implementing standards controlling exchange employees' trading for their own accounts, and (3) adopting adequate oversight procedures to ensure that the safeguards and procedures are followed.
- The exempt exchange must provide access to the SEC to conduct on-site inspections of its facilities.

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<sup>6</sup> This exemption is not available to securities exchanges that are presently registered as such under the Exchange Act. *See* Release 34-59165 n.14. The SEC notes that such exchanges could form a subsidiary or affiliate to operate an exchange pursuant to the exemption.

<sup>7</sup> Regulation ATS, 17 CFR 242.300-303, contains a regulatory framework for "alternative trading systems" that perform many of the same functions as exchanges. *See* Release 34-59165 n.25. Although the SEC used Regulation ATS as the model for the exemption from Sections 5 and 6 of the Exchange Act, there is one major difference: Regulation ATS is predicated on the "exchange" entity being registered with the SEC as a broker-dealer, but that requirement is not part of this exemption. In recognition of this, the SEC has added conditions that require recordkeeping with respect to operations, subscribers, and orders, as well as requiring reporting to the SEC, and other examination and informational controls.

A broker-dealer that effects transactions in non-excluded CDS, or reports such transactions, on an exchange that is exempted pursuant to this order is granted an exemption from Section 5 of the Exchange Act, which otherwise would prohibit the broker-dealer from effecting or reporting transactions in such securities on an exchange unless the exchange was registered or was exempt from registration due to its limited trading volume.

### CCP Exemption

Both LIFFE Administration and Management (“LIFFE A&M”) and LCH.Clearnet Ltd. (“LCH.Clearnet”) are granted exemptions from provisions of the Exchange Act with respect to their activities in clearing and settling Cleared Index CDS.<sup>8</sup> LCH.Clearnet acts as the CCP for all transactions processed through LIFFE A&M’s OTC derivatives processing service, called Bclear. LCH.Clearnet is a “recognized clearing house” in the United Kingdom (“U.K.”), and LIFFE A&M is a “recognized investment exchange” in the U.K. The U.K. Financial Services Authority (“FSA”) is the main regulator of LCH.Clearnet and the Bank of England oversees its payment system. The SEC is temporarily exempting LCH.Clearnet from the requirement to register as a clearing agency under Section 17A of the Exchange Act to perform the function of a clearing agency (*i.e.*, central counterparty) for Cleared Index CDS transactions for U.S. market participants.<sup>9</sup> LIFFE A&M and LCH.Clearnet represent that the CCP will operate in accordance with the following features:<sup>10</sup>

- LIFFE A&M’s OTC derivatives processing service, Bclear, will provide a mechanism for the processing and centralized clearing of CDS based on credit default swap indices. Bclear processes OTC transactions that are submitted by members or authorized customers, and these transactions are then submitted for clearance to LCH.Clearnet. LIFFE A&M will make available on its website the contract specifications for index CDS that can be processed and cleared through the Bclear service.

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<sup>8</sup> The CCP Exemption is limited to “Cleared Index CDS,” which are non-excluded CDS that are (i) submitted (or offered, purchased or sold on terms providing for submission) to LCH.Clearnet, and (ii) offered only to, purchased only by, and sold only to Eligible Contract Participants (“ECPs”), and in which the reference index is an index in which 80 percent or more of the index’s weighting is comprised of the entities or securities described in the Order. The order provides no definition of “index.” An ECP is defined in Section 1a(12) of the Commodity Exchange Act (“CEA”) as, among others, a financial institution (as defined in Section 1a(15) of the CEA), an investment company registered under the Investment Company Act of 1940, a U.S.-registered broker-dealer, or a wealthy individual, in each case acting for its, his or her own account.

<sup>9</sup> The exemption is not limited to transactions in Cleared Index CDS that occur on exchanges. However, the exemption appears to contemplate that the index-based CDS that will be cleared by LCH.Clearnet will have standardized specifications and therefore will be non-excluded swaps. See Release 34-59164, Section II.A.1.

<sup>10</sup> It is not clear whether or how the SEC has substantiated these representations. See Release 34-59164, Section II.D. and nn.15 and 19.

- LIFFE A&M has two categories of members, clearing members and non-clearing members. All transactions of non-clearing members must be cleared through a specific clearing member. All clearing members must be members of LCH.Clearnet and are subject to standards of capital adequacy, and a LIFFE A&M member will be considered to be “acting as principal” for any transaction it effects.
- LCH.Clearnet requires the posting of initial margin and maintenance margin for all clearing accounts.
- LCH.Clearnet accepts a wide variety of collateral from clearing members in meeting their initial and net liquidation value margin payments.
- LCH.Clearnet may declare a clearing member in default when it appears to LCH.Clearnet that such clearing member may be unable, or may become unable, to meet its obligations. As the legal counterparty to each clearing member, LCH.Clearnet bears any loss arising from the default of a clearing member, beyond the margin deposits held in security in respect of the defaulting member’s liabilities. LCH.Clearnet holds a default fund comprising approximately £600 million.
- LCH.Clearnet subjects clearing members that undertake business for clients to U.K. client money and asset rules or, if they are authorized outside the U.K., to similar rules of their relevant regulator.
- LCH.Clearnet represents that its rules require its clearing members to (1) meet specific capital adequacy standards that vary depending on the type of activities undertaken by the member, (2) provide copies of audited annual financial statements to LCH.Clearnet, and (3) notify LCH.Clearnet upon the happening of certain material events, such as significant reductions in shareholders’ funds or net capital.

To avoid deterring market participants from promptly using CCPs, the SEC will apply substantially the same jurisdictional framework that applies to transactions in excluded swaps<sup>11</sup> to LCH.Clearnet, LIFFE A&M, and eligible contract participants solely with respect to

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<sup>11</sup> As discussed above, the SEC has limited jurisdiction over excluded swaps. This exemption, in effect, states that the SEC will not exert jurisdiction beyond what it can exercise with respect to excluded swaps. The SEC may be modeling this exemption on an earlier interpretive statement about clearing agency activity. See “Confirmation and Affirmation of Securities Trades; Matching,” SEC Release No. 34-39829 (Apr. 6, 1998). See also SEC Release No. 34-44188 (Apr. 17, 2001) (granting conditional exemption from clearing agency registration to Global Joint Venture Matching Services - US, LLC (n/k/a Omgeo)). Additionally, the SEC is adopting a form of “unilateral recognition” of the FSA regulatory scheme for LCH.Clearnet and LIFFE A&M.

transactions in Cleared Index CDS, although the SEC also is retaining its enforcement authority under Exchange Act provisions.<sup>12</sup>

This exemption is not available to (i) ECPs that receive or hold funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared Index CDS positions for other persons, (ii) ECPs that are “self-regulatory organizations, and (iii) brokers and dealers registered under Exchange Act Section 15(b) (other than pursuant to paragraph (11) thereof). However, a similar conditional exemption is available to LIFFE A&M members that receive or hold funds and securities as described above if: (i) the member is in material compliance with LIFFE A&M rules and applicable LCH.Clearnet rules with respect to Cleared Index CDS;<sup>13</sup> and (ii) to the extent that the member receives or holds funds or securities for U.S. persons:

- The US persons are not natural persons (but are ECPs);
- The LCH.Clearnet member segregates the funds and securities of U.S. persons from its own assets;<sup>14</sup> and
- The LCH.Clearnet member discloses the absence of SEC regulation, U.S. broker-dealer asset segregation provisions, and Securities Investor Protection Act (“SIPA”) coverage.<sup>15</sup>

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<sup>12</sup> This exemption does not extend to government securities provisions or Sections 5, 6, 12, 13, 14, 15, 16, or 17A of the Exchange Act. However, the SEC notes that these provisions are addressed in separate exemptions and the interim final temporary rules.

<sup>13</sup> Although not an express condition of the Order, the SEC states that it is also relying on LIFFE A&M’s representation that, before offering Index CDS services to U.S. persons, it will adopt a requirement that will prohibit a LIFFE A&M member from directly or indirectly submitting, or permitting an authorized customer to submit, an Index CDS to the Bclear service when the member receives or holds funds or securities for U.S. persons for the purpose of purchasing, selling, clearing, settling, or holding that Index CDS position, unless the member, in connection with such Index CDS activities, is regulated by (i) a signatory to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, (ii) a signatory to a bilateral arrangement with the SEC for enforcement cooperation, or (iii) a financial regulatory authority in Ireland or Sweden. Release 34-59164, text at nn.43-44.

<sup>14</sup> The member may not permit U.S. persons, even though they are ECPs, to opt out of segregation requirements for such funds and securities.

<sup>15</sup> This is similar to some of the conditions in the pending Rule 15a-6 amendments for foreign broker-dealers. See SEC Release No. 34-58047 (Jun. 27, 2008). SIPA created the Securities Investor Protection Corporation (“SIPC”), a nonprofit, private membership corporation to which most broker-dealers are required to belong, and established a fund administered by SIPC designed to protect the customers of broker-dealers subject to the Exchange Act from loss in the case of financial failure of the member.

U.S.-registered broker-dealers are separately exempted, solely with respect to Cleared Index CDS, from Exchange Act provisions that do not apply to excluded swap agreements, except that registered broker-dealers remain subject to a full range of U.S. customer protection and credit provisions, such as Rules 15c3-1 and 15c3-3 and Regulation T. The Order does not contain a restriction on U.S.-registered broker-dealers' receiving and holding funds and securities for natural persons who are ECPs, nor is a customer restricted from entering into certain transactions with the broker-dealer to the extent permitted by the Exchange Act asset segregation rule, Rule 15c3-3. It also appears that, if the Cleared Index CDS is held in an account with a U.S. broker-dealer, it would be eligible for SIPA protection if it is a security under Section 3(a)(10) of the Exchange Act.

Transparency

The availability of data about CDS is an important component of the exemption. Specifically, LCH.Clearnet must make available to the public on terms that are fair and reasonable and not unreasonably discriminatory (1) all end-of-day settlement prices and any other prices with respect to Cleared Index CDS that LCH.Clearnet or LIFFE A&M may establish to calculate mark-to-market margin requirements for their participants, and (2) any other pricing or valuation information with respect to Cleared Index CDS that is published or distributed by either of them. In addition, LCH.Clearnet will make annual audited financial statements available on its Website.

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If you have any questions regarding this memorandum, please contact Thomas H. French (212-728-8124, tfrench@willkie.com), Roger D. Blanc (212-728-8206, rblanc@willkie.com), Larry E. Bergmann, (202-303-1103, lbergmann@willkie.com) Martin R. Miller (212-728-8690, mmiller@willkie.com), Matthew B. Comstock (202-303-1257, mcomstock@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, DC 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, DC telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at [www.willkie.com](http://www.willkie.com).

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