SEC approves Chicago Mercantile Exchange Inc. As the third central counterparty for the clearance of credit-default swaps

On March 13, 2009, the Securities and Exchange Commission ("SEC") announced that it had approved certain temporary and conditional exemptions that would allow the Chicago Mercantile Exchange Inc. ("CME") to operate a central counterparty for the clearance of credit-default swaps ("CDSs").[1] This comes as the third announcement approving the operation of such a central counterparty since November 14, 2008, when the President's Working Group on Financial Markets ("PWG") first announced its initiatives to strengthen the oversight and infrastructure of the over-the-counter ("OTC") derivatives markets.[2] Similarly, on December 24, 2008 and March 6, 2009, LCH.Clearnet Ltd. ("LCH") and ICE US Trust LLC ("ICE"), respectively, were each granted temporary and conditional approval to operate central counterparties for the clearance of CDSs.[3] The time periods, terms and conditions of these three approvals (the "Approvals") are substantially the same.

Pursuant to Section 36(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which gives the SEC general exemptive authority with respect to the Exchange Act, the Approvals give each of the three central counterparties a number of exemptions for an initial period of nine months from the day such exemption is granted, e.g. CME's exemptions will last until December 14, 2009. During this initial period, the SEC intends to monitor the impact of the central counterparties on the CDS market, with particular focus on any anti-competitive effects with respect to transaction fees and access to market data and clearing services. The SEC has also asked that interested parties submit comments on the Approvals and the perceived effects of the central counterparties on the CDS market.

In general, each central counterparty is exempt from (1) Section 17A of the Exchange Act and (2) the provisions of the Exchange Act other than those that relate to fraud, manipulation of prices and insider trading -- a treatment similar to that presently afforded to security-based swap agreements. In addition, in certain circumstances, the exemptions extend to (1) any member of a central counterparty that receives or holds funds or securities for other parties and (2) certain registered broker-dealers.

A brief description of the exemptions and conditions provided by the SEC to each central counterparty follows:

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1 *See Order Granting Temporary Exemptions Under The Securities Exchange Act Of 1934 In Connection With Request Of Chicago Mercantile Exchange Inc. And Citadel Investment Group, L.L.C. Related To Central Clearing Of Credit Default Swaps, And Request For Comments*, Securities and Exchange Commission, Release No. 34-59578 (March 13, 2009) available at http://www.sec.gov/rules/exorders/2009/34-59578.pdf.

2 For a more detailed discussion of these initiatives and how they relate to certain proposals made by the New York Insurance Department, see *President's Working Group Takes Lead on CDS Regulation, NY Insurance Department Steps Aside*, Cahill Gordon & Reindel LLP Firm Memorandum (December 2, 2008) available at http://www.cahill.com/news/memoranda/000126.

3 *See 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*, Securities and Exchange Commission, Release No. 34-59164 (granting temporary exemptions to LCH.Clearnet Ltd.) (December 24, 2008) available at http://www.sec.gov/rules/exorders/2008/34-59165.pdf; *Order Granting Temporary Exemptions Under The Securities Exchange Act Of 1934 In Connection With Request On Behalf Of Ice Us Trust LLC Related To Central Clearing Of Credit Default Swaps, And Request For Comments*, Securities and Exchange Commission, Release No. 34-59527 (March 6, 2009) available at http://www.sec.gov/rules/exorders/2009/34-59527.pdf.

I. Exemption from Section 17A

Absent the exemptions granted, a central counterparty would be required to register with the SEC in accordance with Section 17A of the Exchange Act before performing the functions of a clearing agency with respect to any non-excluded CDS securities, specifically the novation of trades and the generation of money and settlement obligations for participants. The Approvals provide that the three central counterparties will be exempt from registration solely with respect to performing the functions of a clearing agency for Cleared CDSs.[4]

According to the SEC, the exemption from Section 17A's registration requirement is partly justified by the fact that each central counterparty meets or will meet the standards set forth in the 2004 report entitled Recommendation for Central Counterparties,[5] which established a framework for central counterparties that are generally consistent with Section 17A. Specifically, an effective central counterparty should have (i) the ability to facilitate prompt and accurate clearance and settlement of transactions and safeguard its users' assets and (ii) sound risk management, including the ability to appropriately determine and collect clearing funds and monitor its users' trading activity.

There are several conditions that each central counterparty must comply with in order for the exemption from Section 17A to be available, most of which are designed to ensure that CDS market participants have adequate information about the market and its processes. Specifically, each central counterparty must (i) provide its annual audited financial statements on its website, (ii) preserve records of all its activities as a clearing agency in the CDS market with respect to Cleared CDSs, (iii) supply relevant information to the SEC and allow access and inspection by the SEC of its relevant facilities and records, (iv) notify the SEC about material disciplinary actions or terminations relating to market participants, (v) notify the SEC about changes to rules affecting its Cleared CDS clearance and settlement services, (vi) provide the SEC with reports prepared by independent audit personnel, (vii) report significant service outages, and (viii) not materially change its methodology for determining margin levels with respect to Cleared CDS transactions, without prior consent from the SEC and from FINRA with respect to customer margin requirements that would apply to broker-dealers (see discussion below). In addition, each central counterparty must make available to the public all end-of-day settlement prices and any other pricing or valuation information with respect to Cleared CDSs as is published or disseminated by such central counterparty.

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4 For purposes of the exemptions provided by the Approvals, "Cleared CDS" means a CDS that is submitted (or offered, purchased, or sold on terms providing for submission) to a central counterparty, that is offered only to, purchased only by, and sold only to eligible contract participants (as defined in Section 1a(12) of the Commodity Exchange Act as in effect on the date of the applicable Approval (other than a person that is an eligible contract participant under paragraph (C) of that section)), and in which: (1) the reference entity, the issuer of the reference security, or the reference security is one of the following: (i) an entity reporting under the Exchange Act, providing information required by Rule 144A(d)(4) of the Securities Act of 1933, as amended, or about which financial information is otherwise publicly available; (ii) a foreign private issuer whose securities are listed outside the United States and that has its principal trading market outside the United States; (iii) a foreign sovereign debt security; (iv) an asset-backed security, as defined in Regulation AB, issued in a registered transaction with publicly available distribution reports; or (v) an asset-backed security issued or guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae; or (2) 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 (1) above.

5 This report was drafted in 2004 by a joint task force of the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions, which consisted of securities regulators and central bankers from 19 countries and the European Union.

II. Expansion of Safe Harbors Applicable to Security-Based Swap Agreements

Under Section 3A of the Exchange Act, "swap agreements" are specifically excluded from the definition of "security" and, as a result, the Exchange Act is generally inapplicable to swap agreements. However, the Exchange Act does apply to "security-based swap agreements," defined to include any swap agreement in which a material term is based on the price, yield, value or volatility of any security.[6] Specifically, security-based swap agreements, or non-excluded agreements, are subject to certain provisions under the Exchange Act prohibiting fraud, manipulation of prices and insider trading.[7]

Pursuant to each of the Approvals, the SEC has adopted a similar framework that will apply to the approved central counterparties and their Cleared CDS transactions. Similar to the treatment of security-based swap agreements under the Exchange Act, the approved central counterparties' Cleared CDS transactions will be exempt from the Exchange Act, except for those provisions that relate to fraud, manipulation of prices and insider trading.

Moreover, this exemption for Cleared CDS under the Exchange Act will extend not only to central counterparties, but also to certain "eligible contract participants", except for those (i) that are self-regulatory organizations, (ii) that are registered broker or dealers or (iii) that receive or hold funds or securities for other persons.[8] In short, for these purposes, the definition of "eligible contract participant" mirrors the definition of the same term under the Commodity Exchange Act, which includes. among others, any financial institution, regulated insurance company, investment company, commodity pool with assets exceeding $5 million, corporation or partnership with assets exceeding $10 million, employee benefit plan, governmental entity or a broker dealer acting on behalf of such an eligible contract participant.[9]

III. Exemptions for Members of Each Approved Central Counterparty

As with certain eligible contract participants described above, the SEC has provided a similar exemption to participating members of each central counterparty. Pursuant to each Approval, such members are exempt from the Exchange Act, except from those provisions relating to fraud, manipulation of prices and insider trading. This exemption is subject to the member being registered with the Commodity Futures Trading Commission as a futures commission merchant[10] and otherwise in material compliance with all rules and regulations of the

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6 *See* Section 206B of the Gramm-Leach Bliley Act.

7 *See* (a) paragraphs (2) through (5) of Section 9(a) of the Exchange Act prohibiting the manipulation of security prices; (b) Section 10(b) of the Exchange Act and underlying rules prohibiting fraud, manipulation or insider trading (but not prophylactic reporting or recordkeeping requirements); (c) Section 20(d) of the Exchange Act providing for antifraud liability in connection with certain derivative transactions; and (d) Section 21A(a)(1) of the Exchange Act relating to the SEC's authority to impose civil penalties for insider trading violations.

8 The exemption does not extend to Sections 5 and 6 of the Exchange Act and, therefore, a national securities exchange that effects transactions of Cleared CDSs would still be required to comply with all requirements under the Exchange Act. However, only with respect to ICE and its participating members, Sections 5 and 6 will not apply to transactions in Cleared CDSs if ICE and such members (i) comply with certain volume reporting requirements within 30 days of the end of each quarter, (ii) establish adequate safeguards and procedures to protect participating members' confidential trading information and (iii) comply with all conditions to the exemption from Section 17A of the Exchange Act, discussed above.

9 For specifics on the definition of "eligible contact participant" see Commodity Exchange Act at Section 1a.

10 Specifically, the exemption requires that the member be registered as a futures commission merchant pursuant to Section 4f(a)(1) of the Commodity Exchange Act, but *not* registered as a broker-dealer pursuant to Section 15(b) of the

applicable central counterparty, specifically those rules and regulations relating to books and records, capital, liquidity and segregation of customers' funds and securities. Also, to the extent that any member receives or holds funds or securities of U.S. eligible contract participant customers, the member must segregate such funds and securities from the member's own assets, regardless of the customers' willingness to "opt out" of such a requirement.

IV. Exemptions for Certain Broker-Dealers

The two exemptions described above are not available to registered broker-dealers. In an effort to avoid creating disincentives for registered broker-dealers to use the approved central counterparties for transactions in Cleared CDSs, the SEC is providing a similar exemption for broker-dealers. Specifically, a registered broker-dealer's Cleared CDS transactions will be generally exempt from the provisions of the Exchange Act in a similar fashion as the exemptions described above, namely excepting those provisions that relate to fraud, manipulation of prices and insider trading.

However, for registered broker-dealers, the SEC has also found it appropriate to make several other provisions of the Exchange Act explicitly applicable to Cleared CDS transactions. With respect to these transactions, a registered broker-dealer will still be subject to provisions that (i) address the unlawful extension of credit, (ii) address the use of unlawful or manipulative devices, (iii) require the making, keeping and furnishing of information, (iv) subject broker-dealers to examination, (v) address net capital, reserves and custody of securities,[11] (vi) require preservation of records and reports to be made, and (vii) require quarterly security counts to be made.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Charles Gilman at 212.701.3403 or cgilman@cahill.com; or Banks Bruce at 212.701.3052 or bbruce@cahill.com.

Exchange Act (other than pursuant to paragraph 11 thereof, which provides for limited registration requirements for broker-dealers effecting transactions solely in security futures products).

[11] For registered-broker dealers holding customer funds and securities relating to Cleared CDS, Exchange Act rules, specifically Rule 15c3-3, that require reserves and custody of securities will not apply if (i) such broker-dealer, as a member of an approved central counterparty, is in material compliance with the applicable rules and regulations of such central counterparty, (ii) the broker-dealer has segregated any U.S. customers' funds and securities of its own assets, regardless of such customer's willingness to "opt out" of such requirement and (iii) the broker-dealer has complied with margin rules for Cleared CDS of the self-regulatory organization that is its designated examining authority.