
SEC Approves Joint Venture of CME and Citadel to Act as a Central Counterparty for Credit Default Swaps

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On March 13, 2009, the Securities and Exchange Commission ("SEC" or "Commission") approved temporary exemptions¹ for the Chicago Mercantile Exchange, Inc. ("CME") to operate as a central counterparty ("CCP") for certain non-excluded credit default swap ("CDS") contracts submitted to or traded through CMDX, a trading and clearing platform for CDS created through a joint venture between CME and Citadel Investment Group ("Citadel").² A CDS is a bilateral contract between two counterparties, the value of which can be based on the underlying obligations of a single entity or group or index of entities, or on a particular security or other debt obligation or an index of securities or other obligations. CDS can be used for a number of different purposes, including hedging risk, taking positions in a certain segment of the market, or capitalizing on credit spreads. Non-excluded CDS are CDS that are not swap agreements, and that therefore (unlike swap agreements) are not expressly excluded from the definition of security in Section 3A of the Exchange Act of 1934 ("Exchange Act").

In November 2008, the President's Working Group on Financial Markets stated that the implementation of a CCP for CDS was a top priority.³ The Commission, the Board of Governors of the Federal Reserve System (FRB) and the Commodity Futures Trading Commission ("CFTC") thereafter signed a Memorandum of Understanding, establishing the framework for consultation and information sharing for issues related to CCPs for CDS.⁴ The Commission has expressed the belief that well-regulated CCPs, through a process of "novation," whereby the CCP becomes the counterparty to each side of an originally bilateral contract, would help promote efficiency and reduce risk in the CDS market and among its participants. In addition, CCPs would be required to maintain records that would assist the Commission to prevent and detect fraud and abusive market practices.

To facilitate the operation of one or more CCPs for the CDS market, the Commission previously issued two orders providing exemptions under the Securities Act of 1933 and the Exchange Act for non-excluded CDS.⁵ Under these orders, and providing certain conditions are met, non-excluded CDS are temporarily exempt from all provisions of the Securities Act, except the antifraud provisions. Non-excluded CDS also are exempt from the Trust Indenture Act of 1939 and from Sections 12(a) and 12(g) of the Exchange Act (the exemptions from Sections 12(a) and 12(g) effectively make

Sections 12, 13, 14, 15(d) and 16 of the Exchange Act inapplicable to non-excluded CDS as well). These orders also exempt any exchange effecting transactions in non-excluded CDS from Sections 5 and 6 of the Exchange Act and any broker-dealer effecting such transactions on an exchange from Section 5 of the Exchange Act.

The CME/Citadel Order grants a temporary exemption, subject to certain conditions, from the requirement that CME register as a clearing agency under Section 17A of the Exchange Act solely to perform functions of a clearing agency for non-excluded CDS. It also temporarily exempts certain eligible contract participants from all Exchange Act requirements with respect to non-excluded CDS cleared by CME other than the antifraud and insider trading provisions. Participants that receive or hold funds or securities on behalf of others will not be required to register as broker-dealers solely in connection with their non-excluded CDS activities, but must meet certain conditions, including registration with the CFTC. Finally, registered broker-dealers, including dually-registered broker-dealer-FCMs (futures commission merchants) will be temporarily exempted from all Exchange Act provisions and rules that do not apply to security-based swaps other than Sections 7(c), 15(c)(3), 17(a), 17(b), Regulation T and Rules 15c3-1, 15c3-3,⁶ 17a-3 through 17a-5 and 17a-13. The temporary exemptions will expire on December 14, 2009.

The SEC has granted similar exemptions to allow two other parties to act as CCPs.⁷ The CME platform differs from the platforms of these other approved CCPs in a number of ways.⁸ Specifically, participants of the CME platform would not be subject to the margin requirements for CDS set forth in recently proposed FINRA Rule 4240.⁹ Instead, the proposed rule requires that for CDS cleared by CME, the applicable margin should be calculated pursuant to CME rules. It also requires a broker-dealer to assess whether the CME requirements are adequate with respect to their customers, and to increase the margin in excess of the minimum where appropriate.

Believing that centralized clearing of CDS should reduce risks to the wider financial system, regulators in the U.S. and Europe have made it a high priority. While it is expected that the movement to centralized clearing will be an adjustment and may take some time,¹⁰ market participants are optimistic. ICE Trust centrally cleared the first CDS in the U.S. on March 13.¹¹

The CME Exemptive Order and Request for Exemptive Relief can be viewed at www.sec.gov/news/press/2009/2009-58.htm.

¹ Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With the 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, Exchange Act Release No. 34, 59578 (March 13, 2009) (the CME/Citadel Order).

² WilmerHale has acted as counsel for Citadel in connection with the request for exemption.

³ See Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With the 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, Exchange

Act Release No. 34, 59578 (March 13, 2009).

⁴See Memorandum of Understanding Between the Board of Governors of the Federal Reserve System, the U.S. Commodity Futures Trading Commission and the U.S. Securities and Exchange Commission Regarding Central Counterparties for Credit Default Swaps (November 14, 2008), available at www.treas.gov/press/releases/reports/finalmou.pdf.

⁵ Temporary Exemptions for Eligible Credit Default Swaps to Facilitate Operation of Central Counterparties to Clear and Settle Credit Default Swaps, Securities Act Release No. 33,8999, Exchange Act Release No. 34,59246, Trust Indenture Act Release No. 33, 2549 (January 14, 2009), available at www.sec.gov/rules/final/2009/33-8999.pdf; 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 Act Release No. 34,59165 (December 24, 2008), available at www.sec.gov/rules/exorders/2008/34-59165.pdf.

⁶ While registered broker-dealers will not be exempt from Exchange Act Rule 15c3-3, dual-registered broker-dealer/FCMs that hold customer funds and securities for the purpose of purchasing, selling, clearing, settling or holding CDS positions cleared by CME in a "futures account" will be exempt from Rule 15c3-3.

⁷See 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, Exchange Act Release No. 34-59614 (December 24, 2008), available at www.sec.gov/rules/exorders/2008/34-59164.pdf; and 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, Exchange Act No. 34-59527 (March 6, 2009), available at www.sec.gov/rules/exorders/2009/34-59527.pdf.

⁸ "In a recent release, CME Chief Executive Officer Craig Donohue stated that 'CME's clearinghouse will offer distinct 'key benefits' including 'a time-tested legal and regulatory framework that protects both customer positions and margin.' If a CME clearing member defaults on proprietary positions, all customer positions and collateral will be fully protected. Moreover, CME Clearing will offer 'a state of the art clearing, settlement and risk management solution that provides significant improvements over the existing' over-the-counter CDS infrastructure." SEC Approves Second Clearinghouse to Reduce Systemic Risk of CDS Market, Daily Rep. Exec. (BNA) No. 48, at EE-13 (March 16, 2009).

⁹See Proposed Rule Change Relating to Margin Requirements for Certain Transactions in Credit Default Swaps, SR FINRA 2009-012.

¹⁰See A New Breed of Securities: Credit Default Options Proposed by CBOE, available at www.wilmerhale.com/publications/whPubsDetail.aspx?publication=3592.

¹¹See ICE Clears First U.S. Credit Default Swaps; Other Firms Push to Set Up Clearinghouses, Daily Rep. Exec. (BNA) No. 50, at EE-10 (March 18, 2009).

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