

requirements of Section I(c) of the Plan. Specifically, an SRO may become a party to the Symbology Plan if: (i) It maintains a market for the listing or trading of Plan Securities,<sup>5</sup> in accordance with rules approved by the Commission, which securities are identified by one, two, or three character symbols, on the one hand, or four or five character symbols, on the other hand, in each case prior to any suffix or special conditional identifier; (ii) it signs a current copy of the Plan; and (iii) it pays to the other parties a proportionate share of the aggregate development costs, based upon the number of symbols reserved by the new party during the first twelve (12) months of such party's membership.<sup>6</sup>

The NYSE Group Exchanges and CBOE have submitted a signed copy of the Symbology Plan to the Commission in accordance with the requirement set forth in the Symbology Plan regarding new parties to the plan.

## II. Effectiveness of the Proposed Symbology Plan Amendment

The foregoing proposed Symbology Plan amendments have become effective pursuant to Rule 608(b)(3)(iii)<sup>7</sup> because it involves solely technical or ministerial matters. At any time within sixty days of the filing of these amendments, the Commission may summarily abrogate the amendment and require that it be refiled pursuant to paragraph (b)(1) of Rule 608,<sup>8</sup> if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors or the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanisms of, a national market system or otherwise in furtherance of the purposes of the Act.

## III. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether these amendments are consistent with the Act. Comments may be submitted by any of the following methods:

### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or

<sup>5</sup> "Plan Securities" are defined in the Symbology Plan as securities that: (i) Are NMS securities as currently defined in Rule 600(a)(46) under the Act; and (ii) any other equity securities quoted, traded and/or trade reported through an SRO facility.

<sup>6</sup> Sections I(c) and IV(a) of the Plan.

<sup>7</sup> 17 CFR 242.608(b)(3)(iii).

<sup>8</sup> 17 CFR 242.608(b)(1).

- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number 4-533 on the subject line.

### Paper Comments

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number 4-533. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, on official business days between the hours of 10 a.m. and 3 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number 4-533 and should be submitted on or before January 23, 2009.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>9</sup>

**Florence E. Harmon,**

*Acting Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-59165; File No. S7-35-08]

### 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

December 24, 2008.

#### I. Background

In response to the recent turmoil in the financial markets, the Securities and Exchange Commission ("Commission") has taken multiple actions to protect investors and ensure the integrity of the nation's securities markets.<sup>1</sup> Today, we are taking further action designed to address concerns related to the market in credit default swaps ("CDS"). The over-the-counter ("OTC") market for CDS has been a source of concerns to us and other financial regulators. These concerns include the systemic risk posed by CDS, highlighted by the possible inability of parties to meet their obligations as counterparties and the potential resulting adverse effects on

<sup>1</sup> A nonexclusive list of the Commission's actions to stabilize financial markets during this credit crisis includes: Adopting a package of measures to strengthen investor protections against naked short selling, including rules requiring a hard T+3 close-out, eliminating the options market maker exception of Regulation SHO, and expressly targeting fraud in short selling transactions (*See Securities Exchange Act Release No. 58572* (September 17, 2008), 73 FR 54875 (September 23, 2008)); issuing an emergency order to enhance protections against naked short selling in the securities of primary dealers, Fannie Mae, and Freddie Mac (*See Securities Exchange Act Release No. 58166* (July 15, 2008), 73 FR 42379 (July 21, 2008)); taking temporary emergency action to ban short selling in financial securities (*See Securities Exchange Act Release No. 58592* (September 18, 2008), 73 FR 55169 (September 24, 2008)); approving emergency rulemaking to ensure disclosure of short positions by hedge funds and other institutional money managers (*See Securities Exchange Act Release No. 58591A* (September 21, 2008), 73 FR 55557 (September 25, 2008)); proposing rules to strengthen the regulation of credit rating agencies and making the limits and purposes of credit ratings clearer to investors (*See Securities Exchange Act Release No. 57967* (June 16, 2008), 73 FR 36212 (June 25, 2008)); entering into a Memorandum of Understanding with the Board of Governors of the Federal Reserve System ("FRB") to make sure key federal financial regulators share information and coordinate regulatory activities in important areas of common interest (*See Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest* (July 7, 2008), [http://www.sec.gov/news/press/2008/2008-134\\_mou.pdf](http://www.sec.gov/news/press/2008/2008-134_mou.pdf)).

<sup>9</sup> 17 CFR 200.30-3(a)(12).

other markets and the financial system.<sup>2</sup> Recent credit market events have demonstrated the seriousness of these risks in a CDS market operating without meaningful regulation, transparency,<sup>3</sup> or central counterparties (“CCPs”).<sup>4</sup> These events have emphasized the need for CCPs as mechanisms to help control such risks.<sup>5</sup> A CCP for CDS could be an important step in reducing the counterparty risks inherent in the CDS market, and thereby help mitigate potential systemic impacts. In November 2008, the President’s Working Group on Financial Markets stated that the implementation of a CCP for CDS was a top priority<sup>6</sup> and, in furtherance of this recommendation, the Commission, the FRB and the Commodity Futures Trading Commission (“CFTC”) signed a Memorandum of Understanding<sup>7</sup> that establishes a framework for consultation and information sharing on issues related to CCPs for CDS. Given the continued uncertainty in this market, taking action to help foster the prompt development of CCPs, including granting conditional exemptions from certain provisions of the federal securities laws, is in the public interest.

A CDS is a bilateral contract between two parties, known as counterparties. The value of this financial contract is based on underlying obligations (“reference obligations”) of a single

entity (a “reference entity”) or on a particular security or other debt obligation (“reference security”), or an index of several such entities, securities, or obligations. The obligation of a seller under a CDS to make payments under a CDS contract is triggered by a default or other credit event as to such entity or entities or such security or securities. Investors may use CDS for a variety of reasons, including to offset or insure against risk in their fixed-income portfolios, to take positions in bonds or in segments of the debt market as represented by an index, or to capitalize on the volatility in credit spreads during times of economic uncertainty. In recent years, CDS market volumes have rapidly increased.<sup>8</sup> This growth has coincided with a significant rise in the types and number of entities participating in the CDS market.<sup>9</sup>

The Commission’s authority over this OTC market for CDS is limited. Specifically, section 3A of the Securities Exchange Act of 1934 (“Exchange Act”) limits the Commission’s authority over swap agreements, as defined in section 206A of the Gramm-Leach-Bliley Act.<sup>10</sup> For those CDS that are swap agreements, the exclusion from the definition of security in section 3A of the Exchange Act, and related provisions, will continue to apply. The Commission’s action today does not affect these CDS, and this order does not apply to them. For those CDS that are not swap agreements (“non-excluded CDS”), the Commission’s action today provides certain exemptions to exchanges that effect transactions in such non-excluded CDS and to brokers and dealers that effect transactions in non-excluded CDS on exchanges, and is designed to facilitate the development of one or more CDS exchanges.<sup>11</sup>

In companion actions today, the Commission is temporarily exempting, subject to conditions, LCH.Clearnet Ltd. from the requirement to register as a clearing agency under section 17A of the Exchange Act solely to perform the functions of a clearing agency for non-excluded CDS transactions.<sup>12</sup> To facilitate the operation of one or more CCPs for the CDS market, the Commission has also approved interim final temporary rules providing exemptions under the Securities Act of 1933 and Exchange Act for non-excluded CDS.

In conjunction with these exemptions, the Commission in this order is providing a temporary exemption to any exchange that effects or reports transactions in non-excluded CDS and is not otherwise subject to the requirements under Sections 5 and 6 of the Exchange Act<sup>13</sup> from the requirement to register as a national securities exchange, and to any broker or dealer that effects or reports transactions in non-excluded CDS on such an exempt exchange.<sup>14</sup> The

CDS, proposed by the Chicago Board Options Exchange, were securities because they are options based on the value of a security or securities, options on an interest in a security or securities, or options based on the value of an interest in a security or securities. See Securities Exchange Act Release No. 55871 (June 6, 2007), 72 FR 32372, 32375–77 (June 12, 2007) (File No. SR-CBOE-2006-84) (“CBOE CDO Order”); Securities Exchange Act Release No. 56275 (August 17, 2007), 72 FR 47297 (August 22, 2008) (File No. SR-CBOE-2007-26) (together with the CBOE CDO Order, the “CBOE Orders”). The Commission made special note that, “because credit default options will be exchange-traded and not individually negotiated, \* \* \* they are not qualifying swap agreements under Section 206A of the Gramm-Leach-Bliley Act, \* \* \* and, therefore, not excluded from the definition of security by Section 3A of the Exchange Act.” 72 FR at 32376 n. 39. Unlike the options at issue in the CBOE Orders, which had fixed payouts in the event of a default or other credit event, the CDS that are the subject of the Commission’s actions today may provide for the delivery of a debt security or securities against a specified amount, or a cash payment based on the value of a debt security or securities. For those CDS that are not qualifying swap agreements, that have payouts tied to the delivery of debt securities, or that are based on the value of debt securities, there may be arguments in addition to those in the CBOE Orders that such CDS are security options.

<sup>12</sup> See Securities Exchange Act Release No. 59164 (December 24, 2008) (File No. S7-34-08).

<sup>13</sup> 15 U.S.C. 78e and 78f.

<sup>14</sup> A national securities exchange that effects transactions in CDS would continue to be required to comply with all requirements under the Exchange Act applicable to such transactions. A national securities exchange could form subsidiaries or affiliates that operate exchanges exempt under this order. Any subsidiary or affiliate of a registered exchange could not integrate, or otherwise link, the exempt CDS exchange with the registered exchange, including the premises or property of such exchange for effecting or reporting a transaction, without being considered a “facility of the exchange.” See Section 3(a)(2) of the Exchange Act, 15 U.S.C. 78c(a)(2).

<sup>2</sup> In addition to the potential systemic risks that CDS pose to financial stability, we are concerned about other potential risks in this market, including operational risks, risks relating to manipulation and fraud, and regulatory arbitrage risks.

<sup>3</sup> See Policy Objectives for the OTC Derivatives Market, The President’s Working Group on Financial Markets (November 14, 2008), <http://www.ustreas.gov/press/releases/reports/policyobjectives.pdf> (“Public reporting of prices, trading volumes and aggregate open interest should be required to increase market transparency for participants and the public.”).

<sup>4</sup> See The Role of Credit Derivatives in the U.S. Economy Before the H. Agric. Comm., 110th Cong. (2008) (Statement of Erik Sirri, Director of the Division of Trading and Markets, Commission).

<sup>5</sup> See *id.*

<sup>6</sup> See Policy Objectives for the OTC Derivatives Market, The President’s Working Group on Financial Markets (November 14, 2008), <http://www.ustreas.gov/press/releases/reports/policyobjectives.pdf>. See also Policy Statement on Financial Market Developments, The President’s Working Group on Financial Markets (March 13, 2008), [http://www.treas.gov/press/releases/reports/pwgpolicystatementkturmoil\\_03122008.pdf](http://www.treas.gov/press/releases/reports/pwgpolicystatementkturmoil_03122008.pdf); Progress Update on March Policy Statement on Financial Market Developments, The President’s Working Group on Financial Markets (October 2008), <http://www.treas.gov/press/releases/reports/q4progress%20update.pdf>.

<sup>7</sup> See 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), <http://www.treas.gov/press/releases/reports/finalmou.pdf>.

<sup>8</sup> See Semiannual OTC derivatives statistics at end-December 2007, Bank for International Settlements (“BIS”), <http://www.bis.org/statistics/otcder/dt1920a.pdf>.

<sup>9</sup> CDS were initially created to meet the demand of banking institutions looking to hedge and diversify the credit risk attendant with their lending activities. However, financial institutions such as insurance companies, pension funds, securities firms, and hedge funds have entered the CDS market.

<sup>10</sup> 15 U.S.C. 78c-1. Section 3A excludes both a non-security-based and a security-based swap agreement from the definition of “security” under Section 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10). Section 206A of the Gramm-Leach-Bliley Act defines a “swap agreement” as “any agreement, contract, or transaction between eligible contract participants (as defined in section 1a(12) of the Commodity Exchange Act\* \* \* \* \* the material terms of which (other than price and quantity) are subject to individual negotiation.” 15 U.S.C. 78c note.

<sup>11</sup> The Commission found that credit default options and credit default basket options, which are essentially exchange-traded equivalents of OTC

exemptions in this order are subject to the conditions discussed below.

The Commission believes that the CDS market would benefit from the development of exchanges for non-excluded CDS. As the Commission has previously noted when approving a proposed rule change by the Chicago Board Options Exchange to list and trade certain CDS contracts, there are several benefits to trading such products on exchanges rather than over-the-counter.<sup>15</sup> These benefits include a centralized market, standardized contract specifications, transparent quotations, and transaction reporting.<sup>16</sup> Exchange trading would permit real-time matching of orders, and enhance transparency of the CDS market by promoting dissemination of pre-trade quotations as well as post-trade transaction information. Additional pre-trade and post-trade transparency would enable exchange subscribers to better assess market depth and liquidity and allow regulators to better surveil for violations of the securities laws.

Accordingly, the Commission is using its authority under section 36 of the Exchange Act<sup>17</sup> to exempt temporarily any exchange that effects transactions in non-excluded CDS and is not otherwise subject to the requirements under Sections 5 and 6 of the Exchange Act,<sup>18</sup> and the rules and regulations thereunder, from the requirement to register as a national securities exchange under section 6 of the Exchange Act,<sup>19</sup> and from the prohibition in section 5 of the Exchange Act<sup>20</sup> against effecting transactions as an exchange unless it is registered as a national securities exchange or exempt from registration due to the limited volume of its transactions. The Commission finds that such action is necessary and appropriate in the public interest and consistent with the protection of investors to facilitate the operation of one or more CDS exchanges in connection with the establishment of one or more CCP that clear and settle non-excluded CDS.<sup>21</sup> The Commission is also temporarily exempting brokers and dealers from the section 5 prohibition against effecting or reporting transactions in securities otherwise than on a national securities exchange or an exchange that is exempt from registration due to its limited volume.

The conditions to these exemptions will enable to the Commission to oversee the development of CDS exchanges, and to take such additional action as we may deem necessary to promote the public interest and the protection of investors. Moreover, the limited duration of the exemptions provided today will enable one or more CDS exchanges to become operational while we gain experience with the CDS market and evaluate public input, including comments we receive on the temporary exemptions granted in today's order.

## II. Discussion

Section 5 of the Exchange Act states that "[i]t shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange \* \* \* to effect any transaction in a security, or to report any such transactions, unless such exchange (1) is registered as a national securities exchange under section 6 of [the Exchange Act], or (2) is exempted from such registration \* \* \* by reason of the limited volume of transactions effected on such exchange\* \* \*." <sup>22</sup> Section 6 of the Exchange Act sets forth a procedure whereby an exchange<sup>23</sup> may register as a national securities exchange.<sup>24</sup>

Section 36 of the Exchange Act provides that the Commission, "by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of [the Exchange Act] or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." To facilitate the establishment of one or more exchanges for non-excluded CDS, the Commission is exercising its authority under section 36 of the Exchange Act to temporarily exempt any exchange, broker or dealer that effects transactions in non-excluded CDS from the prohibition in Section 5 of the Exchange Act and (in the case of

exchanges) the requirements in Section 6 of the Exchange Act and the rules and regulations thereunder. These temporary exemptions are subject to certain conditions, discussed further below. These conditions on exchanges generally mirror those applicable to alternative trading systems, which are securities trading systems that the Commission previously exempted from exchange registration.<sup>25</sup>

This temporary exemption is designed to allow brokers, dealers, and exchanges to effect transactions in non-excluded CDS on exchanges, subject to certain conditions. The Commission believes the exemption, together with the conditions, is necessary in the public interest and consistent with the protection of investors. In addition, the Commission believes that these conditions will not impede the ability of brokers, dealers, and exchanges to compete in the market for CDS. The limited term of this exemption will provide the Commission with adequate time to evaluate the application of this exemption to non-excluded CDS exchanges, and whether such conditions should be modified. In particular, the Commission will be considering whether Regulation ATS, with or without modifications, could apply to systems that match orders in non-excluded CDS of multiple buyers and sellers.

This temporary exemption is available only to exchanges that effect transactions in non-excluded CDS. To the extent that an exchange is otherwise subject to the requirements of section 5 of the Exchange Act, it must register with the Commission as a national securities exchange under Section 6 of the Exchange Act and the rules and regulations thereunder or comply with the terms of another exemption. Similarly, a broker or dealer is temporarily exempt from the prohibition in Section 5 only to the extent that it effects transactions in non-

<sup>25</sup> See Regulation ATS, 17 CFR 242.300 *et seq.* In 1998, the Commission exercised its exemptive authority under Section 36 of the Exchange Act and its general authority under Section 11A of the Exchange Act, 15 U.S.C. 78k-1, to establish a regulatory framework for "alternative trading systems," which perform many of the same functions as exchanges. Under this framework, an entity that, like an exchange, matches the orders in securities of multiple buyers and sellers according to established, non-discretionary methods is exempt from the definition of "exchange" if it instead registers as a broker-dealer and complies with Regulation ATS. Regulation ATS is designed, among other things, "to adopt a regulatory framework that addresses [the Commission's] concerns without jeopardizing the commercial viability of these markets." Regulation ATS Adopting Release, *supra* note 23, 63 FR at 70846.

<sup>22</sup> 15 U.S.C. 78e.

<sup>23</sup> Section 3(a)(1) of the Exchange Act, 15 U.S.C. 78c(a)(1), defines "exchange." Rule 3b-16 under the Exchange Act, 17 CFR 240.3b-16, defines certain terms used in the statutory definition of exchange. See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Adopting Release") (adopting Rule 3b-16 in addition to Regulation ATS).

<sup>24</sup> 15 U.S.C. 78f. Section 6 of the Exchange Act also sets forth various requirements to which a national securities exchange is subject.

<sup>15</sup> See CBOE Orders, *supra* note 11.

<sup>16</sup> *Id.*

<sup>17</sup> 15 U.S.C. 78mm.

<sup>18</sup> 15 U.S.C. 78e and 78f.

<sup>19</sup> 15 U.S.C. 78f.

<sup>20</sup> 15 U.S.C. 78e.

<sup>21</sup> See *supra* note 12.

excluded CDS on an exchange or reports such transactions on an exchange.

The Commission believes that this order will facilitate the establishment of one or more exchanges that effect transactions in non-excluded CDS. For this reason and the reasons discussed above,<sup>26</sup> the Commission believes that these exemptions are necessary or appropriate in the public interest and consistent with the protection of investors.

As noted, the conditions under which CDS exchanges must operate to qualify for the exemption from exchange registration being granted today are modeled on requirements applicable to alternative trading systems. Like an alternative trading system, a CDS exchange must keep records about its operations, its subscribers, and their orders.<sup>27</sup> A CDS exchange also must provide the Commission with trading information on a quarterly basis<sup>28</sup> and establish procedures to ensure the confidential treatment of trading information.<sup>29</sup> Likewise, a CDS exchange must permit the Commission to examine its premises, systems, and records and must cooperate with the examination of its subscribers.<sup>30</sup> These requirements are designed to allow the Commission to monitor market developments, to ascertain how new entrants are affecting the national market system, and to promote compliance with the federal securities laws generally. The Commission believes that temporarily exempting exchanges that effect transactions in non-excluded CDS from exchange registration, subject to these conditions, is necessary or appropriate in the public interest and is consistent with the protection of investors.

#### A. Exemption From Sections 5 and 6 of the Exchange Act for Exchanges

##### 1. No Self-Regulatory Authority

To be exempt under this order, the exchange must not: (a) Set rules governing the conduct of subscribers other than the conduct of such subscribers trading on such exchange; or (b) discipline subscribers under the Exchange Act other than by exclusion from trading. That is, an exempted exchange may not exercise self-regulatory authority over its subscribers. The Commission intends this condition to be the same requirement as applies to alternative trading systems under

Regulation ATS. As described in the Regulation ATS Adopting Release, self-regulatory authority would include, for example, any restrictions on subscribers' activities outside of the exchange or imposing as a condition of participation any requirement for which the exchange would examine subscribers for compliance. The requirement in Regulation ATS and this condition are based on the Commission's belief that a organization, association, or group of persons that could exercise self-regulatory authority over its subscribers should be registered as a self-regulatory organization ("SRO") and subject to the full responsibilities and supervision that registration entails. The Commission continues to believe that rules governing exchange subscriber conduct may be imposed and enforced only by SROs because of the potential that they may be applied for anti-competitive purposes. However, as we noted in connection with adopting Regulation ATS, the Commission does not intend this condition to preclude a trading system from applying credit standards to its subscribers or requiring subscribers to provide financial information relevant to their activity on the system.<sup>31</sup>

##### 2. Recordkeeping

In addition, to be exempt under this order, an exchange must maintain an audit trail of orders that it receives and transactions that it effects. These records are critical to the Commission's ability to oversee the CDS market, detect and deter illicit market activity, and take action as necessary to address manipulation and fraud, including insider trading. These recordkeeping and record preservation requirements are comparable to those required under Regulation ATS and tailored to apply to non-excluded CDS.<sup>32</sup> Specifically, an exchange must make and keep the following records for a period of not less than three years, the first two years in an easily accessible place:

- A record of subscribers in the exchange (identifying any affiliations between the exchange and subscribers in the exchange, including common directors, officers, or owners);
- Daily summaries of trading, including: (a) Information identifying CDS in which transactions are effected; and (b) transaction volume, expressed in terms of number of trades and total U.S. dollar notional value;

- Time-sequenced records of order information, including: (a) Identity of the party entering an order; (b) identification of non-excluded CDS contract (including the reference entity, security, or index, and notional value); (c) date and time that order was received; (d) price (whether expressed as credit spread, rate, strike, or coupon); (e) whether the order is to buy or sell and any order conditions; (f) any subsequent modification or cancellation of the order; (g) date and time the order was executed, the size (e.g., notional value amount) executed, and the price; and (h) identity of the parties to the transaction.<sup>33</sup>

In addition, as a condition of this exemption, an exchange must preserve the following records:

- For a period of not less than three years, the first two years in an easily accessible place, all notices provided by such exchange to subscribers generally, whether written or communicated through automated means, including, but not limited to, notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, instructions pertaining to access to the market and denials of, or limitations on, access to the exchange; and
- During the life of the enterprise and of any successor enterprise, the exchange's organizational documents and copies of reports filed with the Commission pursuant to this exemption.

An exchange exempt pursuant to this order may comply with these recordkeeping and record preservation requirements through use of a service bureau, depository, or other recordkeeping service that maintains and preserves these records on behalf of the exchange. An agreement with a service bureau, depository, or other recordkeeping service will not relieve the exchange from the responsibility to prepare and maintain the specified records.

<sup>33</sup> These information items, with one exception, must be recorded and kept current by alternative trading systems pursuant to Regulation ATS. See 17 CFR 242.301(b)(8) and 242.302(c). Alternative trading systems are not required by Regulation ATS to keep records of the identity of the party entering an order. The Commission believes, however, that such information could be important to its ability to enforce the securities laws and is, therefore, to be kept as a condition to this exemption. Alternative trading systems must be registered with the Commission as a broker-dealer, and are therefore subject to additional Commission recordkeeping rules. See 17 CFR 242.301(b)(1). An exchange that avails itself of this exemption, however, may not otherwise be subject to requirements under the Exchange Act.

<sup>26</sup> See *supra* notes 15–16 and accompanying text.

<sup>27</sup> Compare 17 CFR 242.301(b)(8), 242.302, and 242.303.

<sup>28</sup> Compare 17 CFR 242.301(b)(9).

<sup>29</sup> Compare 17 CFR 242.301(b)(10).

<sup>30</sup> Compare 17 CFR 242.301(b)(7).

<sup>31</sup> See Regulation ATS Adopting Release, *supra* note 23, 63 FR at 70859.

<sup>32</sup> See 17 CFR 242.301(b)(8), 242.302, and 242.303.

The Commission believes that the types of records an exchange would be required to make and keep pursuant to this condition are records an exchange would keep in the normal course of its business and, therefore, that this condition is not unduly burdensome.

### 3. Regulatory Reporting

An exchange that relies on this order must, within five days of commencing operation, submit a notice to the Commission<sup>34</sup> that includes the following information:

1. Full legal name of the exchange;
2. A description of the exchange's ownership structure;
3. Contact person and contact information;
4. A general description of the CDS contracts that trade on the exchange; and
5. A description of how the exchange operates.

This information is essential for the Commission to understand developments in the CDS market. Any subsequent action regarding this exemption—for example, whether it should be modified, extended, or allowed to expire—is predicated on understanding which market participants are relying on it. In the future, different regulatory frameworks may be appropriate for different market participants. These notices will enable the Commission to commence a dialog with the relevant market participants.

In addition, an exchange that relies on this exemption must report the following information to the Commission within 30 days of the end of each quarter:

1. The total dollar volume of transactions executed during the quarter, broken down by reference entity, security, or index;
2. The total unit volume and/or notional amount executed during the quarter, broken down by reference entity, security, or index; and
3. A list of all subscribers that effected transactions on the exchange during the quarter.

Reporting of this information will assist the Commission in carrying out its responsibility to supervise and regulate the securities markets. This information is similar to that which an alternative trading system must provide quarterly.<sup>35</sup>

<sup>34</sup> Any such notice should be sent to: Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549, and be noted as regarding "CDS Exchange Exemption from Registration."

<sup>35</sup> See 17 CFR 242.301(b)(9)(i); Form ATS-R, 17 CFR 249.638. The Commission notes that an

### 4. Confidentiality of Trading Information

An exchange relying on this order also must establish adequate safeguards and procedures to protect subscribers' confidential trading information. Such safeguards and procedures shall include: (a) Limiting access to the confidential trading information of subscribers to those employees of the exchange who are operating the system or responsible for its compliance with this exemption or any other applicable rules; and (b) implementing standards controlling employees of the exchange trading for their own accounts. The exchange must adopt and implement adequate oversight procedures to ensure that the safeguards and procedures established pursuant to this condition are followed. This condition, which closely tracks a requirement applicable to alternative trading systems,<sup>36</sup> is designed to prevent the misuse of subscriber trading information that is available to the exchange. This should strengthen confidence in the exchange, promoting participation.

### 5. Commission Jurisdiction

Finally, an exchange that relies on this order must provide access to the Commission to conduct on-site inspections of its facilities (including automated systems and systems environment), records, and personnel related to exchange activities. The exchange must cooperate with the Commission in connection with the investigation of any exchange subscribers. This requirement is similar to one in Regulation ATS that applies to alternative trading systems.<sup>37</sup>

Recent market events have clearly demonstrated the importance of the CDS market and its potential to impact other markets, including the equity securities markets. It is therefore imperative that the Commission have examination authority over any exchange that effects transactions in non-excluded CDS, with regard to its compliance with the conditions of the exemption provided

alternative trading system is not required to report to the Commission its transaction volume by security; only aggregate volumes must be reported to the Commission. Reports in most equity securities and many debt securities traded on an ATS are required to be reported to an SRO on a transaction-by-transaction basis. This is not the case for CDS. For this reason, the Commission is conditioning this exemption on an exchange providing quarterly information to the Commission on trading volume broken down by reference entity, security, or index. The Commission believes it is appropriate to require this more specific information from CDS exchanges to better understand the development of the exchange-traded market in non-excluded CDS.

<sup>36</sup> See 17 CFR 242.301(b)(10).

<sup>37</sup> See 17 CFR 242.301(b)(7).

under this order as well as enforcement of the antifraud provisions of the securities laws, including the prohibitions on insider trading. Particularly because the CDS market is so large and involves many market participants that are not directly subject to the Commission's authority, cooperation by the CDS exchange with the Commission in any investigation or enforcement action is crucial.

### B. Exemption From Section 5 of the Exchange Act for Brokers and Dealers

Absent an exemption, section 5 of the Exchange Act<sup>38</sup> would prohibit brokers and dealers from effecting transactions in non-excluded CDS on an exchange that is not a national securities exchange because of that exchange's reliance on this order. The Commission finds that temporarily exempting brokers and dealers that effect transactions in non-excluded CDS on such an exchange from this restriction in section 5 is necessary and appropriate in the public interest and is consistent with the protection of investors because it will facilitate brokers' and dealers' use of CDS exchanges, which for the reasons noted above the Commission believes would be beneficial. Without also exempting brokers and dealers from this section 5 requirement, the Commission's temporary exemption of CDS exchanges would be ineffective, because brokers and dealers would not be permitted to effect transactions on those exchanges.

Section 5 of the Exchange Act recognizes that there are situations where brokers and dealers should be permitted to trade on an exchange that is not registered as a national securities exchange. Section 5 provides in relevant part that brokers and dealers may effect transactions on an exchange that the Commission, by reason of the limited volume of transactions effected on such exchange, has exempted from registration under Section 6. Brokers and dealers are also permitted to effect transactions on alternative trading systems, which are exempted from the definition of "exchange" and thus do not fall within the restriction of Section 5. For the reasons noted above, the Commission finds that it is consistent with the public interest and the protection of investors to grant a temporary exemption from section 5 of the Exchange Act to any broker or dealer that effects transactions in non-excluded CDS, or reports such transactions, on an exchange that is exempted pursuant to this order.

<sup>38</sup> 15 U.S.C. 78e.

### C. Solicitation of Comments

The Commission intends to monitor closely the development of the CDS market and intends to determine to what extent, if any, additional regulatory action may be necessary. For example, as circumstances warrant, certain conditions could be added, altered, or eliminated. Moreover, because this exemption is temporary, the Commission will in the future consider whether it should be extended or allowed to expire. The Commission believes it would be prudent to solicit public comment on its action today, and what action it should take with respect to the CDS market in the future. The Commission is soliciting public comment on all aspects of this exemption, including:

1. Whether the length of this temporary exemption (until September 25, 2009) is appropriate. If not, what should the appropriate duration be?
2. Whether the conditions to the exemption are appropriate. Why or why not? Should other conditions apply? Are any of the present conditions to the exemption provided in this order unnecessary? If so, please specify and explain why such conditions are not needed.
3. Whether exchanges relying on this exemption should ultimately be required to register under the Exchange Act. Why or why not?
4. Whether exchanges for non-excluded CDS can reasonably comply with Regulation ATS. Why or why not? If not, what aspects or conditions of Regulation ATS are problematic? Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/other.shtml>);
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-35-08 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov/>). Follow the instructions for submitting comments.

#### Paper Comments

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090. All submissions should refer to File Number S7-35-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The

Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/other.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

### III. Conclusion

It is hereby ordered pursuant to section 36 of the Exchange Act that until September 25, 2009, an exchange is exempt from the requirements of sections 5 and 6 of the Exchange Act<sup>39</sup> and the rules and regulations thereunder to the extent that such exchange effects or reports transactions in non-excluded CDS and is not otherwise required to register as a national securities exchange, subject to the following conditions:

- (1) The exchange must not: (a) Set rules governing the conduct of subscribers other than the conduct of such subscribers trading on such exchange; or (b) discipline subscribers other than by exclusion from trading;
- (2) The exchange must make and keep for a period of not less than three years, the first two years in an easily accessible place, the following records:
  - A record of subscribers in the exchange (identifying any affiliations between the exchange and subscribers in the exchange, including common directors, officers, or owners);
  - Daily summaries of trading, including (a) information identifying CDS in which transactions are effected; and (b) transaction volume, expressed in terms of number of trades and total U.S. dollar notional value;
  - Time-sequenced records of order information, including: (a) Identity of the party entering an order; (b) identification of non-excluded CDS contract (including the reference entity, security, or index, and notional value); (c) date and time that order was received; (d) price (whether expressed as credit spread, rate, strike, or coupon); (e) whether the order is to buy or sell and any order conditions; (f) any subsequent modification or cancellation of the order; (g) date and time the order was executed, the size (e.g., notional value amount) executed, and the price; and (h) identity of the parties to the transaction;

(3) The exchange must preserve the following records:

- For a period of not less than three years, the first two years in an easily accessible place, all notices provided by such exchange to subscribers generally, whether written or communicated through automated means, including, but not limited to, notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, instructions pertaining to access to the market and denials of, or limitations on, access to the exchange; and

- During the life of the enterprise and of any successor enterprise, the exchange's organizational documents and copies of reports filed with the Commission pursuant to this exemption;

(4) An exchange must, within five days of commencing operation, submit a notice to the Commission that includes the following information:

- Full legal name of the exchange;
- A description of the exchange's ownership structure;
- Contact person and contact information;
- A general description of what CDS contracts trade on the exchange; and
- A description of how the exchange operates;

(5) An exchange must report the following information to the Commission within 30 days of the end of each quarter:

- The total dollar volume of transactions executed during the quarter, broken down by reference entity, security, or index;
- The total unit volume and/or notional amount executed during the quarter, broken down by reference entity, security, or index; and
- A list of all subscribers that effected transactions on the exchange during the quarter;

(6) The exchange must establish adequate safeguards and procedures to protect subscribers' confidential trading information. Such safeguards and procedures shall include: (a) Limiting access to the confidential trading information of subscribers to those employees of the exchange who are operating the system or responsible for its compliance with this exemption or any other applicable rules; and (b) implementing standards controlling employees of the exchange trading for their own accounts. The exchange must adopt and implement adequate oversight procedures to ensure that the safeguards and procedures established pursuant to this condition are followed; and

<sup>39</sup> 15 U.S.C. 78e and 78f.

(7) The exchange must provide access to the Commission to conduct on-site inspections of its facilities (including automated systems and systems environment), records, and personnel related to exchange activities. The exchange must cooperate with the Commission in connection with the investigation of any exchange subscribers.

It is further ordered pursuant to section 36 of the Exchange Act that until September 25, 2009, a broker or dealer that effects transactions in non-excluded CDS, or reports such transactions, on an exchange that is exempted pursuant to this order is exempt from section 5 of the Exchange Act.

By the Commission.

**Florence E. Harmon,**  
*Acting Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-59164; File No. S7-34-08]

### 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

December 24, 2008.

#### I. Introduction

In response to the recent turmoil in the financial markets, the Securities and Exchange Commission ("Commission") has taken multiple actions to protect investors and ensure the integrity of the nation's securities markets.<sup>1</sup> Today the

<sup>1</sup> A nonexclusive list of the Commission's actions to stabilize financial markets during this credit crisis includes: Adopting a package of measures to strengthen investor protections against naked short selling, including rules requiring a hard T+3 close-out, eliminating the options market maker exception of Regulation SHO, and expressly targeting fraud in short selling transactions (*See* Securities Exchange Act Release No. 58572 (September 17, 2008), 73 FR 54875 (September 23, 2008)); issuing an emergency order to enhance protections against naked short selling in the securities of primary dealers, Federal National Mortgage Association ("Fannie Mae"), and Federal Home Loan Mortgage Corporation ("Freddie Mac") (*See* Securities Exchange Act Release No. 58166 (July 15, 2008), 73 FR 42379 (July 21, 2008)); taking temporary emergency action to ban short selling in financial securities (*See* Securities Exchange Act Release No. 58592 (September 18, 2008), 73 FR 55169 (September 24, 2008)); approving emergency rulemaking to ensure disclosure of short positions by hedge funds and other institutional money managers (*See* Securities Exchange Act Release No. 58591A (September 21, 2008), 73 FR 55557 (September 25, 2008)); proposing rules to

Commission is taking further action designed to address concerns related to the market in credit default swaps ("CDS"). The over-the-counter ("OTC") market for CDS has been a source of concerns to us and other financial regulators. These concerns include the systemic risk posed by CDS, highlighted by the possible inability of parties to meet their obligations as counterparties and the potential resulting adverse effects on other markets and the financial system.<sup>2</sup> Recent credit market events have demonstrated the seriousness of these risks in a CDS market operating without meaningful regulation, transparency,<sup>3</sup> or central counterparties ("CCPs").<sup>4</sup> These events have emphasized the need for CCPs as mechanisms to help control such risks.<sup>5</sup> A CCP for CDS could be an important step in reducing the counterparty risks inherent in the CDS market, and thereby help mitigate potential systemic impacts. In November 2008, the President's Working Group on Financial Markets stated that the implementation of a CCP for CDS was a top priority<sup>6</sup>

strengthen the regulation of credit rating agencies and making the limits and purposes of credit ratings clearer to investors (*See* Securities Exchange Act Release No. 57967 (June 16, 2008), 73 FR 36212 (June 25, 2008)); entering into a Memorandum of Understanding with the Board of Governors of the Federal Reserve System ("FRB") to make sure key federal financial regulators share information and coordinate regulatory activities in important areas of common interest (*See* Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest (July 7, 2008), [http://www.sec.gov/news/press/2008/2008-134\\_mou.pdf](http://www.sec.gov/news/press/2008/2008-134_mou.pdf)).

<sup>2</sup> In addition to the potential systemic risks that CDS pose to financial stability, we are concerned about other potential risks in this market, including operational risks, risks relating to manipulation and fraud, and regulatory arbitrage risks.

<sup>3</sup> *See* Policy Objectives for the OTC Derivatives Market, The President's Working Group on Financial Markets, November 14, 2008, available at <http://www.ustreas.gov/press/releases/reports/policyobjectives.pdf> ("Public reporting of prices, trading volumes and aggregate open interest should be required to increase market transparency for participants and the public.").

<sup>4</sup> *See* The Role of Credit Derivatives in the U.S. Economy Before the H. Agric. Comm., 110th Cong. (2008) (Statement of Erik Sirri, Director of the Division of Trading and Markets, Commission).

<sup>5</sup> *See id.*

<sup>6</sup> *See* Policy Objectives for the OTC Derivatives Market, The President's Working Group on Financial Markets (November 14, 2008), <http://www.ustreas.gov/press/releases/reports/policyobjectives.pdf>. *See also* Policy Statement on Financial Market Developments, The President's Working Group on Financial Markets (March 13, 2008), [http://www.treas.gov/press/releases/reports/pwgpolicystatementkturmoil\\_03122008.pdf](http://www.treas.gov/press/releases/reports/pwgpolicystatementkturmoil_03122008.pdf); Progress Update on March Policy Statement on Financial Market Developments, The President's Working Group on Financial Markets (October 2008), <http://www.treas.gov/press/releases/reports/q4progress%20update.pdf>.

and, in furtherance of this recommendation, the Commission, the FRB and the Commodity Futures Trading Commission ("CFTC") signed a Memorandum of Understanding<sup>7</sup> that establishes a framework for consultation and information sharing on issues related to CCPs for CDS. Given the continued uncertainty in this market, taking action to help foster the prompt development of CCPs, including granting conditional exemptions from certain provisions of the federal securities laws, is in the public interest.

A CDS is a bilateral contract between two parties, known as counterparties. The value of this financial contract is based on underlying obligations of a single entity or on a particular security or other debt obligation, or an index of several such entities, securities, or obligations. The obligation of a seller under a CDS to make payments under a CDS contract is triggered by a default or other credit event as to such entity or entities or such security or securities. Investors may use CDS for a variety of reasons, including to offset or insure against risk in their fixed-income portfolios, to take positions in bonds or in segments of the debt market as represented by an index, or to capitalize on the volatility in credit spreads during times of economic uncertainty. In recent years, CDS market volumes have rapidly increased.<sup>8</sup> This growth has coincided with a significant rise in the types and number of entities participating in the CDS market.<sup>9</sup>

The Commission's authority over this OTC market for CDS is limited. Specifically, section 3A of the Securities Exchange Act of 1934 ("Exchange Act") limits the Commission's authority over swap agreements, as defined in section 206A of the Gramm-Leach-Bliley Act.<sup>10</sup>

<sup>7</sup> *See* 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), <http://www.treas.gov/press/releases/reports/finalmou.pdf>.

<sup>8</sup> *See* Semiannual OTC derivatives statistics at end-December 2007, Bank for International Settlements ("BIS"), available at <http://www.bis.org/statistics/otcder/dt1920a.pdf>.

<sup>9</sup> CDS were initially created to meet the demand of banking institutions looking to hedge and diversify the credit risk attendant with their lending activities. However, financial institutions such as insurance companies, pension funds, securities firms, and hedge funds have entered the CDS market.

<sup>10</sup> 15 U.S.C. 78c-1. Section 3A excludes both a non-security-based and a security-based swap agreement from the definition of "security" under Section 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10). Section 206A of the Gramm-Leach-Bliley Act defines a "swap agreement" as "any agreement, contract, or transaction between eligible contract

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