

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-60718; File No. S7-35-08)

September 25, 2009

Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Extending
Temporary Exemptions from Sections 5 and 6 of the Exchange Act for Broker-Dealers
and Exchanges Effecting Transactions in Credit Default Swaps

On December 24, 2008, in connection with its efforts to facilitate the establishment of one or more central counterparties for clearing credit default swap ("CDS") transactions,¹ the Securities and Exchange Commission ("Commission") granted temporary, conditional exemptions from the registration requirements under Sections 5 and 6 of the Securities Exchange Act of 1934 ("Exchange Act") to certain exchanges and broker-dealers ("December Order").² Subject to conditions specified in the December Order, any exchange that effects or reports transactions in CDS that are not swap agreements ("non-excluded CDS")³ and is not otherwise subject to the requirements

¹ 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. The over-the-counter ("OTC") market for CDS poses systemic risk to the financial system as well as operational risks, risks relating to manipulation and fraud, and regulatory arbitrage risks.

² Securities Exchange Act Release No. 59165 (December 24, 2008), 74 FR 133 (January 2, 2009).

³ Section 3A of the Exchange Act limits the Commission's authority over swap agreements, as defined in Section 206A of the Gramm-Leach-Bliley Act. 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-

under Sections 5 and 6 of the Exchange Act,⁴ and the rules and regulations thereunder, is exempt from the requirement to register as a national securities exchange.⁵ In addition, any broker or dealer that effects or reports transactions in non-excluded CDS on such an exchange is exempt from the prohibition on trading activity in Section 5 of the Exchange Act. The December Order expires on September 25, 2009. Pursuant to its authority under Section 36 of the Exchange Act,⁶ for the reasons described herein, the Commission is today extending the exemption granted in the December Order until March 24, 2010.

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" Section 6 of the Exchange Act

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.

⁴ 15 U.S.C. 78e and 78f.

⁵ 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).

⁶ 15 U.S.C. 78mm.

sets forth a procedure whereby an exchange⁷ may register as a national securities exchange.⁸

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."⁹ To facilitate the establishment of one or more exchanges for non-excluded CDS, the Commission in the December Order exercised its authority under Section 36 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.

The exemptions were conditioned on an exchange providing notice to the Commission of its reliance on the December Order, and certain other requirements that generally mirror those applicable to alternative trading systems under Regulation ATS.¹⁰

⁷ 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).

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

⁹ 15 U.S.C. 78mm(a)(1).

¹⁰ 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

As we noted at the time, the temporary exemptions from Sections 5 and 6 of the Exchange Act in the December Order were designed to allow brokers, dealers, and exchanges to effect transactions in non-excluded CDS on exchanges, while providing an opportunity for the Commission to gain experience with the CDS marketplace and consider public input regarding appropriate regulation and oversight.

During the ensuing period, the Commission has reviewed the CDS marketplace and been in contact with various market participants. Our effort has been to understand the operation of the CDS marketplace, evaluate the application of the exemptions in the December Order, and consider whether the conditions we imposed should be modified. In particular, consistent with our December Order, we have considered whether Regulation ATS, with or without modifications, should apply to systems that match orders in non-excluded CDS of multiple buyers and sellers.

Based on its review of the CDS marketplace, the Commission preliminarily believes that an exchange effecting transactions in non-excluded CDS should register under Sections 5 and 6 of the Exchange Act or structure itself as an alternative trading system and comply with the requirements of Regulation ATS. Among other things, Regulation ATS requires that the operator of an alternative trading system be registered as a broker-dealer. The Commission preliminarily believes that broker-dealer registration for exchanges that trade non-excluded CDS, as for other alternative trading systems,

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 7, 63 FR at 70846.

provides important regulatory benefits, is in the public interest, and is consistent with the protection of investors. In particular, regulated broker-dealers that operate alternative trading systems are also required to be FINRA members.¹¹ Membership in FINRA would allow FINRA to integrate trading of CDS on alternative trading systems into its surveillance of trading in economically similar investments, such as debt securities.

As noted, the conditions set out in the December Order under which CDS exchanges must operate are otherwise substantially similar to the requirements established under Regulation ATS.¹² Like the December Order, Regulation ATS would require a CDS exchange to keep records about its operations, its subscribers, and their orders;¹³ provide the Commission with trading information on a quarterly basis;¹⁴ establish procedures to ensure the confidential treatment of trading information;¹⁵ permit the Commission to examine its premises, systems, and records; and cooperate with the examination of its subscribers.¹⁶ In addition, the CDS exchange could not: (a) set rules governing the conduct of subscribers other than the conduct of such subscribers trading

¹¹ The Financial Industry Regulatory Authority ("FINRA") is a national securities association registered with the Commission under Section 15A of the Exchange Act, 15 U.S.C. 78o-3, and thus is a self-regulatory organization ("SRO"), as defined in Section 3(a)(26) of the Exchange Act, 15 U.S.C. 78c(a)(26). As an SRO, FINRA has authority to regulate and supervise its members for compliance with FINRA rules and the federal securities laws generally.

¹² See December Order, supra note 2, 74 FR at 136; Regulation ATS, 17 CFR 242.300 et seq. Generally, 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.

¹³ See 17 CFR 242.301(b)(8), 242.302, and 242.303.

¹⁴ See 17 CFR 242.301(b)(9).

¹⁵ See 17 CFR 242.301(b)(10).

¹⁶ See 17 CFR 242.301(b)(7).

on such exchange; or (b) discipline subscribers under the Exchange Act other than by exclusion from trading.¹⁷ Thus, with regard to these requirements, compliance with Regulation ATS should not create any significant additional regulatory burden for a CDS exchange now relying on the December Order.

The Commission is sensitive not to disrupt existing CDS markets unnecessarily or impose unreasonable burdens on market participants providing or using CDS exchanges. We recognize that restructuring current business activity and registration as a national securities exchange or alternative trading system may reasonably be expected to take some time. Accordingly, the Commission has determined to extend the December Order through March 24, 2010 to permit exchanges facilitating transactions in non-excluded CDS sufficient time to register pursuant to Sections 5 and 6 of the Exchange Act, or comply with the requirements of Regulation ATS, which include registration as a broker-dealer. The conditions specified in the December Order will continue to apply.¹⁸

Likewise, the Commission is extending the exemption it granted in the December Order to brokers and dealers effecting transactions in non-excluded CDS on an exchange that is not a national securities exchange because of that exchange's reliance on the December Order. Absent an exemption, Section 5 of the Exchange Act would prohibit

¹⁷ These prohibitions are based on the Commission's belief that an organization, association, or group of persons that could exercise self-regulatory authority over its subscribers should be registered as an 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, like any alternative trading system, a CDS exchange could apply credit standards to its subscribers or require subscribers to provide financial information relevant to their activity on the system. See Regulation ATS Adopting Release, supra note 7, 63 FR at 70859.

¹⁸ See December Order, supra note 2, 74 FR at 138-39.

brokers and dealers from effecting transactions in non-excluded CDS on such an exchange. As we found in the December Order, the temporary exemption for brokers and dealers 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 reasons noted in the December Order, the Commission believes would be beneficial. This exemption also provides legal certainty to broker-dealers effecting transactions in CDS. 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. Therefore, the Commission finds that it is consistent with the public interest and the protection of investors to extend the December Order, which granted 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 the December Order.

Finally, the Commission notes that, absent comments that articulate a substantial need for further relief, the Commission is unlikely to further extend the December Order beyond March 24, 2010.

Accordingly,

IT IS ORDERED, pursuant to Section 36 of the Exchange Act,¹⁹ that 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,²⁰ and the rules and regulations thereunder, will continue to be exempt from the requirement to register as a national securities exchange under Section 6 of the Exchange Act, and from the prohibition in Section 5 of the Exchange Act 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 through March 24, 2010, 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);

¹⁹ 15 U.S.C. 78mm.

²⁰ 15 U.S.C. 78e and 78f.

- 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; and
- 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

(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,²¹ that until March 24, 2010, 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 will also continue to be exempt from the prohibition on trading activity in Section 5 of the Exchange Act.

By the Commission.

Florence E. Harmon
Deputy Secretary

²¹ 15 U.S.C. 78mm.