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## CFTC Issues Broad Securitization Industry Relief on Commodity Pool Regulation

On Friday, December 7, 2012, the U.S. Commodity Futures Trading Commission (CFTC), through its Division of Swap Dealer and Intermediary Oversight (Division), issued a letter which provides broad relief for certain segments of the securitization industry (December Relief)<sup>1</sup>. The December Relief provides both interpretative relief and no-action relief to securitization vehicles that invest in "commodity interests"<sup>2</sup> as follows: (i) interpretative relief for certain securitization vehicles; (ii) no-action relief for fixed income parties to certain legacy transactions; and (iii) temporary no-action relief for other securitization vehicles until March 31, 2013.

### I. Interpretative Relief

The Division had previously issued an interpretive letter on October 11, 2012 (October Relief)<sup>3</sup>, where it stated that certain securitization vehicles would not be included within the definition of "commodity pool"<sup>4</sup> under the U.S. Commodity Exchange Act as amended (CEA) and the related CFTC regulations if they meet certain conditions. Those conditions are generally as follows:

1. the issuer of the asset-backed securities is operated consistent with the conditions set forth in U.S. Securities and Exchange Commission (SEC) Regulation AB<sup>5</sup> or Rule 3a-7<sup>6</sup> under the U.S. Investment Company Act of 1940 as amended, whether or not the issuer's security offerings are in fact regulated pursuant to either regulation; and
2. the issuer's activities are limited to passively owning or holding a pool of receivables or other financial assets, fixed or revolving, which by their terms convert to cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to security holders; and
3. the entity's use of derivatives is limited to the uses of derivatives permitted under the terms of Regulation AB, which include credit enhancements and the use of derivatives such as interest rate and currency swap agreements to alter the payment characteristics of the cash flows from the issuing entity; and
4. the issuer makes payments to securities holders only from cash flow generated by its pool assets and other permitted rights and assets, and not from or otherwise based upon changes in the value of the entity's assets; and
5. the issuer is not permitted to acquire additional assets or dispose of assets for the primary purpose of realizing gain or minimizing loss due to changes in market value of the vehicle's assets.<sup>7</sup>

In the December Relief, the Division acknowledged, based on its conversations with numerous securitization industry members and their advisers (including Dechert LLP), that certain securitization vehicles that do not satisfy the operating or trading limitations contained in Regulation AB or Rule 3a-7 may nevertheless be

properly excluded from the definition of commodity pool, provided that criteria 2. and 3. above with respect to the ownership of financial assets and swaps usage continue to be satisfied and the use of swaps is no greater than that contemplated by Regulation AB and Rule 3a-7 and such swaps are not used to create investment exposure. An example of such a securitization vehicle is a standard asset-backed commercial paper conduit (ABCP) which is a special purpose entity that issues asset-backed senior promissory notes and uses the proceeds of such notes to acquire interests in financial assets. The notes issued by ABCP conduits may not be asset-backed securities as defined in Regulation AB because they are repaid in the ordinary course from proceeds of newly issued promissory notes or from liquidity and credit facilities. Also, most ABCP conduits do not employ independent trustees as required by Rule 3a-7. While for these reasons ABCP conduits may not satisfy the conditions in the October Relief, the Division concluded that, absent other factors, this type of securitization vehicle would not be a commodity pool for which the operator would be deemed to be a commodity pool operator (CPO)<sup>8</sup> and need to register as such or qualify for a registration exclusion or exemption. This is welcome news given that the ABCP market is approximately \$300 billion in size (down from a pre-credit crisis peak of approximately \$1.4 trillion).

The Division also discussed the traditional (cash) collateralized debt obligations (CDO) structure that owns only financial assets consisting of corporate loans, corporate bonds, or investment grade, fixed income mortgage-backed securities, asset-backed securities, or CDO tranches issued by vehicles that are not commodity pools. Under the terms of this CDO structure, the financial assets are permitted to be traded up to 20% of the aggregate principal balance of all financial assets owned by the issuer per year for three years, and the CDO uses interest rate swaps and currency swaps which cannot be terminated before the related hedged asset has been liquidated. The Division concluded that, absent other factors, this securitization vehicle would not be a commodity pool.

The Division also stated that a covered bond transaction should not be a commodity pool if the underlying collateral pool contains no commodity interests other than swaps which are used only for purposes permitted by Regulation AB and covered bond investors are only entitled to receive payments of accrued interest and repayment of principal of their covered bonds without any condition to payment based upon any swap exposure.

If investors of a securitization vehicle have exposure to swaps which are used to create investment exposure or to swap interest rates or currencies, then the securitization vehicle may be a commodity pool requiring a registered or excluded/exempted CPO. However, swaps used to provide credit support to financial assets in a securitization or the notes issued by a securitization entity should not be viewed as creating investment exposures and should not be considered a commodity pool. Nevertheless, if these swaps used to provide credit support are determined to be commercially unreasonable as credit support with respect to securitization, the Division may conclude that they are commodity pools.

The Division also discussed securitization vehicles that are repackaging vehicles that issue credit-linked or equity-linked notes where the repackaging vehicle owns high quality financial assets but sells credit protection on a broad based index or obtains exposure to a broad based stock index through a swap. This securitization vehicle finances its acquisition of the high quality assets by issuing notes to investors that are linked to credit risks or price changes in the stock index. The Division concluded that this type of securitization vehicle may be a commodity pool because the investors are obtaining a significant component of their investment (upside or downside) from the related swaps.

Also, a repackaging vehicle that acquired a three year bond, issued a tranche of notes, and used swaps to extend the investment experience of the bond (and thus the tranche of notes) to four years may be deemed to be a commodity pool, as would a repackaging vehicle that paired the three year bond with a swap to provide inflation rate protection.

## II. No-Action Relief

The first component of no-action relief provided by the Division is focused on legacy securitization vehicles formed prior to October 12, 2012 which would face significant operational challenges should the CFTC compliance regime be imposed. The Division will not recommend enforcement action against any operator of such a securitization vehicle for failing to register as a CPO if the following criteria are (and remain) satisfied:

1. the issuer issued fixed income securities before October 12, 2012 that are backed by and structured to be paid from (and whose creditworthiness primarily depends on) cash or synthetic assets owned by the issuer; and
2. the issuer has not and will not issue new securities on or after October 12, 2012; and
3. the issuer shall, within five business days of a request by the CFTC, provide an electronic copy of
  - the most recent disclosure document used in connection with the offering of the related securities, and
  - all amendments to the principal documents since issue, and
  - the most recent distribution statement to investors, and
  - if the issuer's securities were offered relying on SEC Rule 144A,<sup>9</sup> a copy of the information that would be provided to investors to satisfy Rule 144A(d)(4).

This no-action relief does not exclude the related securitization vehicle from the definition of commodity pool, and as a result it may still be subject to regulation as a "covered fund" under the final Volcker Rule.<sup>10</sup>

### III. Temporary No-Action Relief

The second component of no-action relief relates to operators of securitization vehicles that are unable to rely upon the October Relief or the December Relief. The Division has pushed back the date by which operators of these types of securitization vehicles must register as CPOs to March 31, 2013 (from December 31, 2012).

### IV. Other Temporary No-Action Relief

On November 29, 2012, the CFTC granted temporary no-action relief for both public and private fund-of-funds managers (FOF Relief),<sup>11</sup> which may be available to operators of certain securitization vehicles. The FOF Relief allows these operators to delay certain CPO compliance until the later of June 30, 2013 or six months from the date that the Division issues revised guidance (or the compliance date, if later) on the application of the calculation of the *de minimis* commodity interest trading tests in the context of CFTC Rules 4.5 and 4.13(a)(3), as long as certain criteria are met.<sup>12</sup>

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#### Footnotes

1 [CFTC Letter No. 12-45](#), Further Exclusions from Commodity Pool Regulation for Certain Securitization Vehicles; No-Action Relief for Certain Securitization Vehicles Formed Prior to October 12, 2012 (Dec. 7, 2012).

2 Commodity interests were previously limited to exchange-traded commodity futures contracts, options on futures, and commodity options (among other instruments). The U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act expanded the definition of commodity interest to include security futures products and certain exchange-traded and over-the-counter derivatives (such as swap, forward, and option contracts), other than swaps (including credit default swaps) referencing single securities or loans or baskets of nine or fewer securities (that is, security-based swaps which are not commodity interests subject to CFTC regulation and are instead regulated by the SEC), forward contracts on non-financial items, and certain limited currency swaps and forwards providing for physical delivery of two currencies. CEA § 4m(3)(C); CFTC Regulation 1.3(yy); Further Definition of "Swap,"

5 17 CFR 270.4a-7.

6 15 USC 80a-3a-7.

7 For a more in-depth discussion of the October Relief, see [DechertOnPoint, Impact of CFTC Swap Regulations on Structured Finance Industry](#).

8 CEA § 1a(11); CFTC Regulation 1.3(cc).

9 15 U.S.C. §77a.

10 For a more in-depth discussion of the the Volcker Rule, see [DechertOnPoint, Volcker Rule Regulations Proposed](#).

11 [CFTC Letter No. 12-38](#), Request for Delayed Compliance Date of Amended Part 4; Rescission of Former Appendix A (Nov. 29, 2012).

12 For a more in-depth discussion of the FOF Relief, see [DechertOnPoint, CFTC Grants Temporary CPO Registration Relief for Private and Public Fund-of-Funds Managers](#).

“Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208 (Aug. 13, 2012) (to be codified at 17 C.F.R. pts 1, 230, 240, and 241).

3 [CFTC Letter No. 12-14](#), Request for Exclusion from Commodity Pool Regulation for Securitization Vehicles (Oct. 11, 2012).

4 A commodity pool is defined as any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests. CEA § 1a(10); CFTC Regulation 4.10(d).

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