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# CFTC Classifies Certain Securitization Vehicles as Not Being Commodity Pools

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Recent changes to the commodity pool regulations under the Commodity Exchange Act (the "CEA") may subject certain securitization transactions and their managers to regulation by the Commodity Futures Trading Commission (the "CFTC"). In a no-action letter issued on December 7, 2012, the CFTC provided limited exclusions from commodity pool regulation for certain categories of securitization vehicles and no-action relief to certain securitization vehicles created before October 12, 2012. It also extends to March 31, 2013 the date by which operators of securitization vehicles that are commodity pools and that do not qualify for an exemption must register with the CFTC as commodity pool operators ("CPOs").

This Alert describes (1) the background of the changes to the CFTC's commodity pool regulations as they relate to securitization vehicles, (2) the scope of the CFTC's CPO registration exemption under CFTC Regulation 4.13(a)(3), and (3) the partial regulatory relief available under CFTC Regulation 4.7(b) for managers of collateralized debt obligation ("CDO") or other securitization vehicles all of whose investors are "qualified eligible persons" ("QEPs") as defined in CFTC Regulation 4.7.[1]

## Background

The CEA provides that funds operated for the purpose of trading in commodity interests are considered to be "commodity pools." "Commodity interests" have historically included futures contracts, commodity options, retail forex transactions and leverage contracts. Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the term "commodity interests" was extended to include "swaps."[2] As a consequence of this extension, pooled investment funds that enter into swaps (separate and apart from other more traditional commodity interest transactions) may now be considered to be "commodity pools."

Absent an exemption, persons who form and/or have responsibilities to administer a commodity pool (the "operators") must register as CPOs.[3] Similarly, absent an exemption, persons who provide commodity interest trading advice to a commodity pool must register as commodity trading advisors ("CTAs").

Although not required by the Dodd-Frank Act, the CFTC has rescinded Regulation 4.13(a)(4), which exempted operators of private funds with highly sophisticated investors from having to register as CPOs, and amended Regulation 4.5 with respect to registered investment companies

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1 We have discussed the changes to the CFTC's commodity pool regulations in several alerts. For our February 2012 alerts on the changes generally, click here and click here. For our alert on the CFTC staff's responses to FAQs regarding some of the changes to the commodity pool regulations affecting funds, click here.

2 The term "swap" generally includes interest rate swaps, most currency swaps and forwards, and credit default or total return swaps that reference broad-based securities indexes.

3 The CFTC staff previously has taken the position that each of the individual trustees of a trust is a CPO. *See* CFTC Staff Letter 10-06 (March 29, 2010). Similarly, the CFTC staff considers the board of directors of a fund set up as a corporate entity to be a CPO. In each case, however, the CPO function can be delegated. *See Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions – CPO/CTA: Amendments to Compliance Obligations* (August 14, 2012, as amended) ("FAQ") (answers to questions 1 and 2 under the heading "Who is the Commodity Pool Operator?").

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("RICs") so that operators thereof must comply with commodity interest trading limits and marketing restrictions to qualify for exclusion from the definition of CPO.[4] As a result of the amendment of Regulation 4.5 and the rescission of Regulation 4.13(a)(4), fund managers may be forced to either comply with the conditions of Regulation 4.5 for RICs or Regulation 4.13(a)(3) for private funds (the "*de minimis*" trading exemption that was retained despite also being proposed to be rescinded), register under the CEA as a CPO, or exit the "commodity interest" markets.

As a consequence of these changes, a securitization vehicle that enters into swaps could be regarded as being a commodity pool if it is "operated for the purpose of trading in commodity interests." If a securitization vehicle were a commodity pool, then its operators or advisers may be subject to registration as CPOs or CTAs. As such they would be subject to a variety of compliance and reporting obligations under the CEA and the CFTC's regulations. These requirements could be problematic for securitization vehicles that utilize swaps to hedge risks because securitization vehicles established before October 12, 2012 did not generally contemplate compliance with the commodity pool regulations and it is often difficult to determine which of their service providers are engaging in activities subject to those regulations.

An initial consideration is to identify the person or persons who would act as the CPO for a securitization vehicle that trades commodity interests. A securitization vehicle often involves a wide variety of service providers and others to provide administration, marketing, custody and asset management services. Many of those persons may have or share discretionary authority over the vehicle's entry into swaps or termination of swaps. Persons who could potentially be considered to be the CPO or CTA of a securitization vehicle could include sponsors, arrangers, trustees, servicers, collateral managers, swap counterparties or others with discretionary authority over the vehicle's entry into swaps or termination of swaps.

## CFTC Exemptive Relief for Securitization Vehicles

The CFTC's Division of Swap Dealers and Intermediary Oversight ("DSIO") has recently issued two letters that provide interpretive guidance exempting certain securitization vehicles from the definition of "commodity pool" (and by extension their servicers or other service providers from being considered to be CPOs or CTAs).[5] In one of these ("CFTC Letter 12-14"), DSIO established general criteria for excluding securitization vehicles from regulation as commodity pools. In the second letter ("CFTC Letter 12-45"), DSIO provided interpretative guidance regarding when it would be appropriate to exclude from the commodity pool regulations securitization vehicles that do not satisfy one or more of the criteria set forth in CFTC Letter 12-14.

### CFTC Letter 12-14

Under CFTC Letter 12-14, a securitization vehicle would not be included within the definition of "commodity pool" under Section 1a(10) of the CEA and under CFTC Regulation 4.10(d) if it engages in passive investment in and financing of financial assets and has limited types of support from swap transactions that would be consistent with the disclosure regime for securitizations under Regulation AB or the exemption of securitizations from regulation under the Investment

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4 *Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations,* 77 Fed. Reg. 11252 (February 24, 2012); *correction notice published at* 77 Fed. Reg. 17328 (March 26, 2012).

5 *See* CFTC Staff Letter No. 12-45 from Gary Barnett, Director of DSIO (December 7, 2012; no addressees); CFTC Staff Letter No. 12-14 from Gary Barnett, Director of DSIO to the American Securitization Forum and the Securities Industry and Financial Markets Association (October 11, 2012).

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Company Act of 1940 ("1940 Act").[6] The conditions for being excluded from the commodity pool regulations as set forth in CFTC Letter 12-14 are as follows:

a. the issuer of the asset-backed securities (the "ABS issuer") is operated consistently with the conditions set forth in 1940 Act Rule 3a-7[7] or in Regulation AB, regardless of whether or not the issuer's security offerings are actually subject to either of those regulations;[8]

b. the ABS issuer's activities are limited to passively owning or holding a pool of receivables or other financial assets that 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;

c. the ABS issuer's use of derivatives is limited to the uses of derivatives permitted under the terms of Regulation AB, which include credit enhancement 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;

d. the ABS 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

e. the ABS 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.

CFTC Letter 12-14 makes clear that the conditions described above are not exclusive, and it invites sponsors of securitizations that do not meet the criteria set forth in CFTC Letter 12-14 to engage in dialogue with the CFTC to determine whether the commodity pool regulations would apply.

## CFTC Letter 12-45

Subsequent to the issuance of CFTC Letter 12-14, DSIO became aware of transactions involving securitization vehicles that do not comply with Regulation AB or Rule 3a-7, but should be excluded categorically from commodity pool regulations. DSIO also became aware that it would be unrealistic to expect non-excluded securitization vehicles and their CPOs to comply with the commodity pool regulations by December 31, 2012. Therefore, DSIO issued CFTC Letter 12-45 in order to achieve three objectives. First, it provides further exclusions from commodity pool regulation for certain securitization vehicles. Second, it provides no-action relief for certain securitization vehicles that were formed prior to October 12, 2012. Third, it extends to March 31, 2013, the registration period for operators of securitization vehicles that are unable to rely upon the terms of CFTC Letter 12-14 or the no-action relief.

## Further Exclusions From the Definition of "Commodity Pool"

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6 17 C.F.R. § 229.1100, *et seq.*

7 17 C.F.R. § 270.3a-7.

8 Rule 3a-7 establishes a basis to exclude certain issuers of asset-backed securities from the definition of "investment company" under the 1940 Act. Regulation AB consists of rules and forms that address in a comprehensive manner the registration and disclosure requirements for asset-backed securities under the Securities Act of 1933 and the reporting requirements for asset-backed securities under the Securities Exchange Act of 1934. The Securities and Exchange Commission has taken the view that securities resulting from synthetic securitizations are not within the definition of "asset-backed security" because the swap relates to an external asset in order to bring the risk of that asset into the pool synthetically, even where payments on the swap or other derivative are conditioned on performance of the assets in the pool held by the issuer.

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CFTC Letter 12-45 expresses the view of DSIO that, in principle, certain securitization vehicles that do not satisfy the operating or trading limitations contained in Regulation AB or Rule 3a-7 may be properly excluded from the definition of commodity pool, provided that (1) the use of swaps is no greater than that contemplated by Regulation AB and Rule 3a-7, (2) such swaps are not used in any way to create an investment exposure, and (3) the securitization vehicle complies with the requirement that its activities are limited to the holding of financial assets.

CFTC Letter 12-45 provides specific examples of transactions that would be excluded from the definition of commodity pool despite not being compliant with Regulation AB or Rule 3a-7. These include standard asset-backed commercial paper conduits ("ABCP"), in which a special purpose entity issues asset-backed senior promissory notes and uses the proceeds of such notes to acquire interests in one or more financial assets. They also include CDOs, in which a special purpose entity is established to acquire, on a leveraged basis, corporate loans, corporate bonds, or investment grade, fixed income mortgage-backed securities, asset-backed securities or CDO tranches issued by vehicles that are not themselves commodity pools.

CFTC Letter 12-45 specifically addresses how the relief would apply to managed CDOs.[9] It provides an example of a CDO with a 3-year reinvestment period during which the issuer may trade up to 20% of the aggregate principal balance of all of the financial assets owned by it. The CDO uses interest rate swaps to convert certain fixed rate financial assets to floating, and foreign exchange swaps to convert Euro-denominated assets to dollars, with none of these swaps being terminable before the related hedged asset has been liquidated. CFTC Letter 12-45 indicates that vehicles engaging in such a transaction, but not otherwise involved in commodity interests, will not be considered to be a commodity pool. However, it leaves the commodity pool classification question unanswered with respect to CDOs that do not match the terms described above. It also does not provide certainty with respect to the entry into or termination of swaps after the end of the reinvestment period in connection with sales of credit improved securities or credit risk securities after the end of the reinvestment period.

CFTC Letter 12-45 affirms that swaps should not be viewed as creating investment exposures if they are used to provide credit support to financial assets in a securitization or the notes issued by the securitization entity to the extent contemplated by Item 1114 of Regulation AB.[10] Therefore, engaging in such swaps should not – without more – require registration of an entity as a CPO. However, CFTC Letter 12-45 states that swaps whose use is "commercially unreasonable as credit support with respect to a securitization" may cause DSIO to conclude that a commodity pool exists.[11]

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9 Managed CDOs do not comply with Rule 3a-7(a)(3)(iii) because of the provision for active trading to realize gains or avoid losses. This is true not only during the reinvestment period, but also after it ends, because CDO documentation typically permits the collateral manager to sell credit improved securities and credit risk securities after the end of the reinvestment period.

10 Item 1114 of Regulation AB contemplates, *inter alia*, (1) external credit enhancement designed to ensure that the asset-backed securities or pool assets will pay in accordance with their terms, such as bond insurance, letters of credit or guarantees, (2) mechanisms to ensure that payments on the asset-backed securities are timely, such as liquidity facilities, lending facilities, guaranteed investment contracts and minimum principal payment agreement (as well as interest rate swap or similar swap transactions to provide incidental changes to cash flow and return, such as where a floating rate of interest is to be paid on a security backed by financial assets that pay a fixed rate of interest) and (3) derivatives whose primary purpose is to provide credit enhancement related to pool assets or the asset-backed securities.

11 As an example of commercially unreasonable credit support, CFTC Letter 12-45 posits a trust that owns floating rate bonds issued by a distressed jurisdiction and that enters into a swap with its affiliate or sponsor pursuant to which the swap counterparty provides credit support for the interest and the principal sufficient to obtain pricing based on a high investment grade rating of the trust's notes. In that example, DSIO indicates that the securitization vehicle may be a commodity pool because the facts and circumstances indicate that the swap is a significant aspect of the investment.

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Thus, a repackaging vehicle may be deemed to be a commodity pool, thus implicating potential CPO registration of its operator, if a significant component of the investment return derives from swaps that the vehicle enters into. One example of investment exposure being based on a swap is where a repackaging vehicle that owns financial assets also has synthetic exposure to a securities index through a swap based upon securities linked to the index. Another example is where a repackaging vehicle uses a swap to extend the effective life of its assets or to provide inflation rate protection.

In addressing covered bonds, CFTC Letter 12-45 makes clear that the collateral pool and the special purpose vehicle would not subject the operator of a vehicle established to issue covered bonds to CPO regulation if the pool and the vehicle contain no “commodity interests” other than swaps used only for purposes permitted by Regulation AB and if payments to the covered bond holders are not conditioned on any swap exposure.

Unlike some of the other no-action relief recently issued by DSIO, CFTC Letter 12-14 and CFTC Letter 12-45 do not require a filing or otherwise establish a procedure by which one may claim the benefit of the exclusion. Although this will provide an administrative benefit, it may expose securitization participants to the risk of being second-guessed by the CFTC if they fail to register as CPOs or CTAs based on an analysis that the CFTC staff questions. In addition, other parties with which the securitization vehicles will transact, such as futures commission merchants or swap dealers, must register and become members of the National Futures Association (“NFA”). As such, these other parties must comply with NFA Bylaw 1101, which prohibits NFA members from engaging in transactions with other persons unless the latter are registered or exempt therefrom. Futures commission merchants and swap dealers may be more comfortable dealing with persons operating in accordance with a claim of exemption pursuant to a notice filing as opposed to a self-executing exemption.

## No-Action Relief for Securitizations Created Before October 12, 2012

DSIO has acknowledged that certain securitization vehicles formed prior to October 12, 2012, whether described above or in addition to those described above, may face operational difficulties in seeking to comply with the commodity pool operator regulations. Therefore, CFTC Letter 12-45 states that DSIO will not recommend that the CFTC take enforcement action against any operator of a securitization vehicle for failing to register as a CPO if (1) the issuer has issued fixed income securities before October 12, 2012 that are backed by and structured to be paid from payments on or proceeds received in respect of, and whose creditworthiness primarily depends upon, cash or synthetic assets owned by the issuer, (2) the issuer has not issued and will not issue new securities on or after October 12, 2012, and (3) the issuer delivers electronic versions of certain documents concerning its existing securities to the CFTC or any division or office thereof, no later than five (5) business days following a request.

The information to be provided consists of (i) the most recent disclosure document used in connection with the offering of the related securities, (ii) the amendments to the principal documents since issue, (iii) the most recent distribution statement to investors and (iv) in the case of securities offered in reliance on Rule 144A under the Securities Act of 1933, a copy of the Rule 144A(d)(4) information that was provided to prospective investors. If the issuer does not provide the information required pursuant to the terms of this no-action position, CFTC Letter 12-45 requires that it affirmatively demonstrate that it cannot obtain the required documents through reasonable commercial efforts.

CFTC Letter 12-45 states that failure to comply with the criteria set forth in the letter will result in the issuer’s inability to rely upon the terms of this relief. Thus, for example, master trusts that are used to securitize revolving assets and that do not clearly fit within the exclusion for standard ABCP conduits may not be able to comply with the information requirements and may therefore

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be unable to claim relief from the commodity pool regulations. Even for term securitizations, the sponsors may have some risk that the no-action relief could be withdrawn retroactively based on future actions, such as the inability to comply with information delivery obligations where the CFTC disagrees with the judgment of whether the issuer has taken commercially reasonable efforts.

Unlike certain other no-action relief, DSIO has not established a procedure by which one may claim the benefit of the exclusion. This may expose securitization participants to the risk of being second-guessed by the CFTC if they fail to register as CPOs or CTAs based on an analysis that the CFTC staff question. Securitization participants may also face questions and perhaps a refusal to deal from swap dealers and futures commission merchants based upon their concerns about complying with NFA Bylaw 1101.

## Looking Beyond the CFTC's Relief for Securitization Vehicles

If a securitization vehicle does not qualify for relief from the commodity pool regulations under CFTC Letters 12-14 or 12-45, its operator may nevertheless be able to avoid CPO registration if the swaps and other commodity interest trading activity of the securitization vehicle comply with the *de minimis* exemption contained in CFTC Regulation 4.13(a)(3). If Regulation 4.13(a)(3) is not available, an operator would likely be required to register as a CPO by March 31, 2013. However, in doing so it may be eligible for the regulatory relief available to CPOs of CDOs and other categories of securitization vehicle whose investors are all QEPs.

### CFTC Regulation 4.13(a)(3)

Regulation 4.13(a)(3) provides an exemption from CPO registration for the operator of a commodity pool that issues interests in transactions that are exempt from registration under the Securities Act of 1933, are not marketed to the public in the United States or marketed as a vehicle for trading commodity interests, are sold only to "accredited investors," certain persons associated with the CPO and "Non-United States persons" and that trade only a *de minimis* amount of commodity interest positions, whether entered into for *bona fide* hedging purposes or otherwise. There are two alternate tests for establishing whether a pool has *de minimis* trading in commodity interests.

*5% Test* Under the 5% test, the aggregate initial margin and option premiums required to establish commodity interest positions cannot be more than 5% of the liquidation value of the pool's portfolio after taking into account unrealized profits and losses; or

*Aggregate Net Notional Value Test* Under the aggregate net notional value test, the aggregate net notional value of commodity interest positions cannot exceed 100% of the liquidation value of the pool's portfolio after taking into account unrealized profits and losses.[12]

### CFTC Regulation 4.7(b)

CFTC Regulation 4.7(b) provides registered CPOs and CTAs with relief from most of the significant disclosure, recordkeeping and reporting requirements under the CEA for commodity pool securitization vehicles all of whose investors are QEPs, among other conditions.

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12 Regulation 4.13(a)(3)(ii)(B)(1) cross references to the CFTC Part 45 regulations by stating that the term "notional value" for any cleared swap is the value as determined consistent with the terms of 17 C.F.R. Part 45. Although it is not clear on its face how the Part 45 regulations should apply to determine the "notional value" of a cleared swap, the CFTC has stated in the FAQ that the notional value of cleared swaps means the notional amount. *See* FAQ (answers to questions 4 and 5 under the heading "Trading Limits").

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This is most obviously relevant to CDO transactions, which are generally structured to be exempt from the definition of "investment company" under Section 3(c)(7) of the 1940 Act (active portfolio management is inconsistent with the requirements of Rule 3a-7), because the definition of QEP includes a "qualified purchaser" (as defined in Section 2(a)(51) of the 1940 Act and the rules thereunder). It could also be relevant to a wider range of transactions that do not qualify under Rule 3a-7 (for example, because they do not have independent trustees or do not invest in qualifying assets) in which all investors are qualified institutional buyers.[13]

Although CFTC Regulation 4.7(b) requires registration with the CFTC, a CPO relying on Regulation 4.7(b) would be spared most of the compliance obligations generally associated with commodity pool operator status[14] and would not be subject to the trading limits discussed above under CFTC Regulation 4.13(a)(3). Compliance with the NFA's rules and interpretive guidance would, however, be required.

## Conclusion

DSIO's issuance of CFTC Letters 12-14 and 12-45 provides welcome relief to operators of securitization vehicles from what many have considered to be an unintended complexity of regulatory changes that were directed at hedge funds and mutual funds. However, DSIO has not provided blanket relief, and it will be incumbent on parties participating in a securitization to establish the basis on which the vehicle would not be considered to be a commodity pool or to initiate discussions with DSIO to determine whether the vehicle would be a commodity pool in doubtful cases. If the securitization vehicle does not come within the exclusions provided or any further general or individualized relief, it will be necessary to identify CPOs and CTAs, address delegation of duties in time to permit all affected persons to register by March 31, 2013 as provided in CFTC Letter 12-45, and also address various operational and compliance issues.

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13 The definition of QEP includes, among other categories, certain institutional investors and investors that are "accredited investors" who own securities and other investments worth at least $2 million. Importantly, investors that are considered "qualified purchasers" under the 1940 Act and the rules there under are automatically considered to be QEPs.

14 Reporting on Form CPO-PQR would, however, generally be required.

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