

DerivativesINSIGHT

December 2012

Further Exclusions From Commodity Pool Regulation for Certain Securitization Vehicles; No-Action Relief for Certain Securitization Vehicles Formed Prior to October 12, 2012

I. Introduction

A. Issues Covered in the No-Action Letter

On December 7, 2012, the US Commodity Futures Trading Commission's ("CFTC") Division of Swap Dealer and Intermediary Oversight (the "Division") issued a no-action letter, number 12-45 (the "12-45 No-Action Letter"),¹ providing (1) further interpretations regarding when exclusions from commodity pool regulation is appropriate, (2) no-action relief for operators of certain securitization vehicles formed prior to October 12, 2012, from failure to register as a CPO and (3) temporary no-action relief for certain securitization vehicles that may not otherwise rely on the no-action relief granted by the 12-14 No-Action Letter or the 12-45 No-Action Letter from failure to register as a CPO until March 31, 2013.

B. Background

The CFTC issued a no-action letter, number 12-14, dated October 12, 2012 (the "12-14 No-Action Letter"),² which excluded certain securitization vehicles from the definition of "commodity pool" under Section 1a(10) of the Commodity Exchange Act (the "CEA") and under Section 4.10(d) of the general regulations promulgated under the CEA (the "CFTC Regulations"), and, thus, also from commodity pool regulations, including commodity pool operator ("CPO") registration requirements, provided such securitization vehicles met the following non-exclusive conditions (the "12-14 Conditions"):

1. The issuer of the securitization vehicle's asset-backed securities (the "Issuer") is operated consistent with the conditions set forth in the Securities and Exchange Commission (the "SEC") Regulation AB ("Regulation AB") or Rule 3a-7 under the Investment Company Act of 1940 ("Rule 3a-7"), whether or not (a) the Issuer has actually offered its asset-backed securities pursuant to disclosure documents complying with Regulation AB or (b) the Issuer's asset-backed security offerings are otherwise regulated pursuant to either regulation, such that the Issuer, pool assets, and issued asset-backed securities satisfy the requirements of either regulation;
2. The Issuer's activities are limited to passively owning or holding a pool of receivables or other financial assets (such financial assets, for the purposes of the 12-14 No-Action Letter, not including transactions whereby an entity obtains exposure to an asset that is not transferred or otherwise part of such pool as is consistent with the guidance



Click [here](#) to learn more about our Derivatives practice.

White & Case offers in-depth, global expertise on a full range of derivatives transactions and related regulatory concerns. Our lawyers are closely monitoring the developments of the new regulatory reforms under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the European Market Infrastructure Regulation and the Markets in Financial Instruments Directive.

Click [here](#) to contact one of our lawyers.

For access to the **DerivativesINSIGHT** Online Resource Center, please click [here](#).

¹ Available on the CFTC website at:

<http://www.cftc.gov/ucm/groups/public/@rllettergeneral/documents/letter/12-45.pdf>.

² Available on the CFTC website at:

<http://www.cftc.gov/ucm/groups/public/@rllettergeneral/documents/letter/12-14.pdf>.

provided by the SEC in its adopting release for Regulation AB), which may be either fixed or revolving (provided, that if the Issuer is a “master trust” as defined under Item 1101(c)(3) of Regulation AB, then the Issuer must comply with Regulation AB and may be permitted to add additional assets to such pool that backs securities in connection with future issuances of asset-backed securities, which may be done in connection with maintaining a minimum pool balance in accordance with transaction agreements for master trusts with revolving periods or receivables or other financial assets that involve revolving accounts), that by their terms convert to cash within a finite time period (including the residual value realized on the disposition of leased assets to the extent consistent with the terms of Regulation AB) plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to security holders;

3. The Issuer’s use of derivatives (*i.e.*, swaps) 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;
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 Issuer’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 securitization vehicle’s assets, provided, that nothing in this requirement shall be construed to permit the use of derivatives beyond those circumstances set forth in subparagraph (3) above.

The 12-14 Conditions represent a type of passive investment in and financing of financial assets that receive only limited types of support from swap transactions and as such qualify to use alternative disclosure regimes under Regulation AB or an exemption from regulation under the Investment Company Act of 1940, provided, however, that if (a) the Issuer’s operating or trading activities are more active than contemplated in the 12-14 No-Action Letter, (b) the Issuer does not limit its investments to financial assets that are used to pay the Issuer’s asset-backed securities or (c) the Issuer uses swaps to create synthetic investment exposure, then the Issuer is not entitled to rely on the exclusion from the definition of “commodity pool” as provided by the 12-14 No-Action Letter.

Following the issuance of the 12-14 No-Action Letter, the Division discussed with securitization sponsors the structures of certain securitization vehicles that did not conform with the 12-14 Conditions to determine whether such non-conforming securitization vehicles might be considered commodity pools and, if so, whether such

non-conforming securitization vehicles warranted other relief under certain circumstances.

The 12-45 No-Action Letter describes certain non-conforming securitization vehicles and provides additional interpretations on whether such non-conforming securitization vehicles may or may not be deemed to be commodity pools by the Division.

II. Further Interpretations Regarding Exclusions From Commodity Pool Regulation for Securitization Vehicles

The Division is of the view that certain securitization vehicles that do not satisfy the operating or trading limitations of Regulation AB or Rule 3a-7, and thus may not meet one or more of the 12-14 Conditions, may still be excluded from the definition of commodity pool if (a) the 12-14 Conditions with respect to ownership of financial assets and derivative/swap usage continues to be satisfied, (b) the use of such swaps is no greater than as contemplated by Regulation AB and Rule 3a-7 and (c) such swaps are not used in any way to create an investment exposure.

12-45 No-Action Letter sets forth the following examples of securitization vehicles that would be excluded from the definition of commodity pool.

A. Asset-Backed Commercial Paper Conduits and Certain Traditional Collateralized Debt Obligations May Not Be Commodity Pools

Examples of such securitization vehicles are the standard asset-backed commercial paper conduit (“ABCP”) and certain traditional collateralized debt obligations (“CDOs”) that own 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 securitization vehicles that are not commodity pools.

The standard ABCP, which issues asset-backed senior promissory notes and uses the proceeds of such note issuances to acquire interests in one or more financial assets, may not meet the 12-14 Conditions because the ABCP may not employ independent trustees as generally required by Rule 3a-7 and the ABCP senior promissory notes may not be asset-back securities as defined in Regulation AB as they are repaid in the ordinary course from proceeds of newly issued promissory notes or liquidity and credit facilities. Traditional CDOs permit financial assets to be traded up to 20 percent of the aggregate principal balance of all financial assets owned by the Issuer for three years and use interest rate swaps to convert certain fixed rate financial assets to floating, foreign exchange swaps, neither of which may be terminated before the related hedge asset has been liquidated.

The Division believes that an investment in either a standard ABCP or such traditional CDOs is not unlike an investment in a traditional securitization vehicle that satisfies Regulation AB or Rule 3a-7 because the investment is essentially in the financial assets of the vehicle and not the swaps and thus, absent other factors, would not be deemed a commodity pool.³

B. Repackaging Securitization Vehicles May Be Commodity Pools

The Division also notes that a repackaging vehicle that issues credit-linked or equity-linked notes where the repackaging vehicle owns high quality financial assets (acquired by issuing such high quality assets by issuing such notes to investors) but sells credit protection on a broad based index or obtains exposure to a broad-based stock index through a swap, may be considered a commodity pool because the investors in the securitization vehicle obtain a significant component of their investment upside or downside from the related swaps. Similarly, 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.

The Division notes, however, that in a covered bond transaction, the collateral pool (and the special purpose vehicle in a structured model) would not be a commodity pool if it contains no commodity interests (as defined in Section 1.3(yy) of the CFTC Regulations) other than any swaps that are used only for purposes permitted by Regulation AB, and covered bond holders 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 derivative exposure.

C. Securitization Vehicles That Create Investment Exposure May Be Commodity Pools

Securitization vehicles with swaps that create investment exposure, other than the commercially reasonable use of swaps 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, also may be considered a commodity pool. For example, if a CDO permitted a 5 percent bucket for synthetic assets consisting of swaps instead of being comprised

completely of financial assets, the CDO may be a commodity pool. The Division notes, however, that given the relatively small size of the synthetic bucket, the operator of such a securitization vehicle may be an exempt CPO pursuant to Section 4.13(a)(3) of the CFTC Regulations. The Division also notes that the commercial reasonableness of the use of swaps to provide credit support is fact-specific. For example, a securitization vehicle, operated by a trust, consisting of floating rate bonds rated as "CCC" and a swap with the trust's affiliate/sponsor pursuant to which a swap counterparty provides credit support for the interest and principal of the floating rate bonds to obtain an "AA" rating of such notes, would be considered a commodity pool because the swap is a significant aspect of the investment.

III. No-Action Relief

A. Relief for Certain Securitizations Formed Prior to October 12, 2012

In addition to the guidance as discussed above, the Division will not recommend that the CFTC take an enforcement action against any operator of a securitization vehicle formed prior to October 12, 2012, 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 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 and will not issue new securities on or after October 12, 2012; and
3. The Issuer shall, promptly upon request of the CFTC an electronic copy of the following: (a) the most recent disclosure document used in connection with the offering of the related securities, (b) all amendments to the principal documents since issue, (c) the most recent distribution statement to investors and (d) if the Issuer's securities were offered relying on Rule 144A under the Securities Act of 1933, as amended, a copy of the information that would be provided to prospective investors to satisfy Rule 144A(d)(4) under the Securities Act of 1933, as amended; provided, that if the Issuer does not provide the information required hereunder, it must demonstrate that it cannot obtain the required documents through reasonable commercial efforts.

³ The Division states, however, that if investors of a securitization vehicle have exposure to swaps that are used to create investment exposure (such as if payments to investors are affected by swaps other than to enhance credit or to swap interest rates or currencies), then the securitization vehicle may be a commodity pool (depending on additional facts and the relative proportion of such swaps relative to the total financial assets of the vehicle).

B. Temporary Relief for Securitization Vehicles Unable to Rely on the 12-14 No-Action Letter or the 12-45 No-Action Letter

The Division notes that they remain open to discussions with securitization sponsors to consider the facts and circumstances of their securitization vehicles that do not conform to the requirements of the 12-14 No-Action Letter or the 12-45 No-Action Letter in order to determine whether such securitization vehicles might still be excluded from the definition of commodity pool and whether other relief might be appropriate under the circumstances. Accordingly, the Division will not recommend the CFTC take enforcement action against the operator of such securitization vehicles for failure to register as a CPO until March 31, 2013.

This DerivativesINSIGHT is provided for your convenience and does not constitute legal advice. It is prepared for the general information of our clients and other interested persons. This DerivativesINSIGHT should not be acted upon in any specific situation without appropriate legal advice and may include links to websites other than the White & Case website.

White & Case has no responsibility for any websites other than its own and does not endorse the information, content, presentation or accuracy, or make any warranty, express or implied, regarding any other website.

This DerivativesINSIGHT is protected by copyright. Material appearing herein may be reproduced or translated with appropriate credit.