



Commodity Pool Regulation

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Derivatives: Commodity Pool Regulation

Background

- Historically, securitization vehicles entered into swaps without being subject to regulation by the Commodity Futures Trading Commission (the “**CFTC**”) as “commodity pools.”
- Dodd-Frank amended the Commodity Exchange Act (the “**CEA**”) to create a statutory definition of “commodity pool,” defined as an “investment trust, syndicate, or similar form of enterprise **operated for the purpose of** trading in commodity interests, including any... swap.” Notably, this new definition for the first time treats swaps as commodity interests.
- Industry participants continue to believe that their securitization vehicles that hold swaps are not commodity pools under the new definition because they are established and operated for the purpose of financing a pool of financial assets, rather than for the purpose of trading in swaps.
- However, the addition of swaps to those interests that may make an entity a commodity pool, coupled with the CFTC’s broad interpretation of its authority to regulate entities involved in swaps, raise a question as to whether securitization vehicles that enter into swaps might be commodity pools under the revised framework.

Derivatives: Commodity Pool Regulation (Continued)

Impact if a Securitization Vehicle Determined to be a Commodity Pool

- If a securitization vehicle were determined to be a “commodity pool,” certain persons who form or have administrative or other responsibilities in relation to the securitization would be “commodity pool operators” (“**CPOs**”) and, without a relevant exemption, would be required to register with the National Futures Association.
- In addition, commodity pools falls within the definition of “covered funds” under the proposed rules implementing Section 619 of Dodd-Frank (the “**Volcker Rule**”), which restricts the ability of banks to own, sponsor or enter into certain transactions with covered funds. Accordingly, securitizations that would otherwise be exempt from the requirements of the Volcker Rule could be deemed to be covered funds subject to the Volcker Rule simply because they make use of swaps for hedging or risk management purposes.

Derivatives: Commodity Pool Regulation (Continued)

The October 11 Letter – Initial Interpretive Guidance

- By letter dated October 11, 2012 (the “**October 11 Letter**”), the Division of Swap Dealer and Intermediary Oversight (the “**Division**”) of the CFTC released interpretive guidance confirming that certain securitization vehicles should not be included within the definition of “commodity pool” and that operators of such vehicles should not be included within the definition of “commodity pool operator” under the CEA and CFTC rules.
- Separately, in a no-action letter dated October 11, 2012, the Division conditionally extended the deadline for registration as a commodity pool operator from October 12, 2012 to December 31, 2012 for vehicles that are commodity pools solely by virtue of their involvement with swaps.
- The October 11 Letter provided relief for many traditional securitization vehicles, but left open questions for other securitization vehicles, including those whose operating or trading activities are more active than contemplated by the October 11 Letter.

Derivatives: Commodity Pool Regulation (Continued)

Initial Interpretive Guidance

In the October 11 Letter, the Division concludes that securitization vehicles that satisfy five criteria should not be “commodity pools” nor should their operators be “commodity pool operators” under the CEA. The Division’s criteria establish an information “safe harbor” that many traditional securitization vehicles will satisfy. Those five criteria are:

1. Entity Must Operate Consistent with Conditions in Regulation AB or Rule 3a-7.

The issuer of the asset-backed securities must be “operated consistent with the conditions set forth in Regulation AB or Rule 3a-7” under the Investment Company Act of 1940 (the “ICA”), whether or not the offering is in fact regulated thereunder, so long as the issuer, pool assets, and asset-backed securities satisfy the requirements of either regulation.

The Division indicates that an issuer engaged in private issuances of asset-backed securities, or that relies on an exemption from registration under the ICA other than Rule 3a-7, may nevertheless satisfy the criterion so long as the issuer was operated consistent with the conditions set forth in Regulation AB or Rule 3a-7. Stated another way, this criterion requires that the issuer, pool assets and issued securities satisfy the requirements of either regulation regardless of whether they are subject to those regulations.

Derivatives: Commodity Pool Regulation (Continued)

2. Activities Limited to Passively Owning the Assets.

- The entity's activities must be limited to passively owning or holding a pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite period of time plus rights and other assets designed to assure the servicing or timely distribution of proceeds.
- The Division confirms that issuers that are master trusts or that issue ABS supported by leased assets would satisfy this criterion so long as the issuer satisfies the terms of Regulation AB (for example, in the case of master trusts, by adding additional assets to the pool only as permitted under Regulation AB and, in the case of lease-based ABS, by capping the portion of the securitized pool balance attributable to the residual value of the leased assets).
- The Division indicates that the term "financial asset" does not include transactions whereby an entity obtains exposure to an asset that is not part of the asset pool. Consequently, synthetic ABS are unable to satisfy this criterion and are excluded from the scope of the Interpretation.

Derivatives: Commodity Pool Regulation (Continued)

3. Limitation on Use of Derivatives.

The entity's use of derivatives is limited to uses permitted under the terms of Regulation AB, which the Division describes to include credit enhancement and the use of interest rate and currency swaps to alter the payment characteristics of the issuer's cash flows.

4. Payments May Not be Linked to Market Value Changes.

The sole source of payments to security holders must be cash flow generated from the assets in the pool, and not from or otherwise based upon changes in the value of the assets in the pool.

5. Prohibition on Trading for Gain or Loss Mitigation.

The issuer may not acquire or dispose of assets for the primary purpose of realizing gain or minimizing losses due to market value fluctuations.

Derivatives: Commodity Pool Regulation (Continued)

The December 7 Letter – Additional, Expanded Interpretive Guidance

- By letter dated December 7, 2012 (the “**December 7 Letter**”), the Division of the CFTC released interpretive guidance significantly expanding the scope of the October 11 Letter. In the December 7 Letter, the Division stated its view that certain securitization vehicles that do not satisfy the operating or trading limitations contained in Regulation AB or Rule 3a-7 should not be “commodity pools,” so long as certain conditions are satisfied.
- The Division also provided broad no action relief from CPO registration requirements for legacy securitizations that issued fixed income securities before October 12, 2012 and that satisfy the other conditions described below.
- Finally, for securitization vehicles that do not fall within the scope of of the interpretive relief or the legacy no-action relief, the Division further extended the deadline for registration as a commodity pool operator from December 31, 2012 to March 31, 2013.

Derivatives: Commodity Pool Regulation (Continued)

Additional, Expanded Interpretive Guidance

- The December 7 Letter expands the scope of the Division's interpretive relief beyond that provided in the October 11 Letter, to cover certain securitization vehicles that do not satisfy the operating or trading limitations contained in Regulation AB or Rule 3a-7 so long as they satisfy the following conditions:
 - (1) the vehicles activities are limited to owning or holding financial assets, as required under criterion 2 from the October 11 Letter; and
 - (2) the vehicles use of swaps is no greater than that contemplated by Regulation AB or Rule 3a-7 and such swaps are not used in any way to create an investment exposure.

Derivatives: Commodity Pool Regulation (Continued)

The Division provides several examples of securitization vehicles that would satisfy the conditions outlined on the previous slide and, therefore, would not ordinarily be commodity pools.

1. Asset-Backed Commercial Paper Conduits

- The Division indicates that standard asset-backed commercial paper (“**ABCP**”) conduits, described as special purpose entities that issue asset-backed senior promissory notes and use the proceeds from the sale of such notes to acquire interests in financial assets, would not ordinarily be commodity pools.
- The Division notes that many ABCP conduits may not meet one or more of the criteria set forth in the October 11 Letter, either because the ABCP does not meet the Regulation AB definition of “asset-backed security” or because the ABCP conduits do not employ independent trustees as generally required by Rule 3a-7.
- Nevertheless, the Division concludes that an investment in a standard ABCP conduit is “not unlike an investment in a traditional securitization that satisfies Regulation AB or Rule 3a-7 in that the investment is essentially in the financial assets in the vehicle and not in the swaps” held by it.

Derivatives: Commodity Pool Regulation (Continued)

2. Collateralized Debt Obligations

- The Division indicates that traditional collateralized debt obligation structures (“**CDOs**”) that own only financial assets consisting of corporate loans, corporate bonds or investment grade mortgage-backed and asset-backed securities, or CDO tranches issued by vehicles that are not themselves commodity pools, would not ordinarily be commodity pools.
- In this example, the Division describes a CDO structure where 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 where interest rate and foreign currency swaps are used to hedge the payment characteristics of the underlying financial assets and may not be terminated before the related hedged assets has become liquidated.
- Once again, the Division likens an investment in a traditional CDO to an investment in a traditional securitization that satisfies Regulation AB or Rule 3a-7, in that the investment is essentially in the financial assets and not in the swaps held by it.
- In contrast, however, the Division indicates that a CDO that uses swaps to create investment exposure, such that investors may be affected by swaps in ways beyond the uses contemplated in Regulation AB or Rule 3a-7, may be a commodity pool. The Division illustrates this principle using an example where the CDO structure permits a 5% bucket for synthetic assets, instead of having 100% of its holdings comprised of financial assets.

Derivatives: Commodity Pool Regulation (Continued)

3. Covered Bonds

- The Division also summarily indicates that in a covered bond transaction neither the collateral pool nor the special purpose vehicle (in a structured model) would ordinarily be a commodity pool if it contains no commodity interests other than swaps that are used only for purposes permitted by Regulation AB.
- Covered bond holders must also be entitled to receive only payments of accrued interest and repayment of principal, without any condition to payment based upon any derivative exposure.

Derivatives: Commodity Pool Regulation (Continued)

Examples of Certain Vehicles that May be Commodity Pools

The Division also provides examples of certain securitization vehicles that, in its view, would not satisfy the conditions outlined in the December 7 Letter and, therefore, may be commodity pools. In each case, the Division bases its view on the premise that the vehicle is using a swap to create an investment exposure in a manner beyond that contemplated by Regulation AB or Rule 3a-7. These examples include:

- A repackaging vehicle that issues credit-linked or equity-linked notes, where the vehicle owns high quality financial assets, but the vehicle (and, in turn, its investors) obtain exposure to a broad based stock index through a swap.
- A repackaging vehicle that pairs a three year bond with a swap to provide its investors with a four year tenor bond or an inflation rate protected bond.
- A repackaging vehicle where the use of a swap is “commercially unreasonable” as credit support, which the Division illustrates in an example that pairs a “CCC” rated bond with a swap from the vehicle’s affiliate or sponsor that provides credit support sufficient to enable the vehicle to issue an “AA” rated note.

Derivatives: Commodity Pool Regulation (Continued)

Discussion of Interpretive Guidance

- As noted by the Division, the conditions for relief set forth in the October 11 Letter essentially define a type of passive investment in and financing of financial assets that receive only limited types of support from swaps and, as such, qualify to use an alternative disclosure regime under Regulation AB or an exemption from regulation under the Investment Company Act of 1940. In cases where an issuer's operating or trading activities are more active than contemplated in the October 11 Letter, where the issuer does not limit its investments to financial assets that are used to pay the issuer's securities, or where the issuer uses swaps to create synthetic investment exposure, the issuer would not be able to claim the exclusion provided in the October 11 Letter.
- The Division's further interpretive guidance in the December 7 Letter provides relief to a broad range of securitization vehicles that do not satisfy the operating or trading limitations contained in Regulation AB or Rule 3a-7, so long as the vehicle's activities are limited to owning or holding financial assets, as required by criterion 2 from the October 11 Letter, and it does not use swaps to create investment exposures in a manner beyond that contemplated by Regulation AB or Rule 3a-7.
- The Division does not define the term "securitization vehicle," but we believe the Division intended the term to be construed broadly, to include any vehicle commonly thought to be a securitization. The Division's examples tend to bear this out – likening standard ABCP conduits, traditional CDOs and even covered bond transactions to investments in traditional securitizations.

Derivatives: Commodity Pool Regulation (Continued)

No-Action Relief for Certain Legacy Transactions

- In the case of legacy securitization transactions that fall outside the scope of both the October 11 Letter and the December 7 Letter, the Division has also provided broad no-action relief from the CPO registration requirements if the following conditions are and remain satisfied:
 - (1) The issuer issued fixed income securities before October 12, 2012 (the date on which CPO registration would have been required but for the October 11 Letter) 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.
 - (3) The issuer shall promptly upon request from the CFTC provide electronic copies of disclosure and other documents pertaining to the transaction, or demonstrate that it cannot do so using commercially reasonable efforts.
- It is important to note that securitization vehicles that are eligible for this no action relief may still be deemed to be commodity pools and, if so, would still fall within the definition of “covered funds” under the proposed Volcker Rule.

Derivatives: Commodity Pool Regulation (Continued)

Temporary No-Action Relief for Securitizations that Cannot Rely on the Interpretive Guidance or the Legacy No-Action Relief

- The Division notes that it remains open to discussions with securitization sponsors that cannot rely on the interpretive guidance or the legacy no-action relief to determine whether those securitizations might properly avoid designation as a commodity pool or whether other relief might be appropriate.
- Because the Division will be continuing its dialogue with the securitization industry, the Division has also provided no action relief extending the deadline for registration as a CPO from December 31, 2012 to March 31, 2013.

Derivatives: Commodity Pool Regulation (Continued)

Registration of Commodity Pool Operators

- If a securitization vehicle were determined to be a “commodity pool,” certain persons who form or have administrative or other responsibilities in relation to the securitization vehicle would be “commodity pool operators” and, without a relevant exemption, register with the National Futures Association by March 31, 2013.
- Certain securitization vehicles may be eligible for the “de minimis” exemption from CPO registration. That exemption, set forth under CFTC Rule 4.13(a)(3), provides registration relief to a CPO operating a pool offered to certain sophisticated investors that engages in a de minimis amount of futures trading.
- Securitizations that plan to take advantage of the de minimis exemption must provide notice to the National Futures Association of the election to do so and must satisfy the other notice requirements of the exemption by March 31, 2013.
- Regardless of whether a CPO registers or is exempt from registration, an entity deemed to be a CPO will be subject to CFTC recordkeeping rules and other general compliance requirements.

Derivatives: Commodity Pool Regulation (Continued)

Commodity Trading Advisors

- With respect to any person who could be required to register as a commodity trade advisor (“CTA”) because it provides advice to securitization entities as to the value or advisability of trading in swaps, the Interpretation does not provide relief.
- A person may be a CTA subject to registration whether or not the entity to which it provides advice is a commodity pool.
- Persons who could otherwise be found to be engaged in providing swap-related advice to a securitization entity may be able to take advantage of several existing exceptions to CTA registration, including an exclusion for persons that advise fewer than 15 persons during a one year period and on exclusions for banks and trust companies providing advice that is incidental to their business.

Derivatives: Commodity Pool Regulation (Continued)

Requirements of CPOs and CTAs

- In general, CPOs and CTAs are subject to increased duties and a heightened standard of care (as compared with sponsors or servicers in securitizations) and, therefore, greater risk of potential liability. CPOs and CTAs also must become members of the National Futures Association (NFA), and NFA members are subject to periodic examination and audit and must ensure that their “associated persons” satisfy certain proficiency examination requirements.
- Persons acting as CPOs or CTAs without registration (or exemption from registration) would be in violation of the CEA and could be subject to penalties.