Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS DECEMBER 21, 2012

Commodity Pool Regulation of Securitization Vehicles – CFTC Staff Expands Prior Relief and Provides Broad Exclusion from Commodity Pool Definition; Also Provides No Action Relief for Legacy Transactions and Extension of CPO Registration Deadline to March 31, 2013

By letter dated December 7, 2012, the Division of Swap Dealer and Intermediary Oversight (the "*Division*") of the Commodity Futures Trading Commission (the "*CFTC*") released interpretive guidance (the "*December 7 Letter*") significantly expanding the scope of its October 11, 2012 interpretive letter (the "*October 11 Letter*"). The October 11 Letter confirmed that securitization vehicles that satisfy five criteria, including a requirement that they operate consistent with either Regulation AB or Rule 3a-7 under the Investment Company Act of 1940, should not be "commodity pools" as a result of holding a swap nor should their operators be required to register as "commodity pool operators" under the Commodity Exchange Act (the "*CEA*") and CFTC rules. Our Client Alert summarizing the October 11 Letter can be found at http://www.chapman.com/media/news/media.1215.pdf.

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 Rules 3a-7 should not be "commodity pools," so long as their activities are limited to owning or holding financial assets, their 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. The Division specifically identifies three types of securitization vehicles — traditional asset-backed commercial paper vehicles, covered bonds and certain CDOs with no synthetic assets — that it believes are not commodity pools.

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 the interpretive relief or the legacy no-action relief, the Division extended the deadline for registration as a commodity pool operator from December 31, 2012 to March 31, 2013.

A copy of the December 7 Letter can be found here: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-45.pdf.

Background

Historically, securitization vehicles entered into swaps without being subject to regulation by the CFTC as "commodity pools." The Dodd-Frank Wall Street Reform and Consumer Protection Act ("*Dodd-Frank*") amended 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. 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 fall 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.

The October 11 Letter — Initial Interpretive Guidance

As discussed in more detail in our Client Alert summarizing the October 11 Letter, the Division's initial interpretive guidance provided relief for securitization vehicles meeting each of the following five criteria:

1. The securitization vehicle must operate consistent with conditions in Regulation AB or Rule 3a-7.
2. The vehicle's activities must be limited to passively owning or holding receivables or other financial assets.
3. The vehicle's use of derivatives must be limited to uses permitted under Regulation AB, which includes use of interest rate and currency swaps and as credit enhancement.
4. Payments to security holders must be sourced from asset pool and may not be linked to market value changes.
5. The vehicle must not acquire or dispose of assets for primary purpose of realizing gain or minimizing loss due to market value changes.

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.

The December 7 Letter — Additional, Expanded Interpretive Guidance

The December 7 Letter expands the scope of the Division's interpretive relief beyond that provided in its 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:

- the vehicle's activities are limited to owning or holding financial assets, as required under criterion 2 from the October 11 Letter, and
- the vehicle's 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.

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

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" ("ABS")[1] 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.

1 The Division observes that ABCP may not meet the Regulation AB-ABS definition because ABCP is repaid in the ordinary course from proceeds of "rolling" commercial paper or, if new commercial paper cannot be issued, from liquidity and credit facilities provided by a financial institution.

Collateralized Debt Obligations

As another example, 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 asset has been 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.[2]

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 any 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.

[2] The Division notes, however, that given the relatively small size of a 5% synthetic bucket, the operator of that CDO may be exempt from registration under the "de minimis" exemption afforded by CFTC Rule 4.13(a)(3).

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 above 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.

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.

We also believe that market participants need not take an overly formulaic approach when applying the December 7 Letter, or the examples included in that letter, to specific transactions and issuing vehicles. As noted above, it is clear that the Division intended its further relief to cover issuers whose operating or trading activities are more active than contemplated in the October 11 Letter. The examples provided by the Division illustrate this principle, but we do not believe those examples were intended, in and of themselves, to introduce further conditions or otherwise further limit the scope of the relief provided.

Instead, we believe that the only limitations on the scope of the relief provided to securitization vehicles are those expressly set forth in the December 7 Letter – namely, that the conditions with respect to the ownership of financial assets and with respect to the usage of swaps continue to be observed.

It is clear, however, that certain securitizations remain beyond the scope of the Division’s relief, such as synthetic securitizations and certain repackaging vehicles tailored to create a specific investment exposure through the use of a swap. In these cases, the Division may view the swap as a “significant component of [the] investment upside or downside” or as significantly altering the character of the exposure that would arise from an investment in the cash assets held in the pool.

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 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.

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.

Conclusion

Most traditional asset-backed and mortgage-backed securitizations were able to continue to operate outside the jurisdiction of the CFTC as a result of the release of the October 11 Letter, and a significantly broader range of securitization vehicles with more active operating and trading activities are able to continue to operate outside the CFTC's jurisdiction as a result of the release of the December 7 Letter, so long as they invest in financial assets and receive only limited types of support from swap transactions. Issuers should, however, consult with their counsel to determine whether their specific structures and asset pools fit within the commodity pool exclusion set forth in these interpretive letters or otherwise fall outside the scope of the CFTC's regulation. For those securitizations that are "commodity pools," an appropriate entity will be required to register as a CPO, or meet the *de minimis* exemption to registration, on or before March 31, 2013.

If you would like to discuss any of the issues addressed in this Client Alert or would simply like to find out more about Chapman, please contact any attorney in Chapman's Asset Securitization Department or visit us online at chapman.com.

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