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Commodity Pool Operators and Commodity Trading Advisors

CFTC Grants Additional Relief from CPO Regulation for Operators of Certain Securitization Vehicles

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By Richard Chen, *Hedge Fund Law Report*

On December 7, 2012, the CFTC's Division of Swap Intermediary Oversight (Division) issued Letter 12-45, expanding the scope of relief from commodity pool regulation for certain securitization and structured finance vehicles (securitization vehicles) and their operators (Follow-On Letter). This additional relief expanded upon the relief granted by the Division in Letter 12-14 (Initial Letter) issued on October 11, 2012 excluding certain securitization vehicles from the definition of a "commodity pool" if delineated conditions are satisfied and a separate no-action letter granting temporary relief from registration for certain non-exempt operators of securitization vehicles deemed to be commodity pools. For starters, in the Follow-On Letter, the Division expanded the exclusion from the definition of "commodity pool" for certain securitization vehicles that trade swaps but did not qualify for the relief granted in the Initial Letter because they could not comply with the trading and operating limitations set forth in Regulation AB and Rule 3a-7 under the Investment Company Act of 1940. Second, the Division granted permanent no-action relief from CPO registration for operators of certain "grandfathered" securitization vehicles as long as certain conditions are satisfied, including the fact that the securitization vehicles have not issued and will not issue new securities on or after October 12, 2012. Third, the Division extended temporary no-action relief for non-exempt CPOs by indicating that it will not take enforcement action if CPOs do not become registered as such until March 31, 2012, where they were previously required to file documentation to register with the CFTC by December 31, 2012. This article summarizes the additional guidance and relief granted in the Follow-On Letter.

Background

In October 2012, the CFTC confronted the necessity of having to determine the commodity pool status of many securitization vehicles that utilize swaps. A commodity pool is defined as "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests." The Dodd-Frank Act expanded the definition of "commodity interest" in CFTC regulations to include swaps. The definition of what constitutes a swap was further refined by the "product definitions" adopted by the CFTC and the SEC, which became effective on October 12, 2012. As such, operators of securitization vehicles have had to consider whether their securitization vehicles that trade swaps are considered to be commodity pools, which could subject such pools to various CFTC compliance obligations and such operators to

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registration as CPOs. See "How Do New Commodities Regulations Impact Hedge Fund Managers with Respect to Registration, Marketing, Trading, Audits and Drafting of Governing Documents?," Hedge Fund Law Report, Vol. 5, No. 18 (May 3, 2012).

Recognizing that many operators of securitization vehicles had to make that determination (and become registered if necessary) prior to the October 12, 2012 effective date of the product definitions, the CFTC issued limited relief for certain types of securitization vehicles that excluded them from the definition of a "commodity pool" and granted temporary registration relief permitting certain securitization vehicles that were required to register by October 12, 2012 to do so by December 31, 2012.

In the Initial Letter, the CFTC provided that whether a pooled investment vehicle such as a securitization vehicle constitutes a "commodity pool" must be determined on a case-by-case basis after evaluating "the facts and circumstances presented in their entirety." The Division "tended to agree" that certain securitization vehicles are "likely not" commodity pools, such as those that "do not have multiple equity participants; do not make allocations of accrued profits or losses; and only issue interests in the form of debt or debt-like interests with a stated interest rate or yield and principal balance and a specific maturity date."

In that regard, the CFTC provided guidance indicating that an asset-backed securitization vehicle that satisfies a number of specific criteria would not come within the definition of a "commodity pool" and that the sponsor of that securitization vehicle would not be deemed a "commodity pool operator." Those criteria are:

- The issuer of the asset-backed securitization vehicle is operated consistent with the conditions set forth in Regulation AB, or Rule 3a-7, whether or not the issuer's securities offerings are in fact regulated pursuant to either regulation, so long as the issuer, pool assets and asset-backed securities satisfy the requirements of either regulation;
- The securitization vehicle's activities are limited to passively owning or holding a pool of receivables or other financial assets, which may be either fixed or revolving, 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;
- The securitization vehicle'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;
- 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
- 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.

The Division made clear in the Initial Letter that it was not concluding that satisfaction of these criteria was the only method of excluding a securitization vehicle from the definition of a commodity pool. In fact, the Division invited sponsors of securitization vehicles to comment on the facts and circumstances of their non-conforming securitization vehicles with the goal of determining whether such vehicles could constitute commodity pools, and, if so, whether additional relief should be granted with respect to such pools.

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Follow-On Letter

Following a period of discussions with the securitization industry, the Division issued the Follow-On Letter in which it provided additional guidance expanding the exclusion from the definition of "commodity pool" for many securitization vehicles and provided additional permanent no-action relief for certain securitization vehicles.

Expanded Exclusion from the Definition of a Commodity Pool

To begin with, the Division expanded the exclusion from the definition of commodity pool for certain securitization vehicles whose offered securities do not qualify as "asset-based securities" pursuant to Regulation AB and do not qualify for an exemption from the definition of "investment company" contained in Rule 3a-7. More specifically, the Division determined to exclude from the definition of commodity pool certain securitization vehicles that do not meet the trading and operating limitations found in Regulation AB or Rule 3a-7 as long as (1) the criterion with respect to the ownership of financial assets is satisfied, (2) the securitization vehicle's use of swaps is no greater than that contemplated by Regulation AB and Rule 3a-7, and (3) swaps are not used in any way to create investment exposure. The Division provided four examples with respect to its guidance:

- *Standard Asset-Backed Commercial Paper Conduit.* This is a special purpose vehicle that issues asset-backed senior promissory notes and uses the resulting proceeds to purchase interests in financial assets. The Follow-On Letter pointed out that the promissory notes issued by such vehicles may not constitute "asset-backed securities" as defined in Regulation AB because they are repaid in the ordinary course from proceeds from newly-issued promissory notes, and, if those cannot be issued, from liquidity and credit facilities provided by a financial institution. In addition, most asset-backed commercial paper conduits do not employ independent trustees, which is generally required by Rule 3a-7. Although such vehicles would not technically satisfy the criteria set forth in the Initial Letter, the Division rationalized that such vehicles should be excluded from the definition of a commodity pool because, like other traditional securitizations, the investment is in the financial assets of the vehicle and not in the swaps.
- *Certain Traditional Collateralized Debt Obligation* (CDOs). The Division next cited the example of a traditional CDO. A typical cash CDO would not satisfy the fixed pool requirements of the Regulation AB definition of "asset-backed security," Rule 3a-7 or the guidance from the Initial Letter because such vehicles typically permit trading in the financial assets held by the CDO. For more on typical CDO and related collateralized loan obligation structures, see "Key Legal and Business Considerations for Hedge Fund Managers When Purchasing Collateralized Loan Obligation Management Contracts," Hedge Fund Law Report, Vol. 3, No. 13 (Apr. 2, 2010). However, to the extent that the CDO 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, then the CDO could qualify for relief pursuant to the Follow-On Letter. Pursuant to the terms of these structures, the financial assets are allowed to be traded up to twenty percent of the aggregate principal balance of all financial assets owned by the issuer for three years. The CDO utilizes foreign exchange swaps to convert Euro-denominated assets into U.S. dollars and interest rate swaps to convert

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fixed-rate financial assets to floating-rate assets. These swaps may not be terminated before the sale of the related hedged asset. The Division concluded that an investment in this type of CDO is not unlike an investment in a securitization vehicle that satisfies Regulation AB or Rule 3a-7 in that the investment is in the financial assets of the vehicle and not in the swaps, which are used to hedge interest rate and currency exposure. However, to the extent that the swaps create investment exposure for an investor (e.g., a swap is used for a purpose other than to enhance credit within reason or swap interest rates or currencies as permitted by Regulation AB), the CDO may then constitute a commodity pool. For instance, if the CDO allows for a five percent bucket for synthetic assets consisting of swaps (as opposed to having all holdings be comprised of financial assets), then the securitization vehicle could constitute a commodity pool. Nonetheless, the operator of such a pool could still qualify for the Rule 4.13(a)(3) registration exemption for pools where there is de minimis trading in commodity interests. See "NFA Workshop Details the Registration and Regulatory Obligations of Hedge Fund Managers That Trade Commodity Interests," Hedge Fund Law Report, Vol. 5, No. 47 (Dec. 13, 2012).

- *Certain Repackaging Vehicles.* A repackaging vehicle that issues credit-linked notes or equity-linked notes where the vehicle owns high quality financial assets, but sells credit protection on a broad-based index or obtains exposure to a broad-based index through a swap, would not qualify for relief pursuant to the Follow-On Letter and could constitute a commodity pool because the investors have significant investment exposure to swaps through the credit-linked notes or equity-linked notes. Other examples where a repackaging vehicle could constitute a commodity pool include (1) a repackaging vehicle that purchases a three-year bond, issues a tranche of notes and uses swaps to extend the experience of a bond (and the tranche of notes) to four years; and (2) a repackaging vehicle that pairs a three-year bond with a swap to provide inflation-rate protection to investors. In either scenario, an investor's investment return is dependent in part on the performance of the swaps. On the other hand, a covered bond transaction where the collateral pool (or the special purpose vehicle in a structured model) contains no commodity interests other than swaps used for purposes permitted by Regulation AB and where investors simply receive payments of accrued interest and repayment of principal on their covered bonds without any condition to payment based on derivative exposure could qualify for the expanded exclusion from the definition of a commodity pool provided in the Follow-On Letter.
- *Swaps Used to Provide Credit Support for Financial Assets.* The Division confirmed that it would not consider a securitization vehicle's commercially reasonable use of swaps for the purpose of providing credit support for financial assets in a securitization or the notes issued by the securitization vehicle to the extent contemplated by Item 1114 of Regulation AB as causing that securitization vehicle to be considered a commodity pool because such swaps would not be deemed to create investment exposure for investors. However, if swaps are used in a commercially unreasonable manner so as to create investment exposure for investors, the securitization vehicle may then constitute a commodity pool. For an example of the commercially unreasonable use of swaps, the Division cited to a securitization vehicle that holds floating-rate bonds rated "CCC" issued by a "distressed jurisdiction" and simultaneously enters into a swap with its affiliate/sponsor which provides credit support for interest and principal sufficient to obtain "AAA" pricing of the

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trust notes. The Division would consider this use of a swap commercially unreasonable thus causing the securitization vehicle to constitute a commodity pool because of the significant investment exposure created by the swap.

Grandfathering Provision

The Division also issued permanent no-action relief from CPO registration for operators of certain securitization vehicles organized prior to October 12, 2012. More specifically, the Division indicated that it would not take enforcement action against CPOs for failing to register as such as long as:

- the issuer issued fixed-income securities prior to October 12, 2012, that are backed by and structured to be paid from payments or proceeds received in respect of, and whose creditworthiness primarily depends upon, cash or synthetic assets owned by the issuer;
- the issuer has not and will not issue new securities on or after October 12, 2012; and
- the issuer will, within five days of receipt by a request from the CFTC, provide an electronic copy of certain transaction documents, including: (1) the disclosure document used in connection with the offering of the related securities, (2) all amendments of the principal documents since issue, (3) the most recent distribution statement issued to investors, and (4) all information that would be supplied to prospective investors pursuant to Rule 144A(d)(4) under the Securities Act of 1933 (Securities Act) if the securities were offered in reliance on Rule 144A under the Securities Act unless the issuer can demonstrate that it could not obtain the aforementioned documents through reasonable commercial efforts.

Temporary No-Action Relief

Setting aside the above-referenced relief granted in the Follow-On Letter, the Division acknowledged that it continues to dialogue with the securitization industry to determine whether additional relief should be granted to those ineligible to rely on the relief granted in either the Initial Letter or the Follow-On Letter. As such, the Division indicated that it will not take enforcement action against the operator of securitization vehicles for failing to register as CPOs until March 31, 2013.

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