

CFTC Staff Confirms that Certain Securitizations are Not Commodity Pools and Extends Registration Deadline for Certain Commodity Pools

By letter dated October 11, 2012, the Division of Swap Dealer and Intermediary Oversight (the "Division") of the Commodity Futures Trading Commission (the "CFTC")¹ released interpretive guidance (the "Interpretation") 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 Commodity Exchange Act (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.

For a copy of the Division's Interpretation visit:
<http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/12-14.pdf>.

For a copy of the Division's no-action letter visit:
<http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/12-15.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

¹ Readers should note that the Division states in the Interpretation that the views expressed therein are the views of the Division only and do not necessarily represent the views of the CFTC or any other division of the CFTC.

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 expansion in the scope of commodity pool regulations to include swaps, coupled with the CFTC's broad interpretation of its authority to regulate entities involved in swaps, raise a question regarding 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 commodity pools (and, by extension, covered funds) subject to the Volcker Rule simply because they make use of swaps for hedging or risk management purposes.

The Division's Interpretation

In the Interpretation, 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. Those five criteria are:

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.²

The Division indicates that an issuer engaged in private issuances of asset-backed securities, or that relies on an exemption or exclusion from registration under the ICA other than Rule 3a-7, may nevertheless satisfy this 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.

Activities Limited to Passively Owning 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 asset-backed securities 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-backed asset-backed securities, by capping the portion of the securitized pool balance attributable to the residual value of the leased assets). On the other hand, 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 asset-backed securities are unable to satisfy this criterion and are excluded from the scope of the Interpretation.

² Regulation AB includes a definition of “asset-backed security” and prescribes disclosure, reporting and other requirements for publicly-registered asset-backed securities. Rule 3a-7 provides an exemption from registration under the ICA for issuers of asset-backed securities and prescribes parameters for eligibility under the rule.

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.

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.

Prohibition of Trading for Gain or Loss Mitigation. The issuer may not acquire or dispose of assets for the primary purpose of realizing gain or minimizing loss due to market value fluctuations.

Discussion

As noted above, a “commodity pool” is defined to be an “investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any . . . swap.” Historically, in furtherance of its customer and market protection mandate, the CFTC has been unwilling to interpret the phrase “operated for the purpose of trading” narrowly; insisting instead that the determination of whether an entity may or may not be a commodity pool requires “an evaluation of all the facts relevant to the entity’s operation.” The Division’s Interpretation represents, therefore, a fairly significant departure from past practice -- establishing the five criteria outlined above as an informal “safe harbor” that many traditional securitization vehicles will satisfy.

Most of the criteria have been adapted from Regulation AB or Rule 3a-7 and, as a consequence, their meaning and scope are generally understood in the marketplace. The one possible exception is the first criterion, which requires that the issuer of the asset-backed securities be “operated consistent with” the conditions set forth in Regulation AB or Rule 3a-7. While application of this criterion in the context of Rule 3a-7 is relatively straightforward, its application in the context of Regulation AB may not be as clear. We believe, however, that the only operating requirements imposed on an issuer in Regulation AB are those set forth in the Regulation AB definition of “asset-backed security.”³ Accordingly, an asset-backed issuer

³ The Regulation AB definition of “asset-backed security” requires: (i) that neither the depositor nor the issuing entity be an investment company; (ii) that the activities of the

that is operated consistent with the conditions set forth in that definition should satisfy the first criterion.

While many traditional securitization vehicles will be able to satisfy the five criteria set forth in the Interpretation, it is also clear that other securitization vehicles will not. It is notable therefore that, while not within the scope of the Interpretation's relief, the Division indicates that it "tends to agree" that entities that meet certain general principles are likely not commodity pools, such as securitization vehicles that do not have multiple equity participants, that do not make allocations of accrued profits or losses, and that 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. Operators of such vehicles, with the advice of counsel, may apply those principles in the totality of the facts relevant to the entity's operations and be comfortable concluding that they are not commodity pools. Alternatively, they may wish to engage in further discussions with the CFTC for particular products or categories of products.⁴

Note, however, that the Interpretation specifically identifies other sorts of financings or investments that may not preclude the issuer from being a commodity pool, such as covered bonds, collateralized debt obligations, collateralized loan obligations, securities backed by insurance-related assets and synthetic securitizations. Vehicles that cannot meet the criteria for explicit relief in the Interpretation, that cannot obtain other relief from the CFTC, or that are not otherwise comfortable concluding that they are not commodity pools subject to the CFTC's regulatory authority must, in the absence of an exemption, identify a party acting as a CPO with respect to such

issuing entity be limited to passively owning or holding the asset pool, issuing the asset-backed securities and engaging in other activities incidental thereto; (iii) that, with some exceptions, the asset pool be discrete and be comprised of self-liquidating financial assets; and (iv) that the securities themselves be primarily serviced by the associated cash flows.

⁴ The Interpretation includes a specific notation that the Division remains open to discussions with securitization sponsors to consider the facts and circumstances of their securitization structures with a view to determining whether or not they might not be properly considered a commodity pool, or where not sufficiently assured, whether other relief might be appropriate under the circumstances, such as where a fund might be treated as an exempt pool.

vehicle and complete the registration process by December 31, 2012.

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 CPO registration relief to a CPO operating a pool offered to certain sophisticated investors that engages in a de minimis amount of futures trading. To qualify for the de minimis exemption, the pool must meet one of the following tests with respect to its commodity interest positions, whether entered into for bona fide hedging purposes or otherwise:

(1) Five Percent Test: The aggregate initial margin or premiums required to establish such positions, determined at the time the most recent position was established, will not exceed 5 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into; or

(2) Net Notional Test: The aggregate net notional value of such positions, determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into.

However, vehicles that meet the exemption will be commodity pools and, therefore, will be subject to the CFTC's recordkeeping rules and other general compliance requirements of CPOs. In addition, banks with ownership interests in or relationships with exempt commodity pools may still be subject to the constraints of the Volcker Rule.

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 December 31, 2012.

With respect to any person who could be required to register as a commodity trading adviser ("CTA") because it provides advice to securitization entities as to the value of or the advisability of trading in swaps, the Interpretation does not provide relief. The Interpretation only addresses the definition of commodity pool, and 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 an exclusion for banks and trust companies providing advice that is incidental to their business.

Conclusion

Most traditional asset-backed and mortgage-backed securities may continue to operate outside the jurisdiction of the CFTC as a result of the release of the Interpretation. 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 the Interpretation 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 December 31, 2012.

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.

Rachel George
202.478.6454
george@chapman.com

Bill Tueting
312.845.2956
tueting@chapman.com

Tim Mohan
312.845.2966
mohan@chapman.com

Mike Mitchell
202.478.6446
mitchell@chapman.com

Ken Marin
212.655.2510
marin@chapman.com

Felicia Graham
202.478.6450
graham@chapman.com

John Hitt
312.845.2979
hitt@chapman.com

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