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The Impact of CPO Rule Changes

In December changes to the rules of the **Commodity Futures Trading Commission** relating to funds and other collective investment vehicles will require many investment managers, banks and other financial institutions to register for the first time as commodity pool operators if they operate such funds, or as commodity trading advisers if they advise funds with respect to regulated commodity investments and are not the relevant fund's CPO.

Under their current interpretation, these regulations are likely to result in significant new obligations for sponsors or managers of securitizations and other structured finance transactions that involve swaps. Further, when the new regulations are combined with the proposed regulations to implement the **Volcker Rule**, the ability of banks that are subject to the Volcker Rule to engage in securitizations, certain covered bond programs and other structured finance transactions may be significantly curtailed.

The CPO Rule Changes

As amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the U.S. Commodity Exchange Act defines a commodity pool as "any investment trust, syndicate, or similar enterprise operated for the purpose of trading in commodity interests, including any … commodity for future delivery, securities futures product or swap…" There is no definitive guidance on how the term "operated for the purpose" should be interpreted. The CFTC has traditionally taken the position that an investment vehicle that executes a single regulated transaction would fall within the commodity pool definition. If that interpretation stands, there is a danger that special purpose vehicles established in connection with securitizations, structured covered bond programs, real estate investment trusts and other structured finance transactions that issue securities to any U.S. investors would constitute commodity pools and thereby become subject to CFTC regulation.

The CEA also defines a commodity pool operator as a person that is "engaged in a business that is of the nature of a commodity pool, investment trust, syndicate or similar form of enterprise, and who, in connection therewith, solicits, accepts or receives funds [or other property] for the purpose of trading in commodity interests…" A commodity interest for these purposes will include swap transactions that are regulated by the CFTC, including interest rate and currency swaps. Significantly, the CPO definition covers a wider range of funds than simply commodity pools--it is not limited to funds that are operated for the purpose of trading in commodity interests, but rather captures any investment vehicles that engage in swap transactions and other commodity futures or options and sell securities or ownership interests to U.S. investors.

A person engaged in the business of being a CPO must be registered with the **National Futures Association** (the self-regulatory organization for the regulated commodities markets). Historically, the CFTC's rules for CPO registration included broad exemptions from the registration requirement for managers of private funds and SEC registered investment companies that met certain requirements, including that the funds were not marketed as vehicles for trading in the commodity futures or commodity options markets.

Many managers relied on these exemptions to remain outside the registration obligations. However, a rulemaking approved by the CFTC commissioners in February 2012 rescinded those exemptions, leaving only narrow exemptions for

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operators of private funds and registered investment companies whose exposure to commodity interests fell below prescribed *de minimis* thresholds and which met other requirements, including that interests in the funds (i.e. equity or debt securities issued by the funds) are exempt from registration under the Securities Act of 1933 and are offered or sold without marketing to the public in the U.S.

Most securitizations, covered bonds, REITs and other structured finance transactions use swaps to match the cashflows on the underlying asset portfolio to the payments on their liabilities or as a risk-management tool to hedge interest rate, currency or other risks. Some transactions, such as synthetic credit-linked note deals, also use swaps as the primary asset on which the cashflows of the transaction are based.

Unless they are amended by an interpretive release by the CFTC, these changes will have two primary results for the securitization and structured finance markets.

CPO Registration Obligation

Arrangers of securitizations, covered bonds, REITs and other structured finance transactions will have to identify the entity that constitutes the commodity pool operator for that deal, and ensure that that entity, or a permitted delegate, is duly registered and complying with CFTC rules applicable to CPOs unless (a) the securities issued in connection with the transaction are not registered with the **Securities and Exchange Commission** and (b) the required the aggregate initial margin required from the issuer under swaps executed in connection with the transaction is less than 5% of the liquidation value of the issuer's assets or the net notional amount of those swaps is less than 100% of the liquidation value of the issuer's assets, in each case at the time the most recent swap is executed.

These *de minimis* rules raise several practical problems. Structured finance swaps do not typically require the issuer to post initial margin, because the swap counterparty is a secured party under the collateral arrangements for the transaction and has recourse to the full assets of the issuer, subject only to any applicable priority of payments. In the absence of guidance from the CFTC, it is not clear how structured finance arrangers should interpret whether the initial margin test can be met. Further, changes in circumstances may result in a formerly compliant issuer failing the notional amount test, for example, because the market value of its assets declines or because the cashflows permit payments received on the underlying assets straight through to investors. Similarly, many transactions use both interest rate hedges to convert periodic income on the underlying assets into a predictable cashflow and currency swaps to convert that cashflow into the currency of the issuer's liabilities. The aggregate notional amount of those swaps may exceed 100% of the value of the issuer's assets.

The rule also presents the practical difficulty of identifying an appropriate entity to register as the CPO of the issuer. In a traditional fund structure, the CPO is generally the general partner or investment manager of the fund. In structured finance transactions, however, particularly where the asset portfolio is not managed, there is no equivalent entity. The bank arranger of the transaction is unlikely to want to take the responsibility of acting as CPO of a transaction arranged for a third-party client, and the sponsor or originator may not be the appropriate party if the transaction is intended to be protected from the originator's bankruptcy. It is possible that the corporate services firm that acts as the issuer's administrator may be prepared to act as its CPO, but this is likely to add significant costs and complexity to the transaction, and that administrator would need assistance from the asset servicer and other service providers to prepare the periodic reports required from a CPO.

Volcker Rule issues

The other significant challenge presented by the CFTC's new rules, however, may have an even more serious effect on the securitization and structure finance markets.

Under the current proposed regulations to implement the Volcker Rule, banks that are subject to the Volcker Rule are prohibited from engaging in certain types of transaction, including loans, asset sales and derivatives, with entities that are defined as covered funds. The proposed regulations include commodity pools within the definition of covered funds. The prohibition applies to covered funds that are organized and offered by the bank or for which the bank is the sponsor, which is a broad term that includes the ability to select the managers and/or directors of the fund.

Unless this prohibition is amended, either by changes made in the final regulations implementing the Volcker Rule or by interpreting the scope of "commodity pool" to exclude structured finance and securitization vehicles, it is may well prevent banks from engaging in securitizations, structured covered bonds, credit-linked notes and other structured finance transactions.

Conclusion

The changes to the CFTC's CPO rules are final and, pursuant to a no-action letter issued by the CFTC, are currently scheduled to take effect on Dec.31, 2012. As their implications have become clear, however, many industry groups have approached the CFTC to clarify that the rules should not be interpreted in a manner that would prevent the effectiveness of the securitization and structured finance markets. It remains to be seen whether the CFTC will issue such guidance, or whether the industry can adopt new structures that avoid triggering the rules. In the meantime, there is considerable uncertainty as to whether these rules, which were intended to provide transparency over the funds industry's activities in the regulated commodities markets, will change the shape of the securitization markets.

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