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Client Memorandum October 2012

CFTC Staff Letter Offers Relief to Certain Securitization Vehicles by Specifying Criteria for Exclusion from the Definition of Commodity Pool

The CFTC's Division of Swap Dealer and Intermediary Oversight has issued interpretive relief that excludes any securitization vehicle that satisfies five specified criteria from the definition of "commodity pool". As a result, the operators of these vehicles will not need to register with the CFTC as "commodity pool operators" and the vehicles themselves will not be "covered funds" for purposes of the Volcker Rule as a result of possible "commodity pool" status. However, this relief does not extend to entities used in a significant number of structured finance transactions, including guarantor entities in covered bond structures, most ABCP conduits, and issuers in most CLO, CDO and synthetic securitizations.

On October 11, 2012, the Division of Swap Dealer and Intermediary Oversight (the "Division") of the U.S. Commodity Futures Trading Commission (the "CFTC") issued an interpretative letter (the "CFTC Staff Letter") that provides guidance and sets out criteria that would exclude certain securitization vehicles from the definition of "commodity pool" under Section 1a(10) of the U.S. Commodity Exchange Act (the "CEA") and Rule 4.10(d) under the CEA and thereby exempts sponsors or managers of such vehicles from being required to register as a commodity pool operator ("CPO"). The CFTC Staff Letter is available here. The CFTC Staff Letter responds to requests from the American Securitization Forum and SIFMA for interpretive or no-action relief for certain entities that issue traditional asset-backed securities as well as for other entities that are involved in covered bond transactions, collateralized loan obligation transactions (CLOs), collateralized debt obligation transactions (CDOs) and synthetic securitizations. These requests reflected market participants' concerns regarding the prospect of a heightened regulatory burden and related uncertainties if relief from commodity pool status was not provided.

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Background

Under the CEA, a "commodity pool" is defined as any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests. Historically, "commodity interests" were largely limited to futures and options contracts. However, as a result of changes mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act") the definition of "commodity interest" was expanded to include swaps. For any non-exempt investment entity considered to be a commodity pool, the entity generally acting as its manager will be required to register with the CFTC as the CPO for that entity.

In addition, earlier this year, the CFTC rescinded long-standing exemptions from the CPO registration requirements that had been available to managers of commodity pools that were investment companies which were registered under the U.S. Investment Company Act of 1940, as amended (the "1940 Act") and to private commodity pools meeting certain tests.

As a result of these changes, securitization vehicles, guarantor entities holding cover pools for covered bonds, and other investment entities that have entered, or will enter, into one or more swaps, could fall within the CFTC's broad interpretation of the definition of commodity pool and therefore subject the managers and sponsors of such entities to regulation and registration as a CPO.

The Specified Criteria

The CFTC Staff Letter states that the Division will interpret the definition of commodity pool to exclude securitization vehicles that meet all of the following five criteria:

1. "The issuer of the asset-backed securities is operated consistent with the conditions set forth in Regulation AB ***or*** Rule 3a-7 [under the 1940 Act], whether or not the issuer's security offerings are in fact regulated pursuant to either regulation, such that the issuer, pool assets, and issued securities satisfy the requirements of ***either*** regulation" (footnotes omitted, emphasis added).
   - The CFTC Staff Letter notes specifically that the above criterion does not require the securitization vehicle to actually issue securities in a publicly registered offering under Regulation AB or for the vehicle to rely solely on the exemption provided by Rule 3a-7 of the 1940 Act (as the case may be), but it does require the vehicle to be "operated consistent with the conditions" set forth in Regulation AB or Rule 3a-7. While the exact meaning of this phrase is not particularly clear (especially in the context of Regulation AB), market participants may interpret this reference to apply primarily to the formal requirements for asset-backed securities contained in Item 1101 of Regulation AB.
   - Compliance with the requirements of Rule 3a-7 will be crucial for vehicles not able to "operate consistent with the conditions" contained in Regulation AB (*e.g.,* vehicles with significant delinquent loans or extended prefunding or revolving periods). Rule 3a-7 generally requires, among other things, the use of a U.S. bank or trust company (which includes an overseas branch of such an entity) as trustee, a perfected security interest in the securitized assets, and that cash flows from the securitized assets are under the control of the trustee.
2. "The entity'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" (footnotes omitted).
   - Although the CFTC Staff Letter refers to "passively" owning or holding assets, a footnote clarifies that entities which are "master trusts" meeting the requirements of Regulation AB may be permitted to add additional assets in accordance with the requirements of Regulation AB.

3. "The entity'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."
   - This criterion would bring in an important element of Regulation AB, even for investment entities that are able to rely on Rule 3a-7.
4. "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.
5. 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 vehicle's assets." (footnote omitted)
   - The prior two criteria bring in elements of Rule 3a-7, even for investment entities that seek to comply with Regulation AB. In particular, the last criterion effectively eliminates relief for any actively managed entity where the underlying assets are bought and sold on a regular basis, *e.g.*, to capture the value in an asset whose credit prospects have improved since the asset was acquired by the vehicle.

Any vehicle meeting the above criteria will not be included in the definition of commodity pool and its "operator" (generally, its manager or sponsor) therefore will not be subject to registration and regulation as a CPO.

The nature of the CFTC Staff Letter's relief is also helpful for entities (primarily banks) concerned about compliance with the "Volcker Rule" provisions of the Dodd Frank Act. Generally speaking, investment entities (including securitization vehicles) will be considered "covered funds" under the regulations currently proposed in respect of the Volcker Rule (the "Proposed Volcker Regulations") if the entity needs to rely on one of the "private fund" exemptions from registration under the 1940 Act or if the entity is a "commodity pool". Many securitization vehicles do not need to rely on one of the private fund exemptions but do fall within the definition of a commodity pool due to the use of swaps. Due to vehicles meeting the above criteria being excluded from the definition of commodity pool (as opposed to the managers or sponsors of such vehicles being granted relief from registration as a CPO), these vehicles should also be excluded from the "covered funds" definition under the Proposed Volcker Regulations.

No Exclusion For Other Investment Entities

The CFTC Staff Letter declined to grant relief in response to requests from the American Securitization Forum and SIFMA for similar interpretive or no-action relief for a number of other types of entities, including guarantor entities in covered bond structures (whether or not there is a regulation or statute relating to covered bonds in the relevant jurisdiction), entities that are involved in most ABCP structures, and most CLOs, CDOs and synthetic securitizations. Further, securitizations involving cash flows from physical commodities, such as crude oil or agricultural products, if involving hedges of the price of these commodities, would clearly not be covered by the relief in the CFTC Staff Letter. In addition to potential CPO registration, if any of these entities are classified as commodity pools, then, under the Proposed Volcker Regulations, these entities would be considered "covered funds" and their "sponsors" would be subject to significant limitations and regulatory burdens under the Volcker Rule.

Investment managers, sponsors or issuers, as applicable (or delegates thereof) of "legacy" structured transactions, such as covered bonds, ABCP conduits, CLOs or CDOs, which do not satisfy the five specified criteria for exclusion contained in the CFTC Staff Letter will either need to file for CPO registration or obtain a separate exemption from the CFTC by December 31, 2012. However, some of the managers and sponsors of these legacy transactions may be able to qualify for an exemption under the *de minimis* thresholds in CFTC Rule 4.13(a)(3), which require that (1) the securities issued in connection with the transaction are not registered with the U.S. Securities and Exchange Commission and (2) 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. Maintaining such exemption may increase reporting obligations and administrative

costs not contemplated by the original structure and may also cause the issuer to be a "covered fund" under the Proposed Volcker Regulations.

No-Action Relief for Timing of Registration as a CPO

In addition, the CFTC issued a separate Staff Letter on October 12 granting no-action relief to persons that are required to register as a CPO solely as a result of swap activity ("Swap Persons"). Pursuant to the letter, the CFTC will not recommend enforcement against any Swap Person for failing to register as a CPO if (1) such Swap Person submits a registration application (including the necessary fingerprint cards) with the National Futures Association ("NFA") by December 31, 2012, and (2) such Swap Person makes a good faith effort to comply with the regulations applicable to CPOs after December 31, 2012 as if it was registered as a CPO. This relief will terminate on the date a Swap Person is notified by the NFA of its registration or five days after it is notified by the NFA that it may be disqualified from registration. Effectively, this sets the compliance date for all CPOs at December 31, 2012.

Additional Relief Possible

In addition to the exclusion based on satisfying the five specified criteria, the CFTC Staff Letter states that other securitization vehicles, including 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 are likely not commodity pools. The Division states that they are open to discussions with, and may grant (on a case by case basis) requests for relief for, sponsors of vehicles in these other asset classes consistent with the broader principles set out in the CFTC Staff Letter. It is unclear, however, how the Division will process these types of requests for relief, and whether further categorical relief might be appropriate.

Sponsors and other potential CPOs should strongly consider simultaneously beginning their registration process in order to meet the December 31, 2012 deadline for registration while seeking no action or other relief from the from the CFTC and its staff as it is unclear whether and when any further relief will be forthcoming. Likewise, potential CPOs should also consider whether they meet the requirements for a *de minimis* exemption available under CFTC Rule 4.13(a)(3). If registration is required, potential CPOs should also consider whether delegation of their responsibilities as the registered CPO to another entity would be possible and, if so, whether that approach would be preferable to registration of the sponsor or other entity directly involved in the transaction.

For further details on CPO registration requirements, please refer to our client memorandum "CFTC Significantly Limits the Exemption from Commodity Pool Operator Registration for Registered Investment Advisers and Rescinds the Registration Exemptions for Private Fund Managers and Trading Advisers", which is available here, and our client memorandum "CFTC Confirms December 31, 2012 Registration Deadline for CPOs", which is available here.

Clifford Chance has considerable experience in preparing CPO registration submissions. Please get in touch with your Clifford Chance contacts to learn more about CPO registration requirements and individualized relief for which your firm may consider applying.

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