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CFTC Staff Expands Relief for Securitization Vehicles from the Commodity Pool Provisions of the Commodity Exchange Act, Extends CPO Registration Deadline for Securitization Operators to March 31, 2013; and Grants Relief to Certain Legacy Transactions

Key Takeaways:

- > Prior CFTC staff relief from the statutory definition of “commodity pool” was limited to securitizations that satisfied the conditions of Regulation AB or Investment Company Act Rule 3a-7, including, in particular, passively investing in financial assets, limiting swaps to the permitted uses enumerated in Regulation AB and complying with various other operating and trading limitations and restrictions.
- > The expanded relief adopts a more flexible principles-based approach and is available, so long as
 - > the vehicle’s investments are limited to financial assets; and
 - > swaps are used only for the purposes permitted by Regulation AB or Rule 3a-7 and not to create investment exposure.
- > This means many covered bonds, cash CDOs, repackagings, etc. will not be considered commodity pools even if they fail to satisfy some of the conditions of Regulation AB or Rule 3a-7 so long as they satisfy the two part principles-based approach above.
- > The CFTC staff also granted no-action relief allowing the operators of “legacy” securitization transactions that pre-date October 12, 2012 to avoid registration with the CFTC provided they do not issue new securities, they provide documents and information to the CFTC upon request, and they satisfy certain other criteria.
- > The CFTC staff also extended the CPO registration deadline for the operators of securitization vehicles that are not eligible for relief to March 31, 2013.
- > Additionally, the CFTC staff indicated that it remains open to discussing the treatment of other securitization vehicles that do not fall squarely within the scope of the expanded relief.

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Additional relief for securitizations from the commodity pool provisions of the Commodity Exchange Act, as amended by the Dodd-Frank Act

Although uncertainty remains,¹ many securitization market participants were able to breathe at least a partial sigh of relief on Friday evening as the Commodity Futures Trading Commission's ("CFTC") Division of Swap Dealer and Intermediary Oversight ("DSIO") released its second interpretive letter in respect of commodity pool regulation and certain securitization vehicles (the "**12-45 Letter**") under the Commodity Exchange Act, as amended by the Dodd-Frank Act ("**CEA**").² The 12-45 Letter follows the CFTC's prior no-action letter of October 11, 2012³ (the "**12-14 Letter**" and together with the 12-45 Letter, the "**Securitization Letters**"), which provides that securitization vehicles satisfying certain enumerated criteria would not be commodity pools and thus their operators would not be required to register as commodity pool operators. However, while the 12-14 Letter covered many traditional securitizations, it expressly did not address certain product types and its relief was limited to situations in which its long list of requirements were satisfied, and it provided no legacy relief for existing transactions.

The 12-45 Letter relaxes significantly the criteria for relief and broadens the scope of transaction types for which that relief is available. Additionally, the 12-45 Letter provides relief for legacy transactions satisfying certain criteria and extends until March 31, 2013 the deadline for commodity pool operator ("**CPO**") registration for operators of securitization vehicles. Like the 12-14 Letter, the 12-45 Letter makes clear that merely because a securitization vehicle is not eligible for relief under the Securitization Letters does not necessarily mean that such securitization vehicle is a commodity pool, requiring its operator to register as a CPO, but rather that the DSIO remains open to discussing such non-complying structures with their sponsors to determine whether registration and/or relief is required and, if relief is required, whether and on what basis it might be available.

¹ For instance, for those securitization vehicles that are not covered by the relief in the Securitization Letters, it remains unclear how they will comply with the requirements of the CFTC's Part 4 rules, which govern the conduct of CPOs, given that those rules are tailored to the business of actively managed investment vehicles and not at all to the operations of securitization vehicles. Further, securitization vehicles that are considered commodity pools would be "covered funds" within the meaning of proposed regulations to implement the Volcker Rule, which would impose significant restrictions on the ability of many banking organizations to sponsor and/or transact with them. It remains to be seen whether final regulations to implement the Volcker Rule will remove commodity pools from the list of "covered funds" or whether banking regulators will otherwise grant an exception to securitization vehicles from the Volcker Rule's prohibitions.

² CFTC Staff Letter No. 12-45 (Dec. 7, 2012), available at <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/12-45.pdf>.

³ CFTC Staff Letter No. 12-14 (Oct. 11, 2012), available at <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/12-14.pdf>.

The prior relief—the 12-14 Letter

As discussed in our client note of October 17, 2012⁴ and summarized in the 12-45 Letter, the 12-14 Letter articulates a number of conditions, which if satisfied in respect of a securitization vehicle would mean that vehicle is not a commodity pool and its operators would accordingly not be required to register as CPOs. Those conditions include:

- > the issuer of the asset-backed securities is operated in a manner consistent with the conditions set forth in Regulation AB or Investment Company Act Rule 3a-7, whether or not the issuer's offerings are in fact regulated under either of them, such that the issuer, pool assets and issued securities satisfy the requirements of either of them;⁵
- > the issuer's activities are limited to passively owning or holding a pool of receivables or other financial assets (excluding transactions where the issuer obtains exposure to an asset that is not transferred or otherwise part of the asset pool), 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 issuer's use of derivatives is limited to the uses permitted under Regulation AB, including credit enhancement and 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 the 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 vehicle's assets (although master trust and revolving structures are permitted).

The 12-45 Letter goes on to explain that these conditions essentially define a type of passive investment in, and financing of, financial assets (both in terms of the issuer's operating and trading activities (the "**Operating or Trading Limitations**")) that makes limited use of swaps.⁶

⁴ Linklaters LLP, *CFTC Extends CPO Registration Deadline and Grants Relief for Most Traditional Securitizations*, available at <http://www.linklaters.com/pdfs/mkt/newyork/A15710674.pdf> ("**Linklaters' October Note**")

⁵ As we suggested in the Linklaters' October Note, the 12-45 Letter confirms that this condition is not intended to be read to include the disclosure requirements of Regulation AB.

⁶ 12-45 Letter at 1-2.

Expanded scope of relief under the 12-45 Letter

Under the 12-14 Letter, relief was not available for securitization vehicles failing to satisfy the Operating or Trading Limitations (or, for that matter, any of the other conditions to relief enumerated therein). Under the 12-45 Letter, the DSIO has now taken the position that failure to satisfy the Operating or Trading Limitations does not preclude relief for securitization vehicles so long as the use of swaps is no greater than that contemplated by Regulation AB and Rule 3a-7, such swaps are not used in any way to create an investment exposure, and the securitization vehicle complies with the requirement that its activities are limited to the holding of financial assets.⁷ Thus, the need to be able to comply with various other aspects of Regulation AB or Rule 3a-7 is no longer relevant to the determination of whether relief is available.⁸

Tangible examples

The DSIO provides several examples of securitization vehicles that do not satisfy the Operating or Trading Limitations or various elements of the other enumerated conditions in the 12-14 Letter, but which nevertheless are not commodity pools.

ABCP Conduits

The first of these examples is a traditional asset-backed commercial paper conduit in the form of a special purpose vehicle (an “**SPV**”) issuing senior notes and using the proceeds to purchase financial assets. The 12-45 Letter explains that such notes might not be asset-backed securities for Regulation AB purposes since they are to be repaid from the proceeds of new issuances of senior notes, or if new senior notes cannot be issued, from liquidity and credit facilities provided by financial institutions. The DSIO also noted that many such structures do not employ independent trustees, as generally required by Rule 3a-7. Notwithstanding their non-compliance with these conditions, the 12-45 Letter goes on to explain that “an investment in the securitization 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. In this example, absent other factors, the vehicle would not be a commodity pool.”⁹

This example is significant as it reflects a departure from the rigid adherence to the enumerated criteria in the 12-14 Letter as a benchmark for relief, and the adoption of a more principles-based approach. This approach looks to whether investors are making investments in financial assets in the SPV and not in the swaps, and whether swaps are being used to create investment exposure or in some other way not permitted under Regulation AB or Rule 3a-7.

⁷ 12-45 Letter at 3.

⁸ For instance, a securitization vehicle need not comply with Regulation AB’s requirement that its pool assets not be non-performing at the time of transfer or with Rule 3a-7’s requirement that the vehicle’s securities be rated in the four highest-rated categories by a credit rating agency. See Linklaters’ October Note at 5-6.

⁹ 12-45 Letter at 3.

Managed Cash CDOs

A CDO holding cash financial assets with up to 20% able to be traded per year for three years is the DSIO's next example. The hypothetical CDO uses interest rate swaps to convert fixed rate assets to floating rate assets and FX swaps to convert Euro assets to U.S. dollar assets, and none of these swaps can be terminated before the related hedged asset has been liquidated. The DSIO again takes the view that an investment in such a structure is not unlike an investment in a traditional securitization satisfying Regulation AB or Rule 3a-7 because the investment is essentially in the financial assets of the SPV and not the swaps. Thus, the DSIO concludes that the vehicle in this example, absent other factors, is not a commodity pool. However, the DSIO goes on to say that if the CDO had a 5% synthetic bucket instead of 100% cash financial assets, it could be a commodity pool (although the DSIO notes that relief from registration might nevertheless be available for its operator given the small size of the synthetic bucket).

Securitization Transactions Not Provided Relief

The 12-45 Letter also provides examples of transactions to which the DSIO is not providing relief and which could be commodity pools. These examples include:

- > a repackaging vehicle issuing credit- or equity-linked notes where the vehicle, though holding financial assets, sells protection on a broad-based index or obtains exposure to a broad-based stock index, using a swap to provide exposure to such index; and
- > a repackaging vehicle holding a three-year bond that issues four-year notes, using a swap to extend the investment experience of the bond and the notes.

In both cases, the DSIO indicated that the repackaging vehicle would be considered a commodity pool, the operator of which would be subject to CPO registration requirements.

Practical Considerations

However, we believe that many traditional vanilla repackagings would fit within the relief provided by the Securitization Letters, including structures where a fixed rate bond is coupled with a floating rate swap to back a floating rate note. Such a swap can be viewed as a hedge for the vehicle and does not form more of a part of the investor's exposure than do the interest rate or currency hedges in the DSIO's CDO example. Further, such structures are distinguishable from the potentially problematic examples of more structured repackagings that the DSIO provided, as the investor's exposure remains primarily to financial assets and not the swaps used for hedging or to adjust the interest or currency characteristics of the repackaged financial asset(s). The DSIO also included covered bonds as examples of securitizations that would not constitute commodity pools so long as they are holding only financial assets, are not creating investment exposure to or otherwise impermissibly using swaps and holders are entitled to receive principal

and interest on the covered bonds, “without any condition to payment based upon any swap exposure.”¹⁰

With that in mind, particular structures must still be considered on a case by case basis to determine the nature of the investor’s investment exposure and whether (1) such exposure is primarily to financial assets akin to an investment in a traditional securitization (with swap usage limited to the permitted uses under Regulation AB and Rule 3a-7) or (2) such exposure is to something more than those financial assets, in respect of which CPO registration or additional relief might need be sought.

The DSIO reaffirmed its view that swaps may be used permissibly to provide credit support to financial assets in securitization structures or the notes issued by securitization vehicles, as contemplated in Regulation AB, and that such use should not be construed as creating investment exposure or transform the entity into a commodity pool. However, the DSIO also explained that such use must be commercially reasonable. If such usage is not commercially reasonable, the securitization vehicle may be a commodity pool and its operator therefore may be subject to the CPO registration requirements. The DSIO described a securitization vehicle, holding floating rate bonds rated “CCC” and entering into a swap providing credit support for interest and principal sufficient to allow the vehicle to issue “AA” rated notes, as a commodity pool because “the swap is a significant aspect of the investment.”¹¹

Legacy Relief for certain securitization vehicles formed prior to October 12, 2012

In addition to the broad interpretive relief discussed above, the DSIO also granted no-action relief to certain “legacy” securitization vehicles from the requirement that their operators register as CPOs.¹² In order to qualify for this relief, a securitization vehicle must satisfy the following criteria:

- > the vehicle must have issued fixed income securities before October 12, 2012 “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;”
- > the vehicle has not and may not issue new securities on or after October 12, 2012; and
- > the vehicle must promptly, upon request of the CFTC or any of its offices or divisions, provide electronic copies of the following:

¹⁰ 12-45 Letter at 4.

¹¹ 12-45 Letter at 4.

¹² We read the term “securitization vehicle” *vis a vis* this legacy relief in the colloquial sense to include vehicles that could in good faith be described as securitization vehicles even if they do not technically fall within the ambit of Regulation AB or Rule 3a-7.

- > the vehicle's most recent disclosure document used in connection with an offering of securities;
- > all amendments to the principal document since the issuance;
- > the most recent distribution statement to investors; and
- > if the offering was conducted under Rule 144A under the Securities Act of 1933, the information provided to prospective investors pursuant to Rule 144A(d)(4).¹³

The scope of the DSIO's relief is limited. Securitization vehicles that satisfy these criteria may still be commodity pools, but their operators need not register with the CFTC. Banking organizations may face restrictions under the Volcker Rule on transacting with such legacy securitization vehicles, as discussed in the Linklaters' October Note.¹⁴

Extension of CPO registration deadline

The 12-45 Letter also granted no-action relief allowing the operators of securitization vehicles to delay registering with the CFTC until March 31, 2013. This relief applies to all operators of securitization vehicles that are unable to qualify for the relief granted in the Securitization Letters.

What if I still am not eligible for relief under the Securitization Letters?

As with the 12-14 Letter, the DSIO makes abundantly clear in the 12-45 Letter that it "remain[s] open to discussion 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 other relief might be appropriate.¹⁵ We think the relief granted so far evinces a good faith effort on the part of the DSIO to consider the needs of market participants and we have no reason to believe that it will not continue to do so going forward. Indeed, the logical basis of the relief granted to date would suggest that additional relief ought to be forthcoming with respect to virtually all structures where the use of swaps is ancillary and not designed to create an investment exposure to those swaps for investors. Of course, this may just be wishful thinking on our part, but we are hard pressed to say that the distinction between a vehicle investing in financial assets and one investing in non-financial assets should, all other things being equal, be determinative with respect to the vehicle's status as a commodity pool.

¹³ If the vehicle does not provide the listed information it must demonstrate that it cannot obtain such information through reasonable commercial efforts. 12-45 Letter at 5.

¹⁴ Linklaters' October Note at 7-8.

¹⁵ 12-45 Letter at 5.

Final Thoughts

Together, the Securitization Letters provide significant clarification as to the DSIO's views regarding the scope of what constitutes a commodity pool *vis a vis* securitization vehicles and entities resembling them. The legacy relief, although not as broad as it might have been, will also be of significant benefit to the market, avoiding the needless costs and burdens that would have been associated with the myriad registrations that would otherwise have been required in respect of legacy transactions. Additionally, the extension of the registration deadline will be of benefit for numerous market participants as well as the regulators as there remain many complex issues to be resolved and the resolution of those issues may very well have a profound impact not only on who is required to register, but also with respect to the panoply of decisions potential registrants and related entities will need to consider.

Indeed, as discussed extensively in the Linklaters' October Note, many outstanding issues remain regarding the interplay with the Volcker Rule and, perhaps more mundanely, with respect to the Part 4 requirements that apply to registered CPOs and how such requirements are to be implemented and construed in the context of securitization platforms that were created and exist under what is clearly an incongruous regulatory framework.

Linklaters

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CFTC Expands Scope of Relief for Securitizations from the Commodity Pool Provisions of the CEA

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