Relief from CFTC's New Commodity Pool Regulation May Be In Sight for Certain Securitization Transactions as Deadline Looms

Under new Commodity Futures Trading Commission (CFTC) rules scheduled to become effective on October 12th of this year, if an investment trust or similar entity is viewed as "trading" in swaps, its sponsor and other responsible parties may be required to register with the CFTC as "commodity pool operators" (CPOs) or may be required to register as "commodity trading advisors" (CTAs). There has been concern that holding even one swap will be treated as "trading." Accordingly, any securitization vehicle that holds a swap would then be subject to possible CFTC regulation, and any such vehicle sponsored by a banking entity would be considered at risk for treatment as a "commodity pool," and therefore a "covered fund" under the proposed Volcker Rule regulations.

Industry participants have been seeking relief from the CFTC, and have received preliminary indications that some form of relief will be made available. It is hoped that any such relief would be in the form of an exemptive order, and that the CFTC would provide relief on a temporary basis, pending the effective date of such an exemptive order, by a no-action letter no later than October 12th. The scope and timing of any such exemptive order remains uncertain.

This client alert supersedes our client alert dated September 28, 2012, issued prior to the most recent developments, and describes certain factors which will have to be considered, as any no-action letter or exemptive order is considered.

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), swaps (other than security-based swaps) were brought within the jurisdiction of the CFTC by inserting certain new provisions into, or amending certain existing provisions of, the Commodity Exchange Act (CEA).[1] The new provisions are broadly worded, and have raised concerns that investment trusts or other special purpose vehicles that act as ordinary end-users of swaps, including securitization vehicles that hold only one swap, might subject the sponsors or other parties involved in the organization and operation of such vehicles to registration with the CFTC as CPOs or CTAs.

The new requirements become effective on October 12th of this year, 60 days after publication in the Federal Register of a new joint rule (Swap Definition Rule) of the CFTC and the Securities and Exchange Commission (SEC),[2] which, among other things, further defines the swaps that are subject to the new provisions. Absent an exemption, even parties that operate existing securitization vehicles would likely have to register.

A number of industry participants have sought exemptive relief from the CFTC or, absent that, at least an extension of the deadline for sufficient time to permit consideration of such an exemption. Only recently have such representatives reported that such relief may be available, as described below.

Despite the likelihood of some form of relief, understanding the background of the issue remains important to the industry as it prepares for and interprets the anticipated no-action letter and comments on any proposed exemptive order. That background will continue to be even more relevant, of course, if such relief is not provided by the CFTC or, if it is, for those securitization vehicles that fall outside its scope.

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1 Section 721 of the Dodd-Frank Act amended the definition of "commodity pool" and "commodity pool operator" to include swaps within the list of commodity interests to be regulated by the CFTC.

2 The Swap Definition Rule was announced in a joint release with the SEC in the CFTC's RIN 3038-AD46 and the SEC's Release 33-9338; 34-67453.

Summary of the Relevant Provisions

The CEA prohibits a CPO or CTA from engaging in its business without registration with the CFTC. A CTA need not register if it has advised no more than 15 persons over the preceding 12 months and does not hold itself out generally as a commodity advisor. A CPO, however, has no such exception, and becomes subject to the registration requirement with a single commodity pool.[3]

The definition of "commodity pool" in the CEA was added by the Dodd-Frank Act and includes "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any … swap." The definition of "commodity pool operator" was modified in a similarly broad fashion, to include any person "engaged in a business that is of the nature of a commodity pool … for the purpose of trading in commodity interests, including any … swap." Note that the definitions capture only investment trusts or similar enterprises, and therefore do not capture a typical corporate end-user, but could capture a securitization vehicle. The keys to the interpretation of these definitions, however, are the word "trading" and the general nature and activities of commodity pools. That is,

1. Should an entity that merely invests in commodity interests for hedging purposes, rather than buying and selling them, be regarded as "trading" in such interests?
2. Should an entity formed for the purpose of investment in assets other than commodity interests, and that pays most investors a debt-like principal amount and accrued interest, rather than a share of profit, be regarded as a commodity pool because an ancillary part of its strategy includes investing in a swap for hedging purposes?

There has been concern that the CFTC would view holding a single swap as "trading." This has been compounded by a lack of clarity regarding the types of investment vehicles that might be treated as commodity pools. The diversity in the current structures of investment vehicles currently operated by CPOs suggests that it will be difficult to distinguish securitization vehicles based on their structure. The courts have interpreted "commodity pool," as defined in previous CFTC regulations, more narrowly. The court in the 1986 Ninth Circuit case *Lopez v. Dean Witter Reynolds, Inc.*[4] stated:

> Those courts which have raised the issue require the following factors to be present in a commodity pool: (1) an investment organization in which the funds of various investors are solicited and combined into a single account for the purpose of investing in commodity futures contracts; (2) common funds used to execute transactions on behalf of the entire account; (3) participants share pro rata in accrued profits or losses from the commodity futures trading; and (4) the transactions are traded by a commodity pool operator in the name of the pool rather than in the name of any individual investor.

This definition has generally been followed by the courts. The decision that the investment vehicle in *Lopez* was not a commodity pool rested largely on the third element and the fact that different investors were allocated different commodity interests based on their particular circumstances. It did not turn on whether the vehicle was trading or merely investing. Nevertheless, the third element in the *Lopez* test may present an argument that a securitization structure, which typically pays all investors, other than investors

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[3] The focus of this Client Memorandum is on CPOs. Securitizations may also require registration of managers of multiple commodity pools as CTAs. The definition of a CTA has also been expanded by the Dodd-Frank Act, and includes "any person who … for compensation, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of, or the advisability of, trading in … any contract of sale of a commodity for future delivery, security futures product or swap…"

[4] 805 F.2d 880, at 884.

in one residual class, a principal amount plus interest, rather than a share of the profits,[5] should not be regarded as a commodity pool.

Given that the *Lopez* decision interpreted CFTC regulations rather than the CEA, it is unclear to what extent the tests enunciated in that case are still applicable, in light of the CFTC's current broad interpretation of the definition of "commodity pool." It has been unclear whether prior CFTC interpretations governing commodity pools would remain applicable to a securitization trust holding just one swap. The introduction of swaps into the definition of "commodity pool" may create an issue of first impression when interpreting the concept of "trading" in commodities. It is possible that the CFTC may consider in a positive light that securitization vehicles typically use swaps for purposes of hedging (including the matching of interest rates or currencies relating to the assets held in the vehicle to the interest rates or currency of liabilities issued by the vehicle) rather than with a view to earning a profit on the swap itself, and therefore not consider holding of such a swap as "trading." It is arguable that Congress may not have intended to bring such vehicles, which use swaps purely for hedging and not trading for profit, into the world of commodity pool registration and regulation.

Relevant Exemptions

The new CFTC rules do provide certain exemptions, including, in particular, an exemption (De Minimis Exemption) from registration for operators of certain investment trusts whose securities were sold pursuant to an exemption from the registration requirements of the Securities Act of 1933 (1933 Act), and which engage in a *de minimis* amount of swap activity.[6] The tests in the De Minimis Exemption appear to be focused on more traditional commodity pools, however, and the application of the exemption to securitization vehicles is unclear absent further interpretive guidance from the CFTC. Further, since it is CPOs and CTAs who have to register, rather than the commodity pools themselves, an operator or advisor can avoid registration only if it has a registration exemption for every relationship it has with a commodity pool, or if it is one of the types of entities generally excluded from the registration requirement, namely a bank, an insurance company or a registered investment company.

Swaps That Are Captured by the New Rule

The Dodd-Frank Act added a definition of "swap" to the CEA[7] that broadly defined the term and specifically includes interest rate swaps, currency swaps, total return swaps and credit default swaps, but

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5 Further, such investors are often paid in some form of sequential pay basis rather than being paid pro rata.

6 The CFTC's Rule 4.13 provides exemptions from registration for a related CPO in a number of circumstances, the most helpful of which, found in Rule 4.13(a)(3), is for funds that are not offered publicly, are sold to accredited investors and hold only *de minimis* amounts of commodity interests. The measure of activity is based on satisfying either of two tests for its swap positions (whether entered into for hedging purposes or otherwise), namely (i) that the initial margin, premiums and required minimum security deposit required to establish such positions not exceed 5 percent of the liquidation value of the pool's portfolio, or (ii) the aggregate net notional value of such positions not exceed 100 percent of the liquidation value of the pool's portfolio. Computing some of these values may not be straightforward in ordinary securitizations.

A more generous exemption previously found in Rule 4.13(a)(4) has been deleted, and those who previously relied on that exemption have until December 31, 2012 to come into compliance.

7 A "swap" is generally defined under Section 1a(47) of the CEA as "any agreement, contract, or transaction (i) that is a put, call, cap, floor, collar, or similar option … for the purchase or sale … of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interest or property of any kind; (ii) that provides for any purchase, sale, payment or delivery … dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence; (iii) that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments or indebtedness, indices, quantitative measure, or other financial or economic interests" without conveying an underlying asset, and (iv) additional similar categories. The definition specifically includes interest rate swaps, caps, floors and collars, cross-currency rate swaps, basis swaps, currency swaps, total return swaps, debt index swaps, credit default

(continued...)

specifically excludes most "security-based swaps," namely swaps that relate to the performance of individual securities or loans and narrow-based securities indexes, and are therefore subject to the jurisdiction of the SEC. Certain other products, such as many types of insurance, loan participations and contractual provisions in loans that might otherwise fall within a broad reading of the term "swap," have been excluded by the Swap Definition Rule. Accordingly, products whose presence can create a commodity pool are generally those that (i) are the types of products specifically identified in the definition of "swap," (ii) are not security-based swaps and (iii) are not otherwise excluded by the Swap Definition Rule.

Identifying the Relevant Commodity Pool

The definition of "commodity pool" would appear to apply on an entity basis, even though commodity pools themselves are not subject to direct regulation. If a securitization trust or similar entity holds a swap, even if the swap benefits just one class of the securities issued by the entity, the entity as a whole (rather than the one class) is subject to being regarded as a commodity pool. If a separate trust is formed to hold one class of securities and a swap, that separate trust could be a commodity pool. If interests in that trust are held by just one investor, however, so that same result could be achieved by selling the swap directly to the investor rather than to the securitization trust, it is arguable that the trust should not be characterized as a commodity pool, but there is no precedent available to support that conclusion.

Identifying the Commodity Pool Operators

The CEA defines a CPO as a person involved with a commodity pool or similar enterprise who "solicits, accepts, or receives from others, funds, securities or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests …" It would therefore appear to encompass a sponsor and depositor in a typical securitization structure, as the parties arranging for the initial sale of the securities of the entity and the acquisition of the assets.

CFTC interpretations have also identified the party with authority to change the commodity pool's CTA as a possible CPO.[8] It is unclear how that test would be applied in the context of a securitization, particularly where the pool of assets is fixed and the only active roles are those of one or more servicers and, to the extent of distributions, reporting and securities transfers, a trustee or securities administrator. None of such entities make investment decisions for the entity. Even in the context of collateral managers utilized in most collateralized loan or debt obligation structures, where there may be more active management of underlying assets, the decisions with respect to the assets are made by an investment manager engaged by contract and generally not subject to change absent breach of that contract.

Registering as a Commodity Pool Operator or Commodity Trading Advisor

To register, a CPO or CTA must register with the National Futures Association (NFA) by completing Form 7-R and paying a fee and membership dues. Its principals and certain employees must complete Form 8-R, have their fingerprints taken, and pay certain fees and, as to associated persons (some of whom may be principals), pass the Series 3 examination (with some exceptions). Offering documents for commodity pools operated by the CPO or advised by the CTA must contain certain specified boilerplate disclosure language and specific information about the pool. Monthly (or quarterly, depending on the size of the pool) and annual reports must generally be provided to the investors in the commodity pool, as well as to the NFA.

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swaps and several other categories of swaps. It specifically excludes, however, among other categories, security-based swaps.

[8] See, *e.g.*, the CFTC release adopting its Rule 4.5 at 50 Fed. Reg. 15,868, footnote 26.

The Consequences of Failing to Register as a Commodity Pool Operator

CPOs that fail to register are subject to fine, disgorgement of earnings and the rescission of agreements with investors. In addition, if an investment vehicle is a commodity pool that is required to be, but is not, operated by a registered CPO, it will not satisfy the definition of "eligible contract participant," making participation in OTC swaps impossible. Further, if a company is required to register as a CPO, individuals associated with the company may be liable for failing to register as associated persons of that company.

In a Standard Securitization, the Information Required to be Provided to Investors in a Commodity Pool Is Not Useful

Assuming that a standard securitization vehicle would likely have only one interest rate or currency swap, the information that the SEC requires be provided to investors in a commodity pool is not likely to be useful at all; even if it is useful, it may well be otherwise provided to the investors to satisfy other statutory or regulatory requirements. For example, over the life of the securitization vehicle, there will probably be no realized and unrealized gains and losses on the swaps, since they are not traded, and if they must be replaced or novated, any gain or loss is generally absorbed in securing a replacement swap and is in any event neither passed through to investors nor treated as a potential source of gain or loss in the offering materials. Advisory and management fees will have been specified in advance (most likely in a discussion of servicing or management fees and costs), and brokerage commissions will be rare or non-existent. A securitization structure will not normally be regarded as having something akin to a net asset value, since such a value would not provide the basis for recurring redemptions or new admissions to the investor group of the securitization vehicle. The same can be said of "the total value of the participant's interest or share in the pool as of the end of the reporting period."[9] These concepts just do not exist in a typical securitization.

The Volcker Rule Implications of the Commodity Pool Definition

Under the regulations proposed to implement the portion of the Dodd-Frank Act referred to as the Volcker Rule, commodity pools are treated as "covered funds." Unless such proposed regulations are changed or otherwise clarified, this would subject entities affiliated with insured depository institutions and non-US banks with branches and agencies in the US to ownership and affiliate transaction restrictions with respect to any securitizations that are treated as commodity pools.

It is unclear whether the availability to certain non-US banking organizations of an exemption for funds that are "solely outside of the United States" would be affected if such funds enter into swaps with US counterparties. The fact that the phrase "solely outside of the United States" typically refers only to locations outside the US and to absence of any offer or sale of interests in the fund in the US may support the availability of the exemption in such circumstances.

Under the proposed regulations for the Volcker Rule, securitizations of loans are exempt from the prohibitions on sponsorship or ownership of covered funds by banking entities, notwithstanding that such covered funds hold a limited amount of swaps used solely for hedging. It is unclear whether the express intent of the Volcker Rule, both in the statute and proposed regulations, to exclude such securitizations from regulation notwithstanding the presence of such swaps can be taken as an indication of Congressional intent to exclude securitizations holding swaps for such purpose from regulation as commodity pools.

Relief May Be Available from the CFTC

Only recently have industry participants reported that the CFTC has become receptive to sequentially providing no-action and then exemptive relief for certain types of securitization vehicles. If such relief is

[9] See CFTC Rule 45.22(a)(2)(vi)(B).

provided, it is likely that (i) interim relief would at least temporarily free sponsors and other responsible parties from any obligation to register as CPOs or CTAs as a result of their role with such entities until the contours of exemptive relief are clarified, and (ii) any vehicles that are ultimately exempted would not be "commodity pools." An exempted pool would not have to be operated or advised by persons registered as CPOs or CTAs, nor would it automatically become a "covered fund" under the Volcker Rule. It is anticipated that the CFTC will provide its temporary relief from registration requirements by issuing a no-action letter by the October 12th deadline.

The CFTC has not made an official announcement of its intentions regarding relief from the new rule for securitization vehicles, and accordingly the exact form, scope and timing of such relief remains uncertain. It is hoped that a large percentage of current transactions will be either grandfathered permanently or exempted, but it is currently unclear what standards the CFTC will establish as the basis for qualification for any such exemption.

Conclusion

Industry participants are currently left in a cautiously optimistic position. It is hoped that most standard forms of securitization vehicles, to the extent they use swaps on a limited basis exclusively for hedging, will obtain relief. To the extent that relief is not forthcoming, or for those securitization vehicles that do not come within any CFTC no-action letter or exemptive order, either:

1. Sponsors must conclude that the relevant investment vehicle is nevertheless not a commodity pool, despite the presence of one or more swaps and the failure to come within any CFTC relief,
2. Sponsors must conclude that the sponsors and other responsible parties qualify for the De Minimis Exemption from CPO registration discussed in footnote 6 and the accompanying text, or
3. Registration of the investment vehicle's CPOs will be required.

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