

## **CFTC Publishes Relief from “Commodity Pool” Definition for Equity REITs and Certain Securitizations and Extends Rule Effective Date**

The Division of Swap Dealers and Oversight (the Division) of the Commodities Futures Trading Commission (the CFTC) released two interpretative letters excluding from the definition of “commodity pool” (1) investment vehicles that operate in a manner consistent with the constraints set forth in Regulation AB or Investment Company Act Rule 3a-7 (Rule 3a-7) promulgated by the Securities and Exchange Commission (the SEC) and certain other requirements, and (2) equity real estate investment trusts (Equity REITs). Subsequently, the Division extended to December 31, 2012 the deadline for those not excluded from the definition or which have other exemptions to submit their applications for registration as commodity pool operators or commodity trading advisors.

On October 11, 2012, the Division released two interpretative letters. One (the ABS Letter), addressed to the American Securitization Forum (ASF) and SIFMA, excludes certain types of pooled investment vehicles from the definition of “commodity pool” and their operators from the definition of “commodity pool operator.” The other (the REIT Letter), addressed to the National Association of Real Estate Investment Trusts (NAREIT), excludes Equity REITs from the definition of “commodity pool” if they meet certain requirements. As a consequence, a person who acts as an operator of only such pools is excluded from the definition of “commodity pool operator.” The structure of CFTC regulation and certain language in the ABS Letter also indicate that a person acting as an advisor to one of the excluded pools would also be excluded from the definition of “commodity trading advisor” insofar as its advisory activity related only to pools of that type.

Shortly after issuing the ABS Letter and the REIT Letter, the CFTC also made available a no-action letter that provides temporary relief, until December 31, 2012, to entities that do not qualify for exemptive relief from the registration requirements applicable to commodity pool operators and commodity trading advisors (the Registration Relief Letter).

### **Relief for Asset-Backed Securities Under the ABS Letter**

The types of investment pools that benefit from the CFTC’s interpretative relief in the ABS Letter include issuers of asset-backed securities that satisfy certain criteria. The Division stated that “the criteria for exclusion include the following:

- The issuer of the asset-backed securities is operated consistent with the conditions set forth in Regulation AB, or Rule 3a-7, 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;
- 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;
- 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;
- 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; 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."<sup>1</sup>

In a footnote, the CFTC clarified that the term "asset-backed securities" includes mortgage-backed securities. In a separate footnote, the CFTC also stated that its references to Regulation AB and Rule 3a-7 do not require that the securities issued by a vehicle relying on the ABS Letter actually be sold in a public offering complying with Regulation AB, or that the investment vehicle rely exclusively on Rule 3a-7 for its exemption from the Investment Company Act; the relief requires only the issuer of the asset-backed securities operate in a manner consistent with Regulation AB or Rule 3a-7. Master trusts qualify for relief despite the requirement of the second bullet above but must be operated in accordance with Regulation AB in connection with the addition of new assets. It is not clear what the expression "operated consistent with the conditions set forth in Regulation AB" means, given that Regulation AB is essentially a disclosure regulation and imposes operating requirements only by implication through its eligibility requirements and certain aspects of its required disclosures. The fact that Rule 3a-7 is not a disclosure rule could mean that it is these implicit operational provisions or the transaction conditions of Regulation AB, rather than the disclosure requirements, that should be given the greatest weight. This would be in accordance with the fact that the incoming letter from ASF, to which the ABS Letter refers in this context, refers only to the definition of "asset-backed securities" contained in Regulation AB. Furthermore, given the generality of the wording of the relief, there may be some reason to believe that the relief establishes something more like a set of guidelines that need to be elaborated rather than a set of bright-line tests.

To qualify for relief, a pooled investment vehicle must actually hold the financial assets in which it is selling a pooled interest, rather than just having exposure to those assets. In other words, pools with synthetic exposures will need to seek other relief or utilize a registered commodity pool operator. A footnote re-emphasizes that the only derivatives permitted are those mentioned in the third bullet point above. The finite term referred to in the relief is intended to permit the distribution of income from the termination of leases at the end of that term.

Although the CFTC's relief appears to benefit numerous different types of securitizations, some have been explicitly excluded from the broad relief of letter. The Division stated in the ABS Letter that:

your request for relief for entities operating to some extent under any covered bond statute, entities involved in collateralized debt obligations, entities involved in collateralized loan obligations, any insurance-related issuances, and any other synthetic securitizations is overly broad and does not provide any assurance that the related entities or a portion of their assets, operations, or activities would not properly be considered a commodity pool.

The Division also emphatically stated, however, that securitization vehicles that cannot satisfy all of the above criteria may nevertheless be able to obtain relief based on their specific facts and circumstances, and that the Division remains open to discussions with sponsors of such vehicles about such relief. In fact, the ABS Letter stated quite clearly that other types of vehicles and transactions may be excluded from the definition of "commodity pool." The Division's invitation to seek relief, the clear statement that other vehicles may fall outside the class of pooled investments that concern the CFTC and the guideline-like nature of the requirements for relief may be a basis for optimism that further industry-wide relief may be available for certain asset classes as discussions between industry participants and the CFTC continue. Apparently, what the Division requires is a thorough articulation of the facts, practices and regulatory framework, if any, relating to each class of vehicles or transactions that may be candidates for relief.

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<sup>1</sup> CFTC Interpretative Letter No. 12-14 (footnotes deleted).

In the course of the ABS Letter, the Division elaborated on why it feels that relief can only be granted in cases where the facts and constraints have been made sufficiently precise, rather than more generally to wider asset classes. This elaboration included a discussion of the *Lopez* case.<sup>2</sup> From the Division's discussion it is possible to conclude that it views that case as not being particularly dispositive in determining whether or not a pooled investment vehicle is a commodity pool. It stated that:

the failure of a fund to satisfy one or more of the factors [mentioned in *Lopez*] does not mean that the fund is not a pool. The Division believes that it is required to evaluate the facts and circumstances presented in their entirety and determine whether a pooled investment vehicle possessing such characteristics should properly be considered to be a commodity pool.

This regulatory position renders it more difficult than it might otherwise be to reach reasonably certain conclusions about the characterization of a pooled investment without enlisting the assistance of the CFTC. It would appear, for example, from the wording of the ABS Letter that asset-backed commercial paper (ABCP) conduits that hold swaps may still be considered commodity pools unless it can be concluded that they can be operated consistently with the conditions of Rule 3a-7 (even if they rely on a different Investment Company Act exemption) or can otherwise be determined not to be a commodity pool, but the Division did not provide much assistance reaching either of these conclusions. Other types of vehicles or transactions for which relief potentially may need to be found outside narrow readings of the ABS Letter include:

- Future flow, tax lien, franchise, royalty, billboard, and time share transactions;
- Some equipment lease transactions;
- Container lease transactions;
- Project bonds;
- Pre-deal warehousing;
- Auto lease transactions;
- Non-performing mortgage loan and related transactions;
- Certain Islamic finance transactions;
- Repo-related transactions;
- Transactions that cannot rely on Rule 3a-7 solely due to use of non-US trustees;
- Insurance-linked securities and catastrophe bonds; and
- Certain student loan transactions.

Neither the ABS Letter nor the Regulatory Relief Letter grandfathered existing transactions, despite an indication in the ABS Letter that such relief was requested. It should be noted, however, that, since mere conformity with the constraints Regulation AB or Rule 3a-7 suffices, as opposed to the actual application of those regulations, some transactions may in effect be grandfathered.

### **Relief for Equity REITs Under the REIT Letter**

The REIT Letter also deals with pooled investments, but the differences between a real estate investment trust and the kinds of vehicles exempted under the ABS Letter led the Division to phrase the conditions to its relief in somewhat different terms, as follows:

- “The REIT primarily derives its income from the ownership and management of real estate and uses derivatives for the limited purpose of “mitigat[ing] their exposure to changes in interest rates or fluctuations in currency”;

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<sup>2</sup> *Lopez v. Dean Witter Reynolds Inc.*, 805 F.2d 880 (9<sup>th</sup> Cir. 1986)

- The REIT is operated so as to comply with all of the requirements of a REIT election under the Internal Revenue Code, including 26 U.S.C. §856(c)(2) (the 75 percent test) and 26 U.S.C. §856(c)(3) (the 95 percent test); and
- The REIT has identified itself as an equity REIT in Item G of its last U.S. income tax return on Form 1120-REIT and continues to qualify as such, or, if the REIT has not yet filed its first tax filing with the Internal Revenue Service, the REIT has stated its intention to do so to its participants and effectuates its stated intention.”<sup>3</sup>

What the REIT Letter has in common with the ABS Letter is the association of the form of the relief with the existence of standards imposed by another regulator that specify what kind of vehicle an Equity REIT must be and a limitation of the uses to which derivatives may be put. Note, however, that, unlike the REIT Letter, the ABS Letter permits the use of derivatives for credit support. In addition, the REIT Letter lacks the detailed discussion of *Lopez* found in the ABS Letter. This indicates, perhaps, that Equity REITs simply don't resemble commodity pools in the mind of the Division as much as asset-backed securities do.

### Temporary Relief From Registration

The Regulatory Relief Letter provides relief to a number of different kinds of persons subject to the Commodity Exchange Act. To the extent it applies to persons required to register as commodity pool operators and commodity trading advisors or as associated persons of such registrants, it affords them until December 31, 2012 to file the application that **starts** the process of getting registered. Since the process requires application to the National Futures Association (the NFA), one of the Division's concerns was that, absent such temporary relief, the NFA would be overwhelmed with new applicants and that delays in registering the persons involved could lead to market disruptions. As long as the application has been properly completed and filed, along with necessary fingerprint cards, before the deadline, relief under the Regulatory Relief Letter continues until registration has been completed. This presumably means that an organization cannot commence activities that would require anyone to register until all of the necessary registrants have in fact been registered. Registration of a person is complete when the NFA notifies the person to that effect. Relief from registration also terminates five days after the NFA serves notice on a person that the person may be disqualified from registration.

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<sup>3</sup> CFTC Interpretive Letter 12-13 (footnotes omitted).