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# CFTC Issues Interpretive Guidance for Securitizations and Defers Registration Deadline for Certain Persons

Securitization entities and most issuers of similar structured products (collectively, **structured finance entities**) historically have not been regulated as commodity pools by the Commodity Futures Trading Commission (**CFTC**)[1] because, among other reasons, they generally do not hold commodity interests as defined under prior law and regulation. However, the expanded scope of the definition of "commodity pool" under the Dodd-Frank Act,[2] which includes "swaps" as commodity interests, raised a question whether existing and new structured finance entities that have entered or will enter into swaps could be viewed as commodity pools. There was concern that, absent interpretive relief by the CFTC, persons forming or involved with the operation of structured finance entities that enter into swaps, including such entities in existence prior to the change in law, would have to consider whether they were required to register with the CFTC as "commodity pool operators" (**CPOs**) and meet the resulting regulatory burdens.[3] A person who forms or is involved with the operation of a commodity pool without being registered or exempt from CPO registration could be subject to fines and other potential penalties or liabilities; among other potential adverse consequences, an entity classified as a commodity pool that does not have a registered CPO or one exempt from registration would no longer be an "eligible contract participant" able to enter into over-the-counter swaps.

On October 11, 2012, the Division of Swap Dealer and Intermediary Oversight (**Division**) of the CFTC issued an interpretation that the definition of "commodity pool" under the Commodity Exchange Act (**CEA**)[4] does not include securitization vehicles that meet certain specified criteria (**Securitization Letter**).[5] In general, the exclusion is for securitizations under the SEC's Regulation AB or Rule 3a-7, with some distinctions and interpretive issues summarized below. The Securitization Letter was issued in response to industry trade association requests for clarification of the status under the CEA and regulations thereunder of structured finance entities that use swaps.[6] Although the interpretation leaves open a number of areas on which interpretive or other relief had been sought, it nevertheless will provide clarity for a significant portion of the traditional securitization market.

In most cases, sponsors and other related persons of structured finance entities not covered by the Securitization Letter will have some additional time in which to consider appropriate action in view of a letter issued by the Division on October 12, 2012, entitled "Temporary Registration No-Action Relief" (**Temporary No-Action Relief**). In pertinent

1 See our client alert of July 3, 2012, "Potential Regulation of Securitization Vehicles as Commodity Pools."

2 The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (**Dodd-Frank Act**), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3 The concern arose because of the broad interpretation the CFTC has given in the past to the concept of "an investment trust" or similar enterprise "operated for the purpose of trading" in commodity interests. Although participants in the structured finance markets generally believe that securitization entities and most other structured finance entities are not similar to investment trusts and typically are not permitted to engage in trading activities (and even those for which some trading is permitted generally do not trade "commodity interests" as opposed to loans or securities), the CFTC historically has been reluctant to prune back its broad interpretation to exclude categories of transactions from regulation as commodity pools.

4 Codified as amended at 7 U.S.C. §§1-26.

5 See CFTC Staff Letter 12-14.

6 See American Securitization Forum letters to CFTC staff of August 17, 2012 and October 5, 2012, and Securities Industry and Financial Markets Association letter to CFTC of August 21, 2012.

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part from a structured finance standpoint,[7] the Temporary No-Action Relief effectively extends to December 31, 2012, the date by which certain persons would be required to register as a CPO or Commodity Trading Advisor (**CTA**) or to establish an applicable exemption from registration.[8] In general, the Temporary No-Action Relief applies to persons to whom a registration deadline of October 12, 2012 otherwise would have applied and whose activities in question relate solely to "swaps," as defined in the CEA and regulations thereunder (as opposed to futures, options or other instruments that were within the CFTC's jurisdiction prior to October 12, 2012). It is available if (i) the entity's appropriate registration application and the application materials for each of its principals and associated persons are filed with the National Futures Association (NFA) by December 31, 2012, and (ii) on and after December 31, 2012, the entity or individual makes a good faith effort to comply with the CEA and the CFTC's rules applicable to its activities as a CPO, CTA or associated person of either of the foregoing.[9] However, because it can take several weeks (or months for a large institution) to determine and prepare the necessary data and other materials required for registration, the deadline for CPO registration effectively remains imminent, notwithstanding the extension. Persons who are concerned the CFTC may view them as required to register as a CPO with respect to structured finance entities should consider promptly pursuing no-action or interpretive relief. As further discussed below, by registering as a CPO with respect to structured finance entities a person would submit itself to reporting and other compliance requirements, as to itself and the relevant entities, that in their current form are largely inapplicable to structured finance entities and related activities such that full compliance could be problematic or even unfeasible.

## Transactions Excluded Under the Securitization Letter

In the Securitization Letter, the Division summarizes its concerns with narrowing the definition of "commodity pool," as opposed to evaluating facts and circumstances in their entirety to determine whether a "pooled investment vehicle" should be considered to be a commodity pool. However, the Division then provides the analytical framework for its determination that securitization vehicles meeting certain criteria should not be included in the definition of "commodity pool" and their "operators" should not be considered within the definition of "commodity pool operator." The criteria are stated as follows, but the Securitization Letter includes further detail via footnotes:

- "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

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7 The Temporary No-Action Relief also covers introducing brokers, floor brokers, floor traders and associated persons of those CFTC-regulated intermediaries or of futures commission merchants, provided that each would have otherwise been required to register solely because of activities involving swaps.

8 With respect to a CPO, reporting and other compliance requirements would be substantially reduced, though not eliminated, if an exemption from CPO registration were available with respect to all relevant entities, but there could be interpretive difficulty in applying the criteria for exemption under the CFTC's Rule 4.13(a)(3) in its current form to a structured finance entity. Rule 4.13(a)(3) in any case would be potentially available only for private offerings that satisfy a de minimis test with respect to commodity interests. In addition, an exemption from CPO registration (as opposed to exclusion from the definitions of "commodity pool operator" and "commodity pool"), would leave unaddressed potentially material legal issues arising under other law and regulation, or contracts, that can result from an entity being classified as a "commodity pool," even if an exempt pool.

With respect to a CTA, whether a person is acting or required to register in that capacity is only partly a function of whether the activities in question relate to advising a "commodity pool," and must be analyzed whether or not the advised person is a commodity pool.

9 See CFTC Staff Letter 12-15.

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."

Although Regulation AB by its terms relates to registered offerings, a footnote in the Securitization Letter indicates that Regulation AB can be relied upon in determining whether an issuer qualifies for the exclusion from the definition of commodity pool even in connection with private issuances. This language treats Rule 144A and other private issuances of asset-backed securities the same as publicly registered transactions for purposes of the exclusion if they "operate consistent with the conditions set forth in Regulation AB … such that the issuer, pool assets, and issued securities satisfy the requirements of [Regulation AB]". While not free from doubt, this would seem to indicate that private issuances seeking to rely on Regulation AB for the exclusion must satisfy the definitional and structural conditions, but not necessarily the extensive disclosure and reporting requirements, of Regulation AB. This reading is supported by the fact that Rule 3a-7, which can be relied upon as an alternative to Regulation AB for the exclusion, has definitional requirements for eligible assets and structural conditions but not disclosure or reporting requirements.

## Remaining Problems for Structured Finance Entities

Based upon the above summary, while many traditional securitizations have been excluded from commodity pool regulation, there are many types of structured finance transactions that fall outside the exclusion.[10] Notably, the Division's criteria would not cover issuers of asset-backed commercial paper or collateralized loan obligations, unless, in either case, structured to comply with Rule 3a-7 and otherwise in compliance with the criteria above. And there will be transactions as to which the determination is not completely clear.

This is particularly problematic for structures in place before the change in law (**legacy transactions**) where, given the structural and documentation constraints to which structured finance entities typically are subject, it can be difficult to impossible to make operational changes after the closing date. While the Securitization Letter indicates that the Division remains open to discussion, based on facts and circumstances, whether certain structures might not be considered to be commodity pools, or might be treated as exempt pools,[11] there is no assurance that such relief would be granted by December 31.

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10 In the Securitization Letter, the Division refers to particular structural types as to which it views the requested exclusion to be overly broad: "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." However, the Division does not appear to be precluding the possibility of narrower relief in the future for certain of those structures with appropriate criteria or for exclusion under the Securitization Letter if one of those structures, for example a cash CLO, satisfied the five specified criteria.

11 See note 8 above; treatment as an exempt pool would reduce CPO compliance burdens and expenses substantially, but would leave unaddressed other legal issues.

For a structured finance entity, the prospect of registration is highly problematic for many reasons, including —

- The extensive reporting and other compliance requirements applicable to commodity pool operators with respect to their operated pools were designed for investment funds and other investment vehicles that have structures, activities and purposes very different from those of structured finance entities, and thus are largely inapplicable by their terms to most structured finance entities, and unclear as to how compliance would be achieved by such persons (including which one or more persons might be viewed as the CPO).
- Some specific CFTC disclosure requirements for offering materials would be misleading as applied to a securitization and otherwise could conflict with applicable SEC requirements.
- The prospectus approval requirements would undermine the utility of shelf registrations, and beyond that, given the mismatch of required information and structural type, and the understandable unfamiliarity with structured finance of the persons reviewing (the NFA), could significantly delay offerings.
- It would be difficult for any person structuring a new structured finance entity to determine how compliance with commodity pool regulation might be achieved, and could be completely unfeasible in the context of a legacy transaction.
- As noted above, determining and preparing the necessary data and other materials required for registration can take many weeks or, for a large institution, months; therefore, the deadline for commodity pool operator registration and compliance, although extended by the Temporary No-Action Relief, effectively remains imminent.
- There are a number of significant potential adverse effects that could result from the characterization of structured finance entities as commodity pools, including for financial institutions under the Volcker Rule.

Thus, while the Securitization Letter provides a welcome clarification of legal status for a large portion of the traditional securitization market, and the Temporary No-Action Relief provides some additional time to consider appropriate action for structures not squarely within the types excluded from commodity pool regulation, substantial problems remain for a large volume of legacy transactions. In addition, uncertainty remains for persons attempting to structure new transactions that may not be clearly within the categories excluded by the Securitization Letter. And the mismatch, described above, between the CFTC's current disclosure, reporting and other compliance requirements for commodity pools, and the structure and operation of nearly all structured finance entities, will pose a formidable challenge for structured finance entities and related persons seeking to comply until those requirements are adjusted to properly accommodate structured finance entities that are not excluded outright from commodity pool classification.