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Impact of CFTC Swap Regulations on Structured Finance Industry

Introduction

In August 2012, the Commodity Futures Trading Commission (CFTC) published a joint rulemaking with the Securities and Exchange Commission (SEC) implementing various Dodd-Frank Act provisions.[1] The new rulemaking, which took effect on October 12, 2012, threatened to subject a wide range of previously excluded or exempted securitization and finance transactions to CFTC regulation as commodity pools. These regulations essentially implement the Dodd-Frank Act's definition of "commodity pool," which changed the definition from "a pool that is operated for trading in commodity futures and options on an exchange" to "a pool that is operated for the purpose of trading in commodity interests, including any … swaps."[2] Thus, the sponsors and advisors to any special purpose vehicle, investment trust or similar entity using swaps, even if only for hedging or risk management purposes, could be required to submit to CFTC registration, disclosure, advertising, recordkeeping, reporting and other regulation. In response to industry and even government requests for relief from the new regulations,[3] the CFTC Staff issued an interpretation letter on Thursday, October 11, 2012, to clarify whether a broad swath of securitization transactions would have to submit to regulation as "commodity pools."[4] The interpretation letter provides an explicit exception for transactions that meet certain criteria, and keeps open the possibility of individualized no-action or de minimis exceptions, while continuing to defend the CFTC's broad baseline definition of commodity pools.

CFTC Relief Plan

The CFTC Staff offered a three-tiered plan for relief. First, the CFTC Staff explained in the interpretation letter noted above its position regarding commodity pool regulation and providing exclusions from the new requirements. In the letter, the CFTC Staff agreed with industry players that "certain entities that meet certain … criteria… are likely not commodity pools, such as securitization vehicles 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 a specific maturity date."[5] To address transactions such as these, the CFTC Staff stated that transactions such as the foregoing that meet all of the following five criteria would be excluded from status as a commodity pool and thus their sponsors and advisors would be exempt from commodity pool operator (CPO) and commodity trading advisor (CTA) registration and regulation:

1. the issuer of the asset-backed securities is operated consistent with conditions of SEC Regulation AB or SEC Rule 3a-7 of the Investment Company Act of 1940;
2. the entity's activities are limited to passively owning or holding a pool of receivables or other financial assets that by their terms convert to cash within a finite period of time;
3. the entity's use of derivatives is limited to the use of derivatives permitted under Regulation AB;
4. the issuer makes payments to securities holders only from cash flow generated by its pool assets and other assets, and not from changes to value in the entity's equity assets; and
5. the issuer may not acquire additional assets or dispose of assets for the primary purpose of realizing gain or minimizing loss due to changing values of the vehicle's assets.[6]

Industry insiders believe that, in application, the exclusion will focus more on the nature of the activities and entities applying than on some of the specific requirements of Regulation AB or Rule 3a-7 such as the filing and disclosure requirements of Regulation AB.[7] However, the scope of terms such as "operated consistent with" remains uncertain and therefore requires further explication.

A number of important transactions, such as asset-backed commercial paper (ABCP), collateralized loan obligations (CLOs), collateralized debt obligations (CDOs) and covered bonds, do not fit this specific exclusion. For transactions such as these, the CFTC Staff stated repeatedly that de minimis exceptions and no-action letters would be considered upon application. This has prompted industry participants to consider other avenues for exclusion or exemption. CFTC Rule 4.13(a)(3), which exempts commodity pool operators from registration and regulation as such who engage only in de minimis pool trading, is one possibility which industry leaders are considering to exempt operators of CLOs, CDOs and other similar securitization transactions.[8] Traditional CMBS and RMBS securitizations should satisfy the five conditions.

In the second part of its relief measure, the CFTC Staff also issued a temporary no-action letter, which lasts until December 31, 2012.[9] This tolling temporarily exempts any person from registration as an introducing broker, CPO, CTA, or associated person of the foregoing where the requirement arises solely from swaps activity of such person. This relief is available to operators and advisors to public and private investment funds, business development companies, finance companies and securitization vehicles.

The final stage of the CFTC relief will arrive by January 1, 2013, when the new rules will take effect unless delayed further (of which there is no indication). Until then, the CFTC and industry participants will continue to consider, interpret and apply the particulars of the interpretative and no-action letters and discuss the options available to various securitization, finance and investment fund vehicles.

Ongoing Concern Over the New Regulations

The CFTC Staff's clarification and temporary relief fails to solve some of the problems produced by the new rules. Primarily, the exclusions and exemptions are practically too narrow. The interpretation does not encompass enough securitization entities and transactions, and therefore leaves a broad patch of the market still subject to CFTC regulation. The list of currently non-excluded securitization deals includes most ABCP, synthetics, CLOs, CDOs, and covered bonds, as well as tax liens, future flow deals, royalty payment streams, auto and equipment lease-backed securities which rely on residuals, insurance-linked securities such as CAT bonds, container leases, time shares, whole businesses and possibly others. Although the CFTC Staff made clear that additional transactions could qualify for regulatory relief, it remains unclear exactly which transactions will be ultimately excluded or exempt. CLOs, for example, may be able to use CFTC Rule 4.13(a)(3) to avoid CPO registration, while ABCP deals in particular face a difficult challenge in obtaining exempt status.

A related issue is the effect on legal opinions covering securitization transactions that do not satisfy the five conditions but which are not substantively commodity pools.

Additionally, the CFTC Staff has not addressed concerns that the new rule will interact with the so-called Volcker Rule in the Dodd-Frank Act. The Volcker Rule was designed as a ban against proprietary trading and targets hedge funds and private equity funds, but has consequences outside its intended purpose with regards to securitizations. If non-exempt securitization vehicles are brought within Volcker Rule regulation, the banks which sponsor these securitization vehicles could not retain ownership interests or other interests in those vehicles. The CFTC has largely deferred to the Volcker regulators to determine how the two will interact.

Conclusion

The new CFTC rules having application to previously excluded or exempted securitization transactions have produced a flurry of industry activity. Although the CFTC Staff has produced one clear exclusion and kept the avenues open for further or additional exclusions or exemptions, it remains unclear whether they will grant any other permanent relief, especially in the case of CLOs, CDOs and ABCP. As a result, participants in these industries are encouraged to work with trade groups and counsel to seek additional no action or interpretive relief as encouraged by the CFTC.

Footnotes

1 Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Recordkeeping, 77 Fed. Reg. 48208 (Aug. 13, 2012).

2 Commodity interests now includes exchange-traded futures contracts, options on futures contracts and commodity options and certain exchange-traded and over-the-counter swaps, forwards and options. “Security based on swaps” are not commodity interests, such as a swap on a narrow-based security index (i.e., generally having 9 or fewer component securities), single security, or single loan (including any interest therein or based on the value thereof) or a credit default swap on a single securities issuer or the issuers in a narrow-based security index.

3 The American Securitization Forum (ASF), as well as House Representatives Frank Lucas (Chairman of the House Committee on Agriculture), Spencer Bachus (Chairman of the House Committee on Financial Services), K. Michael Conaway (Chairman of the House Agricultural Subcommittee on General Farm Commodities and Risk Management), and Scott Garrett (Chairman of the House Subcommittee on Capital Markets and Government Sponsored Enterprises), voiced concern over the new rules.

4 CFTC Interpretive Letter, Re: Request for Exclusion from Commodity Pool Regulation for Securitization Vehicles (Oct. 11, 2012).

5 CFTC Interpretive Letter, at 4.

6 See Interpretive Letter, at 4-5, for specific wording, as well as relevant footnotes.

7 17 CFR 270.3a-7.

8 CFTC Rule 4.13(a)(3) provides in relevant part (note that the de minimis tests are done each time a new position is established):

> § 4.13 Exemption from registration as a commodity pool operator
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> (a) A person is not required to register under the Act as a commodity pool operator if:
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> (3) For each pool for which the person claims exemption from registration under this paragraph (a)(3):
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> (i) Interests in the pool are exempt from registration under the Securities Act of 1933, and such interests are offered and sold without marketing to the public in the United States;
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> (ii) At all times, the pool meets one or the other of the following tests with respect to its commodity interest positions, including positions in security futures products, whether entered into for bona
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> (B) The aggregate net notional value of such positions, determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into. For the purpose of this paragraph:
>
> (1) The term “notional value” shall be calculated for each futures position by multiplying the number of contracts by the size of the contract, in contract units (taking into account any multiplier specified in the contract, by the current market price per unit, for each such option position by multiplying the number of contracts by the size of the contract, adjusted by its delta, in contract units (taking into account any multiplier specified in the contract, by the strike price per unit, for each such retail forex transaction, by calculating the value in U.S. dollars of such transaction, at the time the transaction was established, excluding for this purpose the value in U.S. dollars of offsetting long and short transactions, if any, and for any cleared swap by the value as determined consistent with the terms of part 45 of the CFTC's regulations; and
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> (2) The person may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade; and swaps cleared on the same designated clearing organization where appropriate; and
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> (iii) The person reasonably believes, at the time of investment (or, in the case of an existing pool, at the time of conversion to a pool meeting the criteria of this CFTC Rule 4.13 (a)(3)), that each person who participates in the pool is:
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> (A) An “accredited investor,” as that term is defined in 17 C.F.R. 230.501 of this title;
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> (B) A trust that is not an accredited investor but that was formed by an accredited investor for the benefit of a family member;
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> (C) A “knowledgeable employee,” as that term is defined in 17 C.F.R. 270.3c-5 of this title;
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> (D) A “qualified eligible person,” as that term is defined in CFTC Rule 4.7(a)(2)(viii)(A) or
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> (E) A person eligible to participate in a pool for which the pool operator can claim exemption from registration under paragraph (a)(4) of this section; and
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> (iv) Participations in the pool are not marketed as or in a vehicle for trading in the commodity futures or commodity options markets; Provided, That nothing in paragraph (a)(3) of this section shall

fide hedging purposes or otherwise:

(A) The aggregate initial margin, premiums, and required minimum security deposit for retail forex transactions (as defined in CFTC Rule 5.1(m)) required to establish such positions, determined at the time the most recent position was established, will not exceed 5 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into; Provided, That in the case of an option that is in-the-money at the time of purchase, the in-the-money amount as defined in CFTC Rule 190.01(x) may be excluded in computing such 5 percent; or

prohibit the person from claiming an exemption under this section if it additionally operates one or more pools for which it meets the criteria of paragraph (a)(4) of this section;

9 CFTC No-Action Letter, No-Action Position: Registration Relief for Certain Persons No. 12-22 (October 11, 2012).

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