WHITE PAPER

APPLICABILITY OF U.S. RISK RETENTION RULES TO

STRUCTURED FINANCINGS OF PROVEN, DEVELOPED AND PRODUCING HYDROCARBON WELLS

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*The purpose of this White Paper is to provide general guidance to transaction participants and practitioners in their consideration of the application of 17 C.F.R. Part 246, adopted jointly by the Securities and Exchange Commission ("**SEC**") and five other federal agencies (the "**Agencies**") in October of 2014 (the "**CRR Rules**") pursuant to Section 15G of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), as added by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, to a typical issuance of secured notes by a newly formed special purpose vehicle that owns or will own, among other things, a portfolio of proven, developed and producing hydrocarbon wells (a "**Structured PDP Well Financing**"), as further described below.*

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The Structured PDP Well Financing

In a typical Structured PDP Well Financing, an upstream oil and gas company will transfer ownership of certain assets to a newly-formed bankruptcy remote special purpose vehicle. These assets consist of (i) wellbores and associated leasehold interests that entitle the lessee to extract hydrocarbons from the lands on which they are located or pooled with (the "**Wellbores**") and (ii) personal property and other equipment used to extract those hydrocarbons from the ground (the "**Equipment**").

The acquiring special purpose vehicle will finance the purchase price by issuing one or more tranches of secured notes. The notes will be secured by the Wellbores, the Equipment and by (I) a management services agreement, a back-up management agreement, (if applicable) an operating

agreement and certain agreements ancillary thereto (the "**Service Provider Contracts**"), (II) gathering, processing, marketing and other offtake agreements (the "**Downstream Agreements**"), and (III) hedging agreements to protect against price fluctuation of the hydrocarbons that the issuer expects to generate from the other Collateral (the "**Hedges**," and together with the Wellbores, the Equipment, the Service Provider Contracts and the Downstream Agreements, the "**Collateral**"). The issuer typically enters into the Service Provider Contracts and assumes the Downstream Agreements in connection with the Structured PDP Well Financing. Hedges may be novated to the issuer by the seller of the Wellbores or entered into by the issuer in connection with the transaction.

The issued notes typically have an anticipated repayment date and a longer-dated maturity date. If notes remain outstanding on the anticipated repayment date, a rapid amortization date occurs causing all excess cash to be applied to repayment of the notes. Failure to repay the notes does not result in an event of default until the maturity date.

The CRR Rules

17 C.F.R. Part 246.3(a): **Base risk retention requirement**. Except as otherwise provided in this part, the sponsor[1] of a securitization transaction[2] (or majority-owned affiliate of the sponsor) shall retain

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[1] *Sponsor* means a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.

[2] *Securitization transaction* means a transaction involving the offer and sale of asset-backed securities by an issuing entity.

Asset-backed security has the same meaning as in section 3(a)(79) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(79)), which defines the term as follows:

(79) *Asset-backed security*.—The term "asset-backed security"—

(A) means a fixed-income or other security collateralized by any type of ***self-liquidating financial asset*** (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend ***primarily*** on cash flow from the asset, including—

(i) a collateralized mortgage obligation;
(ii) a collateralized debt obligation;
(iii) a collateralized bond obligation;
(iv) a collateralized debt obligation of asset-backed securities;
(v) a collateralized debt obligation of collateralized debt obligations; and
(vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and

(B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

an economic interest in the credit risk of the securitized assets[3] in accordance with any one of §§246.4 through 246.10.

Whether the CRR Rules apply to a Structured PDP Well Financing therefore depends on whether such a financing constitutes a "securitization transaction" or, in other words, an "offer and sale of asset-backed securities" as defined in the Exchange Act. In order to constitute "asset-backed securities," the offered notes must be collateralized by "*self-liquidating financial assets that . . . depend primarily on the cash flow from the assets*."

The Exchange Act definition lists examples of "asset-backed securities" which, while non-exclusive, consist of collateralized loan, mortgage or debt obligations. The definition also lists loans, leases, mortgages and secured or unsecured receivables as examples of self-liquidating financial assets. While non-exclusive, all of these assets share certain characteristics: they are, or evidence, debt-like payment obligations by an obligor that are typically fixed or calculated according to a stated formula (*i.e.*, a "financial asset"), and the obligor's obligation exists irrespective of, and does not require, any meaningful action by the beneficiary or another party (*i.e.*, it is "self-liquidating"). Put another way, assets independently generate income sufficient to pay back their original cost or by their terms turn into cash. Accordingly, the plain meaning of the Exchange Act definition itself, including the examples provided therein, suggests that the Agencies were concerned with the repackaging of debt-type payment obligations into securities being offered for sale.

The SEC's rulemaking process for Regulation AB[4] provides some additional context for what the SEC considers to be an "asset-backed security." In its 2005 adopting release for Regulation AB, the SEC

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[3] *Securitized asset* means an asset that:

(1) Is transferred, sold, or conveyed to an issuing entity; and

(2) Collateralizes the ABS interests issued by the issuing entity.

ABS interest means:

(1) Any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest (other than an uncertificated regular interest in a REMIC that is held by another REMIC, where both REMICs are part of the same structure and a single REMIC in that structure issues ABS interests to investors, or a non-economic residual interest issued by a REMIC), payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity; and

(2) Does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that:

(i) Are issued primarily to evidence ownership of the issuing entity; and

(ii) The payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity; and

(3) Does not include the right to receive payments for services provided by the holder of such right, including servicing, trustee services and custodial services.

[4] 17 C.F.R. §§ 299.1100 et seq.

highlighted "*a general absence of active pool management*" and "*the self-liquidating nature of pool assets that by their own terms convert into cash*" as key features of "asset-backed securities."[5]

In the same release, the SEC recognized that a meaningful amount of residual value of the assets is uncharacteristic of an "asset-backed security:" "*[E]ven though we are recognizing the growth in lease-backed ABS that include securitizations of residual value, such securitizations are subject to additional factors that are not present in securitizations backed solely by financial assets that convert into cash. . . . In addition, the transaction is not simply dependent on the servicing and amortization of the pool assets, but also on the capability and performance of the party that will be used to convert the physical property into cash and thus realize the residual values. The higher the percentage of cash flows that are to come from residual values, the more important these other factors become and the less the transaction resembles a traditional securitization of financial assets for which our regime for asset-backed securities is designed.*"[6] Even in securitizations where repayment of the offered securities is not dependent on residual value of the underlying assets, these statements evidence the SEC's view that securitizations of self-liquidating financial assets primarily depend on cash flows from the assets themselves and not on the capability or performance of the party generating the cash flows from the underlying assets.

In the 2020 adopting release for its proprietary trading restrictions, the SEC, together with a number of other federal agencies, expressly declined to depart from the Exchange Act definition of "asset-backed securities" by stating: "*Finally, the agencies are not revising the definition of "asset-backed security" in the implementing regulations. The definition of "asset-backed security" in the implementing regulations specifically refers to the meaning specified in section 3(a)(79) of the Exchange Act (15 U.S.C. 78c(a)(79)). This definition is used elsewhere in banking law, and banking entities and others in the loan securitization industry have adapted their operations in reliance on the definition contained in the Exchange Act. Moreover, the 2013 rule*[7] *included the requirement that the fund issue asset backed securities as part of the loan securitization criteria, and banking entities have become familiar with this definition, as they have implemented and utilized the exclusion*."[8] This statement demonstrates that the SEC was aware of how the Exchange Act definition was being applied in practice and that it saw no need to intervene as recently as 2020.

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[5] Asset-Backed Securities, 70 Fed. Reg. 1506, 1513 (Jan. 7, 2005) (codifying 17 C.F.R. pts. 210, 228, 229, 230, 232, 239, 240, 242, 245 and 249).

[6] *Id*. at 1519.

[7] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds; Final Rule, 79 Fed. Reg. 5535 (Jan. 31, 2014) (codified at 12 C.F.R. pts. 44, 248 and 351; 17 C.F.R. pt. 255).

[8] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule, 85 Fed. Reg. 46421, 46441 (July 31, 2020) (codifying 12 C.F.R. pts. 44, 248 and 351; 17 C.F.R. pts. 75 and 255).

The Assets Collateralizing the Notes

In our view, the assets collateralizing the notes issued as part of a Structured PDP Well Financing are not "self-liquidating financial assets," and such notes do not depend "primarily" on cash flows from "self-liquidating financial assets" for payment.

In most states, the issuer's interests in the Wellbores are real property interests coupled (unlike a lessor's interest) with obligations to pay rent and royalties for hydrocarbons produced therefrom. These real property interests held by the issuer as lessee are not financial assets and they do not themselves generate any income. Any income derived from these real property interests of the lessee would not be primarily generated by the Wellbores, but also from whatever activity the issuer, or the operator, conducts on the premises and, of course, the presence of hydrocarbons available for extraction. This is inconsistent with self-liquidating assets, which turn into cash by their terms. Similarly, the Equipment consist of personal property, fixtures and equipment used in the issuer's business of extracting hydrocarbons, and they are not themselves income-generating nor do they entitle the issuer to receive payments. The Equipment neither constitutes financial assets, nor is it self-liquidating by the plain meaning of those terms.

The Service Provider Contracts are commercial agreements between the issuer and several service providers who operate and maintain the Wellbores and Equipment and the business of the issuer. The services performed under the Service Provider Contracts are highly specialized and require extensive expertise and potential capital investment. Without these services, the Collateral would not generate income with which to service the notes, and the service providers' capability and performance will largely determine whether the notes can be repaid on schedule. Because the operator's role in generating cash flows from the Collateral is tied to the performance of the notes, rating agencies and investors conduct due diligence on the operator and ultimately rate and price the notes in part based on their assessment of the operator's ability, reliability and credit risk, among other factors. If the Collateral fails to perform as contemplated by the transaction documents, a back-up manager will have an increased role in the management of the issuer, and possibly the operations of the Wellbores, to try to help improve performance. Ultimately, the holders of the notes will have the ability to replace the manager of the issuer, and possible the operator of the Wellbores, with a third party in a default/foreclosure scenario.

Pursuant to the Downstream Agreements, the issuer's counterparty gathers, processes, treats and markets the produced hydrocarbons. Like the Service Provider Contracts, these are commercial contracts and the income generated from these agreements is a function of the hydrocarbons produced upstream, as well as the capability and performance of the counterparty to the Downstream Agreements. While the issuer receives payments pursuant to certain of the Downstream Agreements, these marketing agreements lack several of the key characteristics of self-liquidating financial assets. First, any cash proceeds are the result of arm's-length sale and purchase transactions for the issuer's hydrocarbons, rather than constituting repayments for debt extended or rent payments for leased properties. The issuer only receives cash in

exchange for product it actually delivers, so the Downstream Agreements do not convert into cash by their terms. Second, in order to deliver any product for sale, the issuer (or its service providers) must expend significant expertise, as described above. Finally, the marketing agreements are of limited duration and revenues generated thereunder are dependent upon prevailing commodity prices at the time of the sale. The marketing agreements typically have terms between one and twelve months and must be renegotiated and replaced at the end of their terms. The pricing under the marketing agreements is tied to prevailing market index prices in the area the hydrocarbon production is sold at the time of sale. The hydrocarbon production itself can be moved across the country and sold into different markets and pricing can vary in each of these markets. Therefore, the actual cash flows generated under the marketing agreements will depend upon efforts of the issuer (or its service providers). For these reasons, the Downstream Agreements are not self-liquidating.

The Hedges are put in place to protect the issuer against fluctuations in commodities prices over the tenor of the notes, but they do not protect the issuer against shortfalls in hydrocarbon production volumes required to repay the notes. The Hedges are financial contracts entered into by the issuer and can turn out to be assets or liabilities. Increases in commodities prices above the strike price of the Hedges would obligate the issuer to make a payment to its counterparty; decreases in commodities prices below the strike price would entitle the issuer to payment from its counterparty. The value of the Hedges can therefore be expected to fluctuate over time and will only represent meaningful cash flows to the issuer if commodities prices drop significantly. Absent such circumstances, the Hedges will not convert into cash by their terms, or at all. Even if commodities prices were to drop significantly for a prolonged period of time, cash flows from the Hedges would almost certainly be inadequate to repay the notes without production from the Collateral. Even if the Hedges are viewed as financial assets of the issuer, their uncertain and fluctuating value and cash flows make it difficult to argue that they are self-liquidating in the sense that they do not convert into cash by their own terms—they may not convert into cash at all.

Furthermore, the notes are collateralized not *primarily* by the Hedges but rather by the entirety of the Collateral. The Hedges are ancillary to the issuer's other assets in that they protect the issuer against commodities price fluctuation in order to preserve the value of its other assets. Accordingly, the performance of the notes does not *primarily* depend on cash flows from the Hedges (even if they are considered financial assets) but is much more reliant on the volume of hydrocarbons obtained from the Wellbores and the capability and performance of the counterparties to the Service Provider Contracts and the Downstream Agreements, which will determine the production quantities and revenues from the produced hydrocarbons. It is therefore more appropriate to say that the performance of the notes depends *primarily* on the active management, capability and performance of the counterparties to the Service Provider Contracts and the Downstream Agreements and the presence of hydrocarbons available for extraction in the Wellbores.

Conclusion

It is our view that the CRR Rules do not apply to the notes issued in connection with a Structured PDP Well Financing because, for the reasons discussed above, the notes do not depend primarily on the cash flow from "self-liquidating financial assets," and therefore the notes do not constitute "asset-backed securities" (as defined by the Exchange Act) for purposes of the CRR Rules.

VINSON & ELKINS LLP