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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

STRUCTURED FINANCE

Paula S. Greenman
New York
212.735.2789
paula.greenman@skadden.com

Andrew M. Faulkner
New York
212.735.2853
andrew.faulkner@skadden.com

DERIVATIVES REGULATION AND LITIGATION

Mark D. Young
Washington, D.C.
202.371.7680
mark.d.young@skadden.com

George M. Gilbert
Washington, D.C.
202.371.7516
george.gilbert@skadden.com

Daniel S. Konar II
Washington, D.C.
202.371.7102
daniel.konar@skadden.com

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1440 New York Avenue, NW,
Washington, D.C. 20005
Telephone: 202.371.7000

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

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Potential Regulation of Securitization Vehicles as Commodity Pools*

Few, if any, securitization vehicles today are subject to regulation by the Commodity Futures Trading Commission (CFTC) as "commodity pools" and most, if not all, securitization vehicles today are eligible to enter into interest rate, currency and other types of swaps as "eligible contract participants" under the Commodity Exchange Act (CEA).[1] A combination of the Dodd-Frank Act[2] and CFTC interpretations inadvertently threatens to change both outcomes. Unless the CFTC acts to provide relief, in a matter of months those who operate securitization vehicles that use swaps, including those in existence prior to the change in law, are in serious jeopardy of being required to register with the CFTC as "commodity pool operators" and meet the resulting regulatory burdens in order for the vehicles to continue to be eligible to enter into swaps to hedge their other assets. Otherwise, these vehicles would be foreclosed from entering into swaps and could encounter a variety of problems even in maintaining pre-existing swaps.

Expanded Definition of 'Commodity Pool'

The Dodd-Frank Act amended the CEA to add "swaps" to the CFTC's jurisdiction. Although the CFTC and SEC have not yet adopted the final rule defining "swap" that will give effect to this amendment, the broad statutory definition includes the products typically used by securitization vehicles to hedge interest rate or currency risk.[3] Among the related changes to the CEA, the Dodd-Frank Act added "swaps" to the list of "commodity interests" in the definition of "commodity pool."[4] As a result, securitization vehicles that enter into swaps — *even a single swap used purely for hedging purposes* — will hold "commodity interests" and accordingly could be viewed as commodity pools by the CFTC.[5]

Persons Potentially Regulated as Commodity Pool Operators, Commodity Trading Advisors

Certain persons who form and/or have administrative or other responsibilities in relation to commodity pools are "commodity pool operators" (CPOs), and absent a relevant exemption with respect to each commodity pool are required to register with the

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* *See also* our memorandum of June 27, 2012, "CFTC's Expanded Jurisdiction Over Swaps May Capture Certain REITs."

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

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 CEA definition includes, among other products, any agreement, contract or transaction commonly known as an interest rate swap, rate cap, rate floor, rate collar or currency swap. 7 U.S.C. § 1a(47)(A).

4 The definition reads, in pertinent part: "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any . . . swap." 7 U.S.C. § 1a(10). The statutory definitions of "commodity pool operator" and "commodity trading advisor" also were amended to add the word "swap." 7 U.S.C. §§ 1a(11), 1a(12).

5 The CFTC has construed the concept of commodity pool broadly and has consistently maintained that there is no minimum trading threshold for qualification as a CPO. *See, e.g.*, the CFTC's final rulemaking relating to compliance obligations for commodity pool operators and commodity trading advisors (the CPO/CTA Rules). 77 Fed. Reg. 11252 (Feb. 24 2012), as partially restated by 77 Fed. Reg. 17328 (March 6, 2012) (to be codified at 17 C.F.R. Pts. 4, 145, 147).

CFTC. Once registered, CPOs may be subject to compliance obligations, including filing certified annual reports and submitting their offering documents for pre-approval. Although most securitization entities would not have a person that clearly corresponds to the role of CPO under commodity pool law and regulation — including because the role encompasses the functions of a sponsor and of a person responsible for ongoing management — candidates for deemed CPO status could include sponsors, depositors, servicers, advisors, collateral managers, trustees and syndicate members.

Similar requirements apply to persons acting in an investment advisory or similar capacity with respect to a commodity pool, who are known as "commodity trading advisors" (CTAs). Although many securitization entities would not have any person designated as such an advisor, persons who potentially could be considered CTAs include collateral managers, servicers, administrative agents or other persons that have authority or discretion in connection with the entity's entry into or termination of swap transactions.

In general, CPOs and CTAs would be subject to increased duties and a heightened standard of care (relative to sponsors or servicers of or advisors to a securitization entity), and thereby a greater risk of potential liability. Registration as a CPO or CTA also requires membership in the National Futures Association (NFA), and NFA members are subject to periodic examination and audit and generally are required to ensure that their "associated persons" satisfy certain proficiency examination requirements.[6] Persons deemed to be acting as a CPO or CTA without being registered or exempt from registration as such would be in violation of the CEA and could be subject to penalties.

Although an exemption from registration as a CPO may be available under the CFTC's Rule 4.13(a)(3) in respect of some privately offered transactions that also satisfy a *de minimis* trading test (based on an objective calculation), there are technical aspects of the regulation that may limit its usefulness for many securitizations.[7] Moreover, there is no such exemption in respect of publicly offered transactions. In any event, while exemption from CPO registration when available reduces certain operational and compliance burdens, the relevant entity is still a commodity pool, and its CPO and CTA are still subject to regulation under the CEA, including its anti-fraud provisions.

Other Issues for Securitizations

Additional issues raised for securitizations if considered commodity pools are:

- Reporting and other requirements applicable to CPOs with respect to their operated pools are unclear as to how they would apply to securitizations.
- The hedging swaps typically used by securitization vehicles are over-the-counter transactions specifically designed for the related securitization. Both under existing law and under the new regulatory regime for swaps, a person must be an "eligible contract participant" (ECP) to enter into such off-exchange swaps, whether or not that person is a commodity pool. However, under new regulations that will become effective as of December 31, 2012 and will apply to existing and new entities, a commodity pool generally will not be an ECP unless formed and operated by a person subject to regulation under the CEA.[8]

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6 An "associated person" of a CPO is any natural person acting in a capacity that involves "(i) the solicitation of funds, securities, or property for a participation in a commodity pool or (ii) the supervision of any person or persons so engaged." *See* 7 U.S.C. § 6(k)(1); 17 C.F.R. § 1.3(aa)(3).

7 17 C.F.R. § 4.13(a)(3). The lack of clarity arises in part from ambiguities created by the new CPO/CTA Rules. *See* the discussion in our client memorandum, dated Feb. 22, 2012, under the heading "Investor Sophistication Restriction Under Rule 4.13(a)(3)."

8 *See* 7 U.S.C. § 1a(18) and joint final rulemaking further defining "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Participant" (the Entity Definitions) 77 Fed. Reg. 30596 (May 23, 2012) (to be codified at 17 C.F.R. Pts. 1 and 140); 17 C.F.R. § 1.3(m), §§ 1.3(m)(5) and 1.3(m)(6).

- The time available for compliance may be as short as a few months away. However, the new regulations are unclear as to the effective date for compliance by CPOs and CTAs in respect of existing entities that were not subject to commodity pool regulation under prior law and regulation. While there is some possibility that date could be as late as December 31, 2012, it could be as soon as 60 days following publication in the Federal Register of the final rules defining the term "swap." Those rules are expected to be published this summer, possibly in July.
- The proposed definition of "covered fund" under the notices of proposed rulemaking to implement the Volcker Rule includes — in addition to investment companies exempted from registration solely by reason of Sections 3(c)(1) or 3(c)(7) of the Investment Company Act — "commodity pools" as defined under the CEA.[9] Among other things, the Volcker Rule would prohibit certain financial institutions from sponsoring or owning interests in "covered funds." Accordingly, if securitization entities that use swaps are viewed as commodity pools by the CFTC, then absent an exclusion from "covered funds" under the Volcker Rule for commodity pools that are securitization entities, financial institutions would be restricted from sponsoring or owning interests in securitization entities that enter into swaps.

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9 *See* the CFTC's notice of proposed rulemaking relating to prohibitions and restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and covered funds.