



## U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Swap Dealer and  
Intermediary Oversight

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CFTC Letter No. 15-21  
No-Action  
March 31, 2015  
Division of Swap Dealer and Intermediary Oversight

### **Re: No-Action Position: Certain Commission Regulations Applicable to Swaps with Legacy Special Purpose Vehicles**

Ladies and Gentlemen:

This letter is in response to a request on behalf of certain swap dealers (“SDs”) provisionally registered with the U.S. Commodity Futures Trading Commission (“**Commission**”) from the Structured Finance Industry Group (“**SFIG**”) to the Division of Swap Dealer and Intermediary Oversight (“**DSIO**”) of the Commission for a position of no-action with respect to a failure by an SD to comply with certain specified Commission regulations when entering into one or more swaps with a structured finance special purpose vehicle (“**SPV**”) in replacement for one or more Legacy SPV Swaps<sup>1</sup> solely for purposes of addressing, or in reasonable anticipation of the occurrence of, a credit downgrade of an SD counterparty to a Legacy SPV Swap.

Specifically, SFIG is requesting that DSIO take a no-action position with respect to an SD’s compliance with the following Commission regulations when entering into a swap in replacement of a Legacy SPV Swap: §§ 23.402(b) and (c), 23.430, 23.431(a)-(b), 23.432, 23.434, 23.502(b), 23.504(b)(4)-(6), and 23.701 (collectively, the “**Specified Regulations**”). SFIG states that an SD would not be able to comply with the Specified Regulations because

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<sup>1</sup> For purposes of this letter, “**Legacy SPV Swap**” means a swap executed on or prior to October 10, 2013 between an SPV whose obligations currently have a credit rating from at least one of Moody’s Investor Services (“Moody’s”), Standard and Poor’s Ratings Services (“S&P”), or Fitch Ratings Inc. (“Fitch”) and a counterparty that, at the time the swap was executed, had a credit rating from at least one of Moody’s, S&P, or Fitch. October 10, 2013 is the date on which certain exemptive relief granted by the Commission expired. *See* Exemptive Order Regarding Compliance with Certain Swap Regulations, 78 FR 43785 at 43793 (July 22, 2013).

restrictions in SPVs' governing documentation may prevent an SPV from taking certain actions required by the SD to comply with the Specified Regulations.<sup>2</sup>

### **Applicable Regulatory Requirements**

Upon registration with the Commission, an SD must submit documentation demonstrating its compliance with any Commission regulation issued pursuant to section 4s(e), (f), (g), (h), (i), (j), (k), and (l) of the Commodity Exchange Act ("CEA") that is applicable to it and for which the compliance date has passed. Such Commission regulations include business conduct standards under subpart H of part 23 of the Commission's regulations promulgated under section 4s(h) of the CEA, and documentation standards under subpart I of part 23 of the Commission's regulations promulgated under section 4s(i) of the CEA. As detailed below, SDs must comply with many of these requirements prior to entering into a swap with any counterparty.

#### **A. Business Conduct Standards with Counterparties**

With respect to business conduct standards with counterparties, section 4s(h) of the CEA provides the Commission with both mandatory and discretionary rulemaking authority to impose business conduct standards on SDs and MSPs in their dealings with counterparties.

Pursuant to section 4s(h) of the CEA, on February 17, 2012, the Commission adopted as final rules subpart H to part 23, which sets forth business conduct standards for SDs and major swap participants ("MSPs") in their dealings with counterparties (the "External BCS").<sup>3</sup>

Of note in relation to this letter, a number of the Commission's rules under the External BCS require SDs and MSPs to provide or obtain specific information from their counterparties and to perform certain due diligence inquiries with respect to their counterparties prior to entering into (or in some cases, offering to enter into) a swap with such counterparties.<sup>4</sup> Certain

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<sup>2</sup> DSIO has previously recognized the significant operational difficulties that may arise if compliance with the Commission's swap regulations was required of existing SPVs. *See, e.g.*, CFTC Letter No. 12-45 (providing relief from "commodity pool" status to certain securitization vehicles formed prior to October 12, 2012).

<sup>3</sup> Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 FR 9734 (Feb. 17, 2012).

<sup>4</sup> *See* Commission regulation § 23.402(b) (requiring SDs to obtain essential facts about their counterparty prior to execution of a transaction); § 23.402(c) (requiring SDs and MSPs to obtain the true name and address and occupation of their counterparty prior to execution of a transaction); § 23.430(a) and (b) (requiring SDs and MSPs to verify that a counterparty meets the eligibility standards for an eligible contract participant and whether the counterparty is a Special Entity before offering to enter into or entering into a swap with such counterparty); § 23.431(a) (requiring SDs and MSPs to provide material information concerning a swap to its counterparty at a reasonably sufficient time prior to entering into the swap); § 23.431(b) (requiring SDs to provide notice to counterparties that they can request and consult on the design of a scenario analysis); § 23.432 (requiring SDs and MSPs to provide notice to counterparties of the right to select clearing and the DCO on which a swap is to be cleared); § 23.434 (requiring SDs and MSPs that recommend a swap to have a reasonable basis to believe that the swap is suitable for the counterparty).

safe harbors under the External BCS permit SDs and MSPs to rely on written representations from their counterparties and standardized disclosures, each of which may require amendments or supplements to an SD's or MSP's relationship documentation with such counterparties prior to entering into a swap with such counterparties.<sup>5</sup>

## **B. Swap Trading Relationship Documentation**

Documentation standards for SDs have been adopted by the Commission pursuant to Sections 4s(h) and 4s(i)(1) of the CEA, which require SDs to “conform with such standards as may be prescribed by the Commission by rule or regulation that relate to timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps,” and Section 4s(i)(2) of the CEA, which requires the Commission to adopt rules “governing documentation standards for swap dealers . . . .” On September 11, 2012, the Commission issued final rules governing swap trading relationship documentation (§ 23.504).<sup>6</sup> Commission regulation § 23.504 requires that an SD execute swap trading relationship documentation meeting the requirements of the rule with a counterparty prior to or contemporaneously with entering into a swap transaction with such counterparty.<sup>7</sup>

Regarding the content of swap trading relationship documentation, each SD must establish policies and procedures reasonably designed to ensure that the parties have agreed in writing to all terms governing their trading relationship, including, among other things, terms related to credit support arrangements, such as initial and variation margin requirements and custodial arrangements, and terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution.<sup>8</sup> With respect to valuation of swaps, SDs must include agreement on the process for determining the value of each swap at any time from execution to the termination, maturity, or expiration of the swap, for the purposes of complying with: (1) the margin requirements under section 4s(e) of the CEA and Commission regulations; and (2) the risk management requirements under section 4s(j) of the CEA and Commission regulations.<sup>9</sup> The documentation also must include either: (1) alternative methods for determining the value of the swap, in the event of the unavailability or other failure of any input required to value the swap; or (2) a valuation dispute resolution

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<sup>5</sup> See § 23.402(d), (e), and (f).

<sup>6</sup> Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 FR 55904 (Sept. 11, 2012).

<sup>7</sup> See § 23.504(a)(2).

<sup>8</sup> See § 23.504(b)(1) and (3).

<sup>9</sup> See § 23.504(b)(4)(i).

process.<sup>10</sup> SDs' documentation must also provide certain information about the parties' status in relation to the orderly liquidation provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Federal Deposit Insurance Act,<sup>11</sup> as well as a prescribed notice on the effect of submitting a swap for clearing on a derivatives clearing organization.<sup>12</sup>

### **Summary of Request for No-Action Position**

#### **A. SPV Credit Ratings and Remedial Actions**

As represented by SFIG, SPVs are formed to issue obligations in structured finance transactions, such as residential mortgage-backed securitizations, commercial mortgage-backed securitizations, asset-backed securitizations, collateralized debt obligation transactions, credit-linked note transactions and other financial asset repackage transactions to provide investors with exposure to a specific risk profile in exchange for a specified return. The obligations issued by SPVs are typically rated by one or more of the principal credit rating agencies.

SPVs commonly enter into swaps with SDs to: (i) hedge certain interest rate, currency, timing and/or other risks to which the SPV is exposed, either due to movements in interest or exchange rates or certain mismatches between the cash flows received by the SPV on the underlying pool of collateral and the payments required to be made by the SPV in respect of the obligations it has issued; or (ii) transfer the credit and/or market risk on certain underlying obligations to or from the SPV.

By entering into a swap with an SD, the SPV takes on SD credit risk (*i.e.*, the risk of non-performance by the SD). SFIG represents that, in order to minimize the impact of SD credit risk on the risk profile of the obligations issued by the SPV, the rating agencies have developed criteria designed to isolate the credit risk of the SD (the "**Delinking Criteria**") so that the rating agencies may assign a credit rating to the obligations issued by the SPV based solely on the quality of the underlying assets of the SPV and the structural features of the SPV, without taking into account the credit quality of the SD.

The Delinking Criteria are prescriptive rules that aim to ensure performance by the SD.

SFIG explains that under the Delinking Criteria, certain provisions of the documents governing the Legacy SPV Swap (the "**Legacy SPV Swap Documentation**") require the SD to take one or more Remedial Actions (as defined below) within designated time periods (in many cases, 30 days or less) following the withdrawal, qualification,<sup>13</sup> and/or downgrade of the SD's

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<sup>10</sup> See § 23.504(b)(4)(ii).

<sup>11</sup> See § 23.504(b)(5).

<sup>12</sup> See § 23.504(b)(6).

<sup>13</sup> For example, if the SD's credit ratings are placed on negative watch or negative outlook.

credit ratings below certain specified thresholds. The purpose of any Remedial Action is to insulate the investors in obligations issued by the SPV from the credit risk of the SD. The taking of any Remedial Action will not affect the material economic terms<sup>14</sup> of the Legacy SPV Swap.

SFIG represents that “**Remedial Action**” means any of the following:

1. Posting of collateral by the SD, which may require the SD and the SPV to enter into a collateral agreement and amend the Legacy SPV Swap Documentation in order to give effect thereto;
2. Replacing the downgraded SD with an entity who satisfies (or whose guarantor satisfies) the applicable credit rating requirements of the Legacy SPV Swap;<sup>15</sup>
3. Obtaining a guaranty of the SD’s obligations under the Legacy SPV Swap from a guarantor that satisfies the requisite credit ratings; or
4. Taking any other action as agreed with each relevant rating agency through procedures that are specified in the Legacy SPV Swap Documentation.

The Remedial Actions required to be taken by SDs and SPVs may include amending a Legacy SPV Swap or amending and transferring the obligations of the SD under a Legacy SPV Swap to a third party or an affiliate of the SD. Although any such action will not change the material economic terms of a Legacy SPV Swap, it may cause a Legacy SPV Swap to be considered a “new swap” or a “swap transaction” for the purposes of the Specified Regulations.<sup>16</sup> This is significant because, as discussed above, the Legacy SPV Swap may not previously have been subject to or affected by some or all of the Specified Regulations because it was entered into prior to the compliance date of such regulations. Thus, a Legacy SPV Swap may be subject to one or more Specified Regulation solely as a result of Remedial Actions taken by the SD and the SPV to remediate a credit ratings downgrade.

## **B. Need for No-Action Position**

As described above, certain of the Remedial Actions require action to be taken by both the SD and the SPV that are party to a Legacy SPV Swap. However, SFIG represents that, due to their limited purpose nature, it is very difficult to cause SPVs to take any action not explicitly

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<sup>14</sup> As represented by SFIG, for the purposes hereof, “material economic terms” means the pricing and other economic terms typically documented in a transaction confirmation that establish the amount and timing of the SPV’s obligations.

<sup>15</sup> This may require making certain technical amendments to the Legacy SPV Swap Documentation.

<sup>16</sup> In order to effect any of the Remedial Actions, the relevant Legacy SPV Swap may need to be amended, which could cause such swap to become subject to most or all of the Specified Regulations. See 77 FR 9734, 9741 (Feb. 17, 2012) and Commission regulations 23.500(1) and 23.504(a)(2).

contemplated by the Legacy SPV Swap Documentation. Although generally organized as trusts, corporations, limited partnerships or limited liability corporations, SPVs are not operating entities. Rather, they are entities established for the limited purpose of effecting a securitization or repackaging financial assets. The permitted activities of SPVs, therefore, are significantly limited through covenants contained in their constitutive documents and transaction agreements, and generally do not include entering into new arrangements or modifications of the kind that may be required to enable an SD to comply with its regulatory obligations under the Specified Regulations.

Since they are not operating entities, SPVs rely on third-party service providers such as administrators, trustees and servicers to satisfy the SPV's obligations under the Legacy SPV Swap Documentation and related structured finance transaction agreements. As with the permitted activities of SPVs, these agreements circumscribe the duties and obligations of service providers. Furthermore, at the time these agreements were put in place, being required to comply with the Specified Regulations was not contemplated and, therefore, not addressed under the Legacy SPV Swap Documentation and related structured finance transaction agreements. Consequently, SFIG represents that it is highly likely that service providers will take the position that it is, at best, unclear whether they have the authority or discretion to take the steps on behalf of SPVs that may be necessary to enable the SD to comply with its regulatory obligations under the Specified Regulations.

Due to the legal and practical impediments described above, SFIG represents that SDs have a reasonable basis to believe that SPVs will not be able to agree to: (i) provide information necessary to satisfy an SD's onboarding procedures required to comply with the Specified Regulations; (ii) further amend their Legacy SPV Swaps, either via an industry-wide protocol or on a bilateral basis, to incorporate contractual provisions; or (iii) enter into new agreements (*e.g.*, agreements related to portfolio reconciliation) that may be required to enable the SD to comply with its regulatory obligations under the Specified Regulations.

### **DSIO No-Action Position**

Based on the foregoing, DSIO believes that a no-action position is appropriate. Accordingly, DSIO will not recommend that the Commission take an enforcement action against an SD for a failure to comply with the Specified Regulations as such regulations may apply to an Legacy SPV Swap, subject to the following conditions:

- (1) The Specified Regulations apply to the SD or the Legacy SPV Swap solely as a result of one or more Remedial Actions taken in accordance with the applicable Delinking Criteria of one or more nationally recognized rating agencies that have rated one or more of the SPV's obligations in response to an actual or reasonably anticipated withdrawal, qualification, and/or downgrade of the credit ratings of the original counterparty to the Legacy SPV Swap; and
- (2) Any Remedial Action taken in accordance with the applicable Delinking Criteria does not alter the material economic terms of the Legacy SPV Swap.

This letter, and the positions taken herein, represent the views of DSIO only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission. The relief issued by this letter does not excuse persons relying on it from compliance with any other applicable requirements contained in the CEA or in the Regulations issued thereunder. This letter does not create or confer any rights for or obligations on any person or persons subject to compliance with the CEA that bind the Commission or any of its other offices or divisions. Further, this letter, and the positions taken herein, is based upon the representations made to DSIO. Any different, changed or omitted material facts or circumstances might render this no-action position void.

Should you have any questions, please do not hesitate to contact me at (202) 418-5495; or Frank Fisanich, Chief Counsel, at (202) 418-5949.

Very truly yours,

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