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Division of Swap Dealer
and Intermediary Oversight

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CFTC Letter No. 12-45
Interpretation and No-Action
December 7, 2012
Division of Swap Dealer and Intermediary Oversight

Re: **Further Exclusions from Commodity Pool Regulation for Certain Securitization Vehicles; No-Action Relief for Certain Securitization Vehicles Formed Prior to October 12, 2012**

Ladies and Gentlemen:

This letter is provided by the Division of Swap Dealer and Intermediary Oversight (the "Division") of the Commodity Futures Trading Commission (the "Commission") and provides interpretations regarding when exclusion from commodity pool regulation for certain securitization vehicles that do not satisfy one or more of the criteria set forth in CFTC Letter No. 12-14 (the "12-14 Letter") issued by the Division on October 11, 2012 is appropriate, as well as no-action relief for certain securitization vehicles formed prior to October 12, 2012.

A. Further Interpretation Regarding Exclusions from Commodity Pool Regulation for Securitization Vehicles

In the 12-14 Letter, the Division determined that certain securitization vehicles would not be included within the definition of "commodity pool" under Section 1a(10)[1] of the Commodity Exchange Act and under Commission Regulation 4.10(d),[2] if they meet certain conditions. Those conditions are as follows:

1. The issuer of the asset-backed securities is operated consistent with the conditions set forth in Securities and Exchange Commission (the "SEC") Regulation AB[3] or Rule 3a-7 under the Investment Company Act of 1940,[4] whether or not the issuer's security offerings are in fact regulated pursuant to either regulation,[5] such that the issuer, pool assets, and issued securities satisfy the requirements of either regulation;

2. The issuer's activities are limited to passively owning or holding a pool of receivables or

[1] 7 U.S.C. 1a(10).
[2] Commission rules referred to herein are found at 17 CFR Ch. I (2012).
[3] 17 CFR 229.1100, *et seq.*
[4] 17 CFR 270.3a-7.
[5] The Division is of the view that an issuer need not offer its securities pursuant to disclosure documents complying with Regulation AB in order to satisfy this condition.

other financial assets,[6] which may be either fixed or revolving,[7] that by their terms convert to cash within a finite time period[8] plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to security holders;

3. The issuer's use of derivatives is limited to the uses of derivatives permitted under the terms of Regulation AB, which include credit enhancements 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;

4. 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

5. The issuer is not permitted to acquire additional assets or dispose of assets for the primary purpose[9] of realizing gain or minimizing loss due to changes in market value of the vehicle's assets.

These conditions essentially define a type of passive investment in and financing of financial assets which receive only limited types of support from swap transactions and as such qualify to use an alternative disclosure regime under Regulation AB or an exemption from regulation under the Investment Company Act of 1940. However, if an issuer's operating or trading activities are more active than contemplated by the 12-14 Letter, the issuer does not limit its investments to financial assets that are used to pay the issuer's securities, or the issuer uses swaps to create synthetic investment exposure, the issuer would not be entitled to claim the exclusion provided in the 12-14 Letter.

In providing the interpretations in the 12-14 Letter, the Division believed that a commodity pool could not satisfy the criteria outlined therein and, thus, those criteria could be used to define securitization vehicles that would not be commodity pools.

However, the Division did not conclude that the interpretations in the 12-14 Letter were the exclusive way that securitization vehicles could be excluded from the definition of commodity pool (or to put it conversely, the Division did not conclude that all securitization vehicles not meeting the criteria would be deemed commodity pools). In fact, in the 12-14 Letter, the Division invited securitization sponsors to discuss the facts and circumstances of their non-conforming securitization structures with the Division with a view to determining whether or not such structures might be considered commodity pools, and if so, whether other relief might be appropriate under the

[6] The term "financial asset" as used in the 12-14 Letter does not include transactions whereby an entity obtains exposure to an asset that is not transferred or otherwise part of the asset pool. This is consistent with guidance provided by the SEC in its adopting release for Regulation AB. *See* 70 FR 1506, 1514 (Jan. 7, 2005).

[7] If the issuer is a "master trust," as that term is defined in Regulation AB, 17 CFR 229.1101(c)(3), then the issuer must comply with the terms of Regulation AB and may be permitted to add additional assets to the pool that backs securities in connection with future issuances of asset-backed securities, which may be done in connection with maintaining a minimum pool balance in accordance with transaction agreements for master trusts with revolving periods or receivables or other financial assets that involve revolving accounts.

[8] Such would include the residual value realized on the disposition of leased assets to the extent consistent with the terms of Regulation AB.

[9] Nothing in this requirement should be construed to permit the use of derivatives beyond those circumstances set forth in the third bullet point above.

circumstances, such as where a fund might be treated as an exempt pool.

In the Division's conversations with securitization sponsors following the issuance of the 12-14 Letter, the Division has discussed a number of transactions involving securitization vehicles that do not satisfy the operating or trading limitations contained in Regulation AB and Rule 3a-7, even though the issuers continue to satisfy the criteria relating to the ownership of financial assets and swap usage, specifically the types of assets described in criterion two and the usage of swaps described in criterion three above. Based on those transactions, the Division is of the view, in principal, that certain securitization vehicles that do not satisfy the operating or trading limitations contained in Regulation AB or Rule 3a-7 may be properly excluded from the definition of commodity pool, provided that the criterion with respect to the ownership of financial assets continues to be satisfied and the use of swaps is no greater than that contemplated by Regulation AB and Rule 3a-7, and such swaps are not used in any way to create an investment exposure.

An example of one such securitization vehicle is a standard asset-backed commercial paper conduit ("ABCP") which is a special purpose entity that issues asset-backed senior promissory notes and uses the proceeds of such notes to acquire interests in one or more financial assets. The notes issued by ABCP conduits may not be asset-backed securities as defined in Regulation AB because they are repaid in the ordinary course from proceeds of newly issued promissory notes or, if new notes cannot be issued, from liquidity and credit facilities provided by a financial institution. Also, many ABCP conduits do not employ independent trustees as generally required by Rule 3a-7.

For these reasons, ABCP conduits may not meet one or more of the criteria set forth in the 12-14 Letter. However, an investment in this securitization is not unlike an investment in a traditional securitization that satisfies Regulation AB or Rule 3a-7 in that the investment is essentially in the financial assets in the vehicle and not in the swaps. In this example, absent other factors, the vehicle would not be a commodity pool.

Another example of such a securitization vehicle is a traditional collateralized debt obligation ("CDO") structure that owns only financial assets consisting of corporate loans, corporate bonds, or investment grade, fixed income mortgage-backed securities, asset-backed securities or CDO tranches issued by vehicles that are not commodity pools. Under the terms of the CDO structure, the financial assets are permitted to be traded up to 20% of the aggregate principal balance of all financial assets owned by the issuer per year for three years. The CDO uses interest rate swaps to convert certain fixed rate financial assets to floating, and foreign exchange swaps to convert Euro-denominated assets to dollars, and none of these swaps may be terminated before the related hedged asset has been liquidated. An investment in this securitization vehicle is not unlike an investment in a traditional securitization structure that satisfies Regulation AB or Rule 3a-7, in that the investment is essentially in the financial assets of the vehicle and not the swaps. In this example, absent other factors, the vehicle would not be deemed a commodity pool.

However, if investors of a securitization vehicle have exposure to swaps which are used to create investment exposure (*e.g.*, the payment to investors is affected by swaps in a way other than to enhance credit (within reason, as discussed further below), or to swap interest rates or currencies, each as permitted under Regulation AB), then the securitization vehicle may be a commodity pool. Thus, for example, if the transaction structure of the CDO described in the paragraph above permitted a 5% bucket for synthetic assets consisting of swaps instead of having 100% of its holdings be comprised of financial assets, that securitization vehicle may be a commodity pool. Note, however, given the relatively small size of the bucket, depending on additional facts, the operator of

such securitization vehicle may be an exempt commodity pool operator pursuant to Commission regulation 4.13(a)(3).

Another example of a securitization vehicle that may be deemed to be a commodity pool is a repackaging vehicle[10] that issues credit-linked or equity-linked notes where the repackaging vehicle owns high quality financial assets, but sells credit protection on a broad based index or obtains exposure to a broad based stock index through a swap. The vehicle finances its acquisition of the high quality assets by issuing notes to investors that are linked to credit risks or price changes in the stock index. In this example, the vehicle may be a commodity pool, because the investors in the securitization vehicle are obtaining a significant component of their investment upside or downside from the related swaps.

Similarly, a repackaging vehicle that acquired a three year bond, issued a tranche of notes, and used swaps to extend the investment experience of the bond (and thus the tranche of notes) to four years may be deemed to be a commodity pool, as would a repackaging vehicle that paired the three year bond with a swap to provide inflation rate protection.

However, in a covered bond transaction, the collateral pool (and the special purpose vehicle in a structured model) would not be a commodity pool if it contains no commodity interests[11] other than any swaps which are used only for purposes permitted by Regulation AB, and covered bond holders are only entitled to receive payments of accrued interest and repayment of principal of their covered bonds, without any condition to payment based upon any derivative exposure.

Finally, the Division affirms its view that swaps used to provide credit support to financial assets in a securitization or the notes issued by the securitization entity, to the extent contemplated by Item 1114 of Regulation AB, should not be viewed as creating investment exposures and should not require registration of an entity as a commodity pool operator ("CPO"). If, however, the use of swaps is commercially unreasonable as credit support with respect to a securitization, the Division may conclude that a commodity pool exists. For example, a trust owns floating rate bonds issued by a distressed jurisdiction rated "CCC". The trust also enters into a swap with its affiliate/sponsor pursuant to which the swap counterparty provides credit support for the interest and the principal sufficient to obtain "AA" pricing of the trust's notes. In this example, the securitization vehicle would be a commodity pool because the facts and circumstances indicate that the swap is a significant aspect of the investment.

B. No-Action Relief for Certain Securitization Vehicles formed prior to October 12, 2012

In addition to the transactions described above, the Division has concluded, following conversations with industry members, that certain securitization vehicles formed prior to October 12, 2012 may face certain significant operational difficulties should the compliance regime in part 4 be

[10] Repackaging vehicles generally involve special purpose entity vehicles, which permit clients to acquire tailored exposure to a variety of asset classes and risk profiles though a single instrument. For example, an investor that is seeking a structured return might request that a financial institution structure a transaction that combines otherwise unrelated credit components (exposure to one or more corporate entities), interest rate components (fixed, floating, inflation-linked, etc.) and maturity components (bullet, scheduled maturity, etc.) that are not currently available "packaged together" in the marketplace.

[11] 17 CFR 1.3(yy), as amended in 77 FR 66288 (Nov. 2, 2012).

imposed. Therefore, the Division will not recommend that the Commission take an enforcement action against any operator of a securitization vehicle for failing to register as a CPO if the following criteria are and remain satisfied:

1. The issuer issued fixed income securities before October 12, 2012 that are backed by and structured to be paid from payments on or proceeds received in respect of, and whose creditworthiness primarily depends upon, cash or synthetic assets owned by the issuer;

2. The issuer has not and will not issue new securities on or after October 12, 2012; and

3. The issuer shall, promptly **upon request** of the Commission or any division or office thereof, and in any event within 5 business days of such request, provide to such requestor an electronic copy of the following: (i) the most recent disclosure document used in connection with the offering of the related securities, (ii) all amendments to the principal documents since issue, (iii) the most recent distribution statement to investors, and (iv) if the issuer's securities were offered relying on Rule 144A[12] under the Securities Act of 1933,[13] a copy of the information that would be provided to prospective investors to satisfy Rule 144A(d)(4);[14] *Provided, that*, if the issuer does not provide the information required hereunder, it must demonstrate that it cannot obtain the required documents through reasonable commercial efforts.

The failure to comply with the criteria of this no-action relief will result in the issuer's inability to rely upon the terms of this relief.

The no-action relief provided herein contains a collection of information, as that term is defined in the Paperwork Reduction Act.[15] Therefore, a control number for the collection must be obtained from the Office of Management and Budget. In accordance with 44 U.S.C. § 3507(d) and 5 C.F.R. §§ 1320.8 and 1320.10, the Division will, by separate action, prepare an information collection request for review and approval by OMB, and will publish in the *Federal Register* a notice and request for public comments on the collection burdens associated with the no-action relief. If approved, a securitization vehicle may not rely on the Division's determination not to recommend an enforcement action to the Commission unless the vehicle provides the information the Division has determined is essential to the provision of no-action relief.

C. Temporary No-Action Relief for Operators of Securitization Vehicles Unable to Rely Upon the Terms of Letter 12-14 or This Letter

As for securitization vehicles that cannot satisfy all the criteria stated above, the Division notes that we remain open to discussions with securitization sponsors to consider the facts and circumstances of their securitization structures with a view to determining whether or not they might not be properly considered a commodity pool, or where not sufficiently assured, whether other relief might be appropriate under the circumstances, such as where a fund might be treated as an exempt pool.

[12] 17 CFR 230.144A.
[13] 15 U.S.C. § 77a, *et seq.*
[14] 17 CFR 230. 144A(d)(4).
[15] 44 U.S.C. § § 3501 *et. seq.*

Because the Division will be continuing its dialogue with the securitization industry, the Division believes that it is appropriate to grant time limited no-action relief to operators of securitization vehicles that are unable to rely upon the relief provided by either Letter 12-14 or this letter. Therefore, the Division will not recommend that the Commission take enforcement action against the operator of a securitization vehicle for failure to register as a CPO until March 31, 2013.

This letter, and the positions taken herein, represent the view of this Division 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 the affected persons from compliance with any other applicable requirements contained in the Act or in the Commission's regulations issued thereunder. Further, this letter, and the relief contained herein, is based upon the representations made to the Division. Any different, changed or omitted material facts or circumstances might render this letter void.

Should you have any questions, please do not hesitate to contact Amanda Olear, Special Counsel, at 202-418-5283.

Very truly yours,

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