U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5000

Division of Swap Dealer and Intermediary Oversight

Matthew B. Kulkin
Director

CFTC Letter No. 17-52
No-Action
October 27, 2017
Division of Swap Dealer and Intermediary Oversight

Re: No-Action Position: Variation Margin Requirements Applicable to Swaps with Legacy Special Purpose Vehicles

Ladies and Gentlemen:

This letter is in response to requests to the Division of Swap Dealer and Intermediary Oversight ("**DSIO**") of the U.S. Commodity Futures Trading Commission ("**Commission**") for a no-action position from multiple entities,[1] each of whom represents or is a sponsor (collectively, the "**Sponsors**") of securitization vehicles that issue rated notes ("**SPVs**"), which SPVs have entered into swaps with certain swap dealers ("**SDs**") registered with the Commission and subject to the Commission's recently adopted margin requirements for uncleared swaps.[2]

The Sponsors state that the request for a no-action position is urgent because Moody's Investor Services ("**Moody's**") and Fitch Ratings Inc. ("**Fitch**") have each issued reports indicating that various rated tranches of SPV-issued notes are under review and could be subject to future negative credit rating changes solely because the Commission's recently adopted margin requirements for uncleared swaps have reduced the likelihood that the SPV's SD swap counterparty could be replaced in the event that it suffers

[1] Navient Solutions, LLC, Request for Relief from Variation Margin Requirements (Feb. 24, 2017); Structured Finance Industry Group, Request for Temporary Relief from March 1, 2017 Variation Margin Compliance Date (Feb. 6, 2017); Orient Corporation, Request for No-Action Relief from CFTC Regulations 23.152-161 in Connection with OSCAR US Funding Trust, et al. (July 13, 2017).

[2] The Commission's margin requirements for uncleared swaps apply only to SDs and major swap participants for which there is not a prudential regulator. *See* 7 U.S.C. 6s(e)(1)(B). SDs and major swap participants for which there is a prudential regulator must meet the margin requirements for uncleared swaps established by the applicable prudential regulator. 7 U.S.C. 6s(e)(1)(A). *See also* 7 U.S.C. 1a(39) (defining the term "Prudential Regulator" to include the Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; the Federal Deposit Insurance Corporation; the Farm Credit Administration; and the Federal Housing Finance Agency). The Prudential Regulators published final margin requirements in November 2015. *See* Margin and Capital Requirements for Covered Swap Entities, 80 FR 74840 (Nov. 30, 2015).

a credit rating downgrade that threatens the credit rating of the SPV's issued notes.[3] Moody's indicated that the SPVs' notes will likely be downgraded by two to three notches.[4] A downgrade of the securities issued by an SPV will, of course, affect its market value, thereby harming current holders of such obligations. Thus, the Commission's uncleared swap margin requirements as applied in this limited circumstance risks posing a serious threat to the price stability of these instruments, despite the fact that replacing the SD counterparty to an SPV swap will not change the material economic terms[5] of the swap itself and has no effect on risk to the SPV, the noteholders, or the financial system.

DSIO believes that no-action relief is necessary and appropriate within the limited circumstances described herein to maintain stability and price certainty for SPV-issued notes that were issued prior to the implementation of the Commission's uncleared swap margin requirements.[6]

Specifically, the Sponsors request a position of no-action from DSIO with respect to a failure by an SD to comply with Commission Regulation 23.153[7] requiring the collection and posting of variation margin when entering into, amending, or novating one or more swaps with an SPV in response to certain credit rating agency-related actions in respect of one or more Legacy SPV Swaps.[8] Any such swap would be entered, amended, or no-

---

[3] *See* Moody's places four auto loan ABS under review for downgrade after updating its approach to counterparty risks (July 27, 2017), available at: https://www.moodys.com/research/Moodys-places-four-auto-loan-ABS-under-review-for-downgrade--PR_370302, and Fitch Places 38 US ABS Tranches with Currency Swaps on RWN (Sept. 29, 2017), available at: https://www.fitchratings.com/site/pr/1028608. Moody's and Fitch had previously announced that the VM Requirements would cause them to reconsider ratings of certain SPV obligations. *See* Moody's updates its approach to assessing counterparty risks in structured finance (July 26, 2017), available at: https://www.moodys.com/research/Moodys-updates-its-approach-to-assessing-counterparty-risks-in-structured--PR_368938, and Fitch: Pending US Swap Rules Could Impact Structured Finance Transactions (Nov. 17, 2016), available at: https://www.fitchratings.com/site/pr/1014938.

[4] *Id.*

[5] As represented by the Sponsors, 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.

[6] 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. 15-21 (providing relief from compliance with certain business conduct and documentation requirements in connection with Legacy SPV Swaps, as defined therein); and CFTC Letter No. 12-45 (providing relief from "commodity pool" status to certain securitization vehicles formed prior to October 12, 2012).

[7] 17 CFR 23.153. The Commission's regulations are found in Chapter 17 of the Code of Federal Regulations, 17 CFR 1 et. seq.

[8] For purposes of this letter, "**Legacy SPV Swap**" means a swap executed prior to March 1, 2017 between an SPV whose obligations currently have a credit rating from at least one of Moody's, Standard and Poor's Ratings Services ("S&P"), or Fitch and a counterparty that, at the time the swap was executed, had a credit

vated 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 while maintaining the same material economic terms. The Sponsors state that an SD would not be able to comply with Commission Regulation 23.153 because restrictions in SPVs' governing documentation may prevent an SPV from taking certain actions required by the SD to comply with such regulation.

I. Regulatory Background

Pursuant to section 4s(e) of the Commodity Exchange Act ("**CEA**"),[9] the Commission is required to promulgate margin requirements for uncleared swaps applicable to each SD for which there is no Prudential Regulator.[10] The Commission published final margin requirements for such SDs in January 2016 (the "**Final Margin Rule**").[11]

As part of the Final Margin Rule, the Commission promulgated Commission Regulation 23.153, which requires SDs to collect and post variation margin with each counterparty that is an SD, major swap participant, or financial end user.[12]

Pursuant to Commission Regulation 23.161, compliance dates for the Final Margin Rule are staggered such that SDs must come into compliance in a series of phases over four years. The first phase affected SDs with the largest outstanding notional amounts of uncleared swaps, which began complying with both the initial and variation margin requirements of the Final Margin Rule on September 1, 2016.[13] The second phase began

---

rating from at least one of Moody's, S&P, or Fitch. March 1, 2017 was the compliance date for the VM Requirements (as defined below). *See also* the definition of "Remedial Action" below.

[9] 7 U.S.C. § 1 et. seq.

[10] *See* 7 U.S.C. § 6s(e)(1)(B).

[11] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 636 (Jan. 6, 2016). The Final Margin Rule, which became effective April 1, 2016, is codified in part 23 of the Commission's regulations. *See* §§ 23.150-159, 161.

[12] *See* Commission Regulation 23.153(a) and (b), 17 CFR 23.153(a) and (b), stating:

> (a) *Initial obligation.* On or before the business day after the day of execution of an uncleared swap between a covered swap entity and a counterparty that is a swap entity or a financial end user, the covered swap entity shall collect the variation margin amount from the counterparty when the amount is positive, or post the variation margin amount with the counterparty when the amount is negative as calculated pursuant to § 23.155 and in a form that complies with § 23.156.
>
> (b) *Continuing obligation.* The covered swap entity shall continue to collect the variation margin amount from, or to post the variation margin amount with, the counterparty as calculated each business day pursuant to § 23.155 and in a form that complies with § 23.156 each business day until such uncleared swap is terminated or expires.

[13] *See* Commission Regulation 23.161(a)(1), 17 CFR 23.161(a)(1).

March 1, 2017 and required SDs to comply with the variation margin requirements of Commission Regulation 23.153 with all relevant counterparties not covered in the first phase (the "**VM Requirements**").[14]

II. Summary of Request for No-Action Position

A. SPV Credit Ratings and Remedial Actions

As represented by the Sponsors, 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 nonperformance by the SD). The Sponsors represent 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 on the quality of the underlying assets of the SPV and the structural features of the SPV and with limited exposure to the credit quality of the SD. Specifically, the Sponsors represent that rating agency criteria assume that the current SD can easily be replaced with a higher rated SD in the event the current SD is downgraded below a certain threshold (typically below a 'A' rating in the case of a transaction rated 'AAA'). In this manner, exposure to any single SD's credit risk is believed to be significantly diminished.

The Sponsors explain 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, qualifica-

---

[14] *See* Commission Regulation 23.161(a)(2), 17 CFR 23.161(a)(2).

tion,[15] and/or downgrade of the SD's credit ratings below certain specified thresholds. The purpose of any Remedial Action is to quickly 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 of the Legacy SPV Swap.

The Remedial Actions required to be taken by SDs and SPVs may include amending a Legacy SPV Swap or novating the obligations of the SD under a Legacy SPV Swap to a third party or an affiliate of the SD.[16] Although any such action will not change the material economic terms of a Legacy SPV Swap, or increase the risks to the SPV or its noteholders, such actions could cause a Legacy SPV Swap to be considered a swap executed after the compliance date for the VM Requirements under the Final Margin Rule and therefore the SD counterparty would be obligated to comply with the VM Requirements with respect to the Legacy SPV Swap. This is significant because, as discussed above, the Legacy SPV Swap may not previously have been subject to or affected by the VM Requirements because it was entered into prior to the compliance date of such regulations. Thus, absent relief, a Legacy SPV Swap could become subject to the VM Requirements <u>solely</u> as a result of Remedial Actions taken by the SD and the SPV in response to action taken by the credit rating agency.

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, the Sponsors represent that, due to their limited purpose nature, it is very difficult to cause SPVs to take any action not explicitly 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 VM Requirements.

---

[15] For example, if the SD's credit ratings are placed on negative watch or negative outlook.

[16] The Sponsors represent that "**Remedial Action**" means: (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 (which may require making certain technical amendments to the Legacy SPV Swap Documentation); (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.

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 VM Requirements was not contemplated and, therefore, not addressed under the Legacy SPV Swap Documentation and related structured finance transaction agreements. Consequently, the Sponsors represent 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 VM Requirements.

Due to the legal and practical impediments described above, the Sponsors represent that SDs have a reasonable basis to believe that SPVs will not be able to agree to: (i) further amend their Legacy SPV Swaps, either via an industry-wide protocol or on a bilateral basis, to incorporate contractual provisions; or (ii) enter into new agreements (*e.g.*, credit support agreements or custodial arrangements) that may be required to enable the SD to comply with its regulatory obligations under the VM Requirements.

Finally, due to the inability of the SPVs to make changes necessary for an SD counterparty to comply with the VM Requirements, it is also unlikely that a new SD counterparty could replace a downgraded SD counterparty, because the new SD counterparty would also be required to comply with the VM Requirements. Because of this reduced likelihood of SD counterparty replacement, the SPV's notes face material credit downgrades, which risk posing a serious threat to the price stability of these instruments. A downgrade of the obligations of an SPV will, of course, affect the their market value, thereby harming current holders of such obligations. If a holder is restricted to only the highest-rated tranches, it may be forced to sell at a time when others are also forced to sell, which could result in additional losses. DSIO notes that these consequences may occur despite the fact that a change in SD counterparty would not entail any change in the material economic terms of the swap, nor would it entail any additional risk to the SPV, the noteholders, or the financial system.

III. DSIO No-Action Position

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

(1) The VM Requirements apply to the SD with respect to the Legacy SPV Swap <u>solely</u> 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 Commission Regulations. 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.

Questions concerning this letter may be directed to me at (202) 418-5213; or Frank Fisanich, Chief Counsel, at (202) 418-5949.

Very truly yours,

Matthew B. Kulkin
Director
Division of Swap Dealer and Intermediary Oversight

cc: Regina Thoele, Compliance
National Futures Association, Chicago

Jamila A. Piracci, OTC Derivatives
National Futures Association, New York