Client Update
CFTC Grants Relief from Commodity Pool Operator Registration for Insurance-Linked Securities Issued by SPVs

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On December 18, 2014, the Division of Swap Dealer and Intermediary Oversight ("DSIO") of the Commodity Futures Trading Commission (the "CFTC") issued a no-action letter[1] granting relief from commodity pool operator ("CPO") registration for entities engaging in insurance-linked securities ("ILS") transactions, subject to certain conditions. The relief allows operators of entities engaging in ILS transactions not to register as a CPO if they satisfy the conditions of the *de minimis* exemption in CFTC regulation 4.13(a)(3) and certain other conditions set forth in the no-action letter.

The relief was granted in response to a letter from the Securities Industry and Financial Markets Association ("SIFMA"), dated August 18, 2014 (the "SIFMA letter").

BACKGROUND

ILS Transactions

ILS transactions allow insurance companies ("Protection Buyers") to obtain from the capital markets collateralized protection against risks[2] insured by them.

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[1] CFTC Letter No. 14-152, dated December 18, 2014, available at: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-152.pdf.

[2] The SIFMA letter notes that ILS transactions provide protection from losses resulting from such events as earthquakes, hurricanes, tornados, hailstorms, fires, floods and other property and casualty related events, extreme mortality, extreme disease, longevity and other risks that are typically covered by insurance.

In a typical ILS transaction for which the relief was granted, a Protection Buyer forms a special purpose vehicle ("SPV" or the "Issuer"). The SPV enters into a risk transfer contract with the Protection Buyer, pursuant to which the Protection Buyer obtains protection against specified and clearly defined trigger events to which it has exposure and anticipates having such exposure for the life of the ILS transaction (typically one to five years). In order to support its obligations under the risk transfer contract, the SPV issues bonds, notes or similar instruments ("Bonds") in an amount equal to its maximum exposure under such contract. The Protection Buyer makes payments under such contract sufficient to cover the Issuer's expenses[3] and to pay interest to the holders of the Bonds ("Bondholders"), each of which is a qualified institutional buyer and, in the case of a U.S. person, is also a qualified purchaser (and thus a "qualified eligible person" under CFTC regulation 4.7(a)).[4]

All proceeds of the Bonds are deposited in a collateral account that serves as security for the Protection Buyer and the Bondholders. Upon the occurrence of a specified trigger event, the contractual payment amount is paid to the Protection Buyer from the collateral account. The coverage provided by the Issuer is 100% secured by liquid collateral and the coverage cannot exceed the collateralized amount.

When an amount is transferred from the collateral account to the Protection Buyer to cover a specified trigger event, the aggregate principal amount of the Bonds is written down in the amount of such transfer. At maturity and upon satisfaction of the risk transfer contract obligations to the Protection Buyer, any remaining funds from the collateral account are used for repayment of the remaining principal balance of the Bonds.

The Bonds are typically offered by means of an offering circular that includes a risk analysis report prepared by an independent statistical modeling company, which uses standard models widely employed by insurers and reinsurers in their own portfolio risk evaluations to provide estimates of expected loss, probability of attachment (where the first loss would be triggered under the Bonds), and

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[3] In order to raise and maintain the capital necessary to provide the specified protection to the Protection Buyer, the Issuer collects premiums from the Protection Buyer, solicits investors to purchase the Bonds issued by it, and manages the pool assets, which will be used to make interest and principal payments to the Bondholders and/or to pay the Protection Buyer when a specified trigger event occurs.

[4] The Bondholders' interest payment consists of the Protection Buyer's payment plus the earnings on the investment of the proceeds from the Bond issuance (net of any payments made by the Issuer to the Protection Buyer under the risk transfer contract).

probability of exhaustion (where the Bond principal would be reduced to zero). The risk analysis forms much of the basis on which Bonds are evaluated, rated and priced. In the no-action letter, the DSIO notes that its finding that the disclosures in these offering circulars are focused on statistical modeling, risk analysis, and probabilities of the occurrence of specified trigger event(s) is consistent with its findings in CFTC Staff Letter 14-111, in which the DSIO concluded that, in the described mortgage credit risk transfer structure, it was not actually the swap mechanism transferring the mortgage credit risk that was being marketed, but rather the quality and actual credit risk of the pool of mortgages underlying the transaction.[5]

Commodity Pool and De Minimis Exemption

Section 1a(10) of the Commodity Exchange Act (the "CEA") and CFTC regulation 4.10(d)(1) define a commodity pool as "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in commodity interests." Commodity interests include futures, options on futures, security futures, swaps, leverage contracts, foreign exchange, spot and forward contracts on physical commodities, and any monies held in an account used for trading commodity interests.

To the extent that the risk transfer contract between the Issuer and the Protection Buyer could be considered a swap, because of the pooling of assets belonging to the Bondholders and the Protection Buyer by the Issuer, the Issuer could fall within the definition of "commodity pool."

In order to rely on the *de minimis* exemption from CPO registration in CFTC regulation 4.13(a)(3), an entity must meet the following conditions:

- Interests in the pool must be exempt from registration under the Securities Act of 1933 (the "Securities Act"), and are offered and sold without marketing to the public in the United States;
- The pool must at all times meet a *de minimis* test pursuant to which either: (a) the margins, premiums and required minimum security deposit for retail forex transactions does not exceed 5% of the liquidation value of the pool's assets (after giving effect to unrealized profits or losses); or (b) the aggregate net notional value of the pool's commodity positions, determined at the time the most recent position was established, does not exceed 100% of the

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5 See CFTC Staff Letter 14-111, pp. 9-10, available at: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-111.pdf]

liquidation value of the pool's portfolio (after taking into account unrealized profits and unrealized losses);

- The CPO reasonably believes at the time of investment that each investor in the pool meets one of certain enumerated tests relating to the financial sophistication of the investor (e.g., accredited investor or qualified eligible person); and
- Participations in the pool are not marketed as, or in a vehicle for, trading in the commodity futures or commodity options markets.

The DSIO notes that, based on the representations in the SIFMA letter, the Bonds are exempt from registration under the Securities Act, are not offered or sold through marketing to the public in the United States and will typically be sold only to sophisticated institutional investors meeting the qualified eligible purchaser standard,[6] and the operator of the Issuer, and the Issuer, will comply with the *de minimis* threshold in regulation 4.13(a)(3).

With respect to the fourth condition, the DSIO notes that ILS transactions raise an issue in that they may fail to satisfy one of the factors to be considered in analyzing whether the fourth condition is met: "Whether the futures/options/swap transactions engaged in by the fund or on behalf of the fund will directly or indirectly be its primary source of potential gains and losses." Because the risk transfer contract between the Protection Buyer and the Issuer is the mechanism for creating and transmitting the insurance-linked risk exposure from the Protection Buyer to the Bondholders, the ILS transaction is the primary source of investment gains and losses to the Bondholders and may violate the fourth condition.

NO-ACTION LETTER

The DSIO states in the no-action letter that the detailed restrictions on the operations and activities of Issuers, combined with the highly specific factual context of ILS transactions, lead the DSIO to believe that the risk transfer contract serves merely as a conduit to transmit the insurance-related risks of the Protection Buyer through the Issuer and to the Bondholders. In this context,

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[6] The SIFMA letter represents that Issuers offer their bonds in "private placements to institutional investors structured to rely on the resale exemption under SEC Rule 144A and Section 3(c)(7) for an exemption from the [Investment Company Act of 1940] with respect to U.S. persons." Pursuant to SEC Rule 144A, bonds from the Issuers are offered and sold only to "qualified institutional buyers that, with respect to U.S. persons, are also qualified purchasers." Additionally, "even though sales outside of the U.S. could be made pursuant to SEC Regulation S, the transactions typically require that non-U.S. persons also meet the qualified institutional buyer standard under Regulation 144A."

and when all of the other three conditions of CFTC regulation 4.13(a)(3) are met, the DSIO accepts the SIFMA letter's representations that the marketing efforts of an Issuer are focused on the analysis and statistical modeling of insurance risks to and for which the Protection Buyer is actually exposed and is seeking coverage, rather than the risks and rewards of the underlying transaction transferring those risks.[7]

The no-action letter provides that the DSIO will not recommend that the CFTC take an enforcement action against any entity characterized as the CPO of an Issuer ("ILS CPO") for failure to register as a CPO pursuant to section 4m(1) of the CEA, provided that:

- The ILS CPO meets the first three conditions for an exemption from CPO registration under CFTC regulation 4.13(a)(3);
- The ILS CPO files a notice of eligibility for an exemption from CPO registration with the National Futures Association pursuant to CFTC regulation 4.13(b) and meets the other terms of regulation 4.13; and
- The ILS CPO operates the Issuer in the following manner:
    - There will be no active management of assets and liabilities over the lifetime of the Issuer.
    - The collateral ("Eligible Collateral") held by the Issuer at all times must:
        - Be in the form of cash or cash-equivalent, "highly liquid" (as that term is defined in CFTC regulation 1.25)[8] assets, limited to: (A) puttable debt issued by the International Bank for Reconstruction and Development ("IBRD"), the European Bank for Reconstruction and Development ("EBRD"), or Kreditanstalt fur Wiederaufbau ("KfW");[9] (B) any U.S.- or European Union-regulated money market

7 In contrast, when a commodity interest transaction is used to create other investment exposures for investors, whether through the provision of leverage or the transmission of other risks, the DSIO would assume that the transaction itself must be marketed as part of the investment package in violation of the fourth condition, making relief under regulation 4.13(a)(3) unavailable.

8 An investment is "highly liquid" under CFTC regulation 1.25(b)(1) if such investment may be converted into cash within one business day without material discount in value.

9 With respect to this type of puttable debt, the SIFMA letter made the following representations: "In the case of medium term note investments (*i.e.*, IBRD, EBRD or KfW), the terms of the notes include a mandatory redemption or early repayment provision which requires the issuer to retire the note and repay the full principal upon notice. Such provision may, however, become effective starting six months to one year from the issue date. If an event trigger payment obligation is triggered under the risk transfer [contract] in the first year, the [Issuer] is permitted to make a payment-in-kind to the [Protection Buyer] by transferring ownership of the medium term note

fund that invests solely in debt issued by the U.S. Treasury or U.S. sponsored agencies, or repurchase and reverse repurchase agreements collateralized by debt issued by the U.S. Treasury or U.S. sponsored agencies; (C) other highly liquid assets; and (D) any other eligible collateral approved by the DSIO or the CFTC from time to time; and

- Either have a maturity date that is on or before the termination date of the risk transfer contract ("Agreement") or be convertible to cash by the issuer/obligor of the collateral upon demand by the Issuer.

- Upon becoming aware[10] that the value of the collateral held by the Issuer is less than the notional amount of the risk transfer contract ("Deficiency"), the Issuer (i) must promptly notify the DSIO of the same in writing and copies of such notice must be provided to the Protection Buyer and the Bondholders pursuant to the notice procedures in the applicable transaction documentation, and (ii) must neither issue any additional bonds nor enter into any commodity interest transactions for so long as such Deficiency exists.
- The payment obligations of the Issuer to the Protection Buyer and to the Bondholders must be secured by the Eligible Collateral, and the security arrangements must provide that obligations to the Protection Buyer under the Agreement will be satisfied form the Eligible Collateral prior to any proceeds of the Eligible Collateral being used to repay principal to the Bondholders.
- The Eligible Collateral must be maintained by the Issuer so that it is available to be distributed in the form of cash or in kind to the

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investment in a principal amount sufficient to cover the payment obligation. The payment obligation under [such contract] for such event is deemed to have been met upon transfer of such note to the [Protection Buyer]. These medium term notes are admitted assets for insurance regulators in most jurisdictions (*i.e.*, New York), and therefore are as good as cash to hold on the [Protection Buyer's] balance sheets."

10 For these purposes, an Issuer will become aware of a Deficiency: (1) with respect to Eligible Collateral for which industry standard pricing sources are available, if a decline in the value of such collateral is determined to result in a Deficiency based on at least weekly monitoring of one or more such pricing sources (by the Issuer or an agent on its behalf); and (2) with respect to Eligible Collateral for which industry standard pricing sources are not available, if the issuer of such collateral has other similar obligations for which standard pricing sources are available, then a decline in the value of such other similar obligations must be utilized as a proxy for determining whether a Deficiency has occurred, and if the issuer of such collateral does not have other similar obligations for which industry standard pricing sources are available, then a Deficiency will be deemed to exist if such collateral is downgraded by an applicable rating agency or upon the occurrence of an event of default with respect to such collateral that is not cured within any applicable cure period.

Protection Buyer at the time a payment becomes due under the risk transfer contract.

- The Eligible Collateral held by the Issuer must be subject to arrangements that protect the Protection Buyer in the event the Issuer becomes subject to an insolvency proceeding, to the extent possible under applicable law. This condition will be satisfied if the Issuer satisfies the following criteria:
  - The powers of the Issuer must be limited so that it may not engage in business or activity other than as necessary or appropriate for serving as an ILS vehicle;
  - The Issuer must be restricted from incurring additional debt, except as necessary or appropriate for entering into additional ILS offerings in the case of a multi-use Issuer, in which case the obligation to repay such additional debt must be secured solely by additional Eligible Collateral obtained in connection with such additional ILS offering;
  - The Issuer must be restricted from entering into any additional commodity interest transactions beyond the swap transaction necessary for the ILS offering, except that a multi-use Issuer may enter into additional swaps to the extent necessary or appropriate in order to enter into additional ILS offerings;
  - The Issuer must be governed by a board of directors (or similar body) comprised of individuals independent of the Protection Buyer;
  - Corporate formalities must be observed between the Issuer and the Protection Buyer (and its affiliates), such that each entity maintains its separate corporate status and identity;
  - As a condition to any agreement imposing obligations on the Issuer, Bondholders, the Protection Buyer and any other potential creditors of the Issuer must be required to waive any right to file an involuntary bankruptcy petition for the Issuer or otherwise initiate a solvency, liquidation, dissolution or other action having substantially similar effect with respect to the Issuer; and
  - The Issuer must be prohibited from filing a voluntary petition for bankruptcy and from engaging in a merger, asset sale (other than for collateral management purposes), consolidation, liquidation, dissolution or other action having substantially similar effect.

The foregoing relief will remain effective until the effective date of any CFTC action in consideration of ILS transactions.

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Please do not hesitate to contact us with any questions.