CLIENT UPDATE

CFTC ISSUES INTERPRETATIVE GUIDANCE TO EQUITY REITS AND CERTAIN SECURITIZATION VEHICLES

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The Commodity Futures Trading Commission's ("CFTC") Division of Swap Dealer and Intermediary Oversight (the "Division") issued interpretative guidance letters on October 11, 2012 stating that real estate investment trusts ("REITs") and securitization vehicles which meet certain criteria are not included within the definition of a "commodity pool,"[1] and, therefore, their operators are not "commodity pool operators" ("CPOs") under the Commodity Exchange Act and the CFTC's regulations.

REAL ESTATE INVESTMENT TRUSTS

According to its letter in response to the National Association of Real Estate Investment Trusts,[2] the Division believes REITs that primarily derive their income from the ownership and management of real estate and use derivatives for the limited purpose of mitigating their interest rate and currency exposure are outside the definition of commodity pool.

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1 Under Section 4.10(d) of the CFTC Regulations and Section 1a(10) of the Commodity Exchange Act, a "commodity pool" is defined as any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, which broadly includes any futures contracts, options on futures, and swaps.

2 Available at: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-13.pdf

Specifically, the Division interprets the definition of "commodity pool" to exclude REITs that satisfy each of the following criteria:

- The REIT primarily derives its income from the ownership and management of real estate and uses derivatives for the limited purpose of mitigating its exposure to changes in interest rates or fluctuations in currency;
- The REIT is operated so as to comply with all of the requirements of a REIT election under the Internal Revenue Code, including 26 U.S.C. §856(c)(2) (the 75 percent test) and 26 U.S.C. §856(c)(3) (the 95 percent test); and
- The REIT has identified itself as an equity REIT in Item G of its last U.S. income tax return on Form 1120-REIT and continues to qualify as such, or, if the REIT has not yet filed its first tax filing with the Internal Revenue Service, the REIT has stated its intention to do so to its participants and effectuates its stated intention.

Relief under this interpretive letter is self-effectuating and does not require any notice or filing with the CFTC.

SECURITIZATION VEHICLES

According to its letter in response to the American Securitization Forum (the "Securitization Letter"),[3] the Division believes that certain entities are likely not commodity pools, such as securitization vehicles that do not have multiple equity participants, do not make allocations of accrued profits or losses (other than gains or losses resulting from permitted dispositions of defaulted financial assets), and only issue interests in the form of debt or debt-like interests with a stated interest rate or yield and principal balance and a specific maturity date.

Specifically, the Division interprets the definition of "commodity pool" to exclude securitization vehicles that satisfy each of the following five criteria:

- The issuer of the asset-backed securities is operated consistent with the conditions set forth in Regulation AB,[4] or Rule 3a-7 under the Investment Company Act,[5] whether or

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3 Available at: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-14.pdf

4 17 CFR 229.1100, et seq. (as of Apr. 2012). Regulation AB is the source of various disclosure items and requirements for "asset-backed securities" filings under the Securities Act of 1933 and the Securities Exchange Act of 1934.

5 17 CFR 270.3a-7 (as of Apr. 2012). Rule 3a-7 under the Investment Company Act excludes asset backed securities issuers from the definition of "investment company" where certain conditions are satisfied, including, in summary: (i) the issuer issues fixed-income securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets; (ii) at the time of initial sale, such securities are rated in one of the four highest categories assigned to long-term debt, or in an equivalent short-term debt category, by at least one nationally-recognized statistical

not the issuer's security offerings are in fact regulated pursuant to either regulation, such that the issuer, pool assets, and issued securities satisfy the requirements of either regulation.

The Division explains that, for the purposes of the Securitization Letter, references to "asset-backed securities" include mortgage-backed securities.

Note that the issuer need only be "operated consistent with" Regulation AB or Rule 3a-7. The intention, as the Division explains, is that (i) Regulation AB may be relied upon when determining whether an issuer of asset-backed securities is excluded from the definition of commodity pool even in connection with private issuances, rather than public, or (ii) Rule 3a-7 may be relied upon in connection with determining whether an issuer of asset-backed securities is excluded from the definition of commodity pool even where the issuer is utilizing another exemption or exclusion from registration under the Investment Company Act. (As it is primarily a disclosure regulation, additional guidance from the CFTC may be required in certain cases to interpret the reference to "operating consistent with" Regulation AB. In the alternative, we believe the Rule 3a-7 requirements may be relied upon with greater certainty.)

- The entity's activities are limited to passively owning or holding a pool of receivables or other financial assets, which may be either fixed or revolving,[6] that by their terms convert to cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to security holders.

  The Division states that the term "financial asset" as used in the Securitization Letter does not include transactions whereby an entity obtains exposure to an asset that is not

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rating agency or are sold to "accredited investors" as defined in paragraphs (1), (2), (3) and 7 of rule 501(a) under the Securities Act of 1933 or an entity in which all of the equity owners come within such paragraphs, or to "qualified institutional buyers" as defined in Rule 144A under the Securities Act of 1933; (iii) the issuer's acquisition or disposition of assets does not result in a downgrade in the rating of the issuer's fixed-income securities, and such assets are not acquired or disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes; and (iv) with regard to certain transactions, the issuer (a) appoints an independent trustee, which does not provide the issuer with credit enhancement, (b) takes reasonable steps to cause such trustee to have a perfected security interest or ownership interest valid against third parties, and (c) takes actions necessary for the cash flows derived from eligible assets for the benefit of the holders of fixed-income securities to be deposited periodically in a segregated account maintained by the trustee consistent with the rating of the outstanding fixed-income securities. "Eligible assets" for these purposes are generally defined to include assets that meet item 2 of the "Securitization Vehicles" section of this memo.

6 If the issuer is a "master trust," as that term is defined in Regulation AB, 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.

transferred or otherwise part of the asset pool. Securitization vehicles with synthetic exposures will therefore not qualify for this exclusion.

Note that such financial assets would, however, include the residual value realized on the disposition of leased assets to the extent consistent with the terms of Regulation AB.

- The entity's use of derivatives is limited to the uses of derivatives permitted under the terms of Regulation AB, which include credit enhancement 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.
- 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.
- The issuer is not permitted to acquire additional assets or dispose of assets for the primary purpose of realizing gain or minimizing loss due to changes in market value of the vehicle's assets.

  The Division notes that nothing in this requirement should be construed to permit the use of derivatives beyond those circumstances set forth in the third item above.

The Division advises that certain entities may not qualify for the relief, including those operating to some extent under any covered bond statute, entities involved in collateralized debt obligations or collateralized loan obligations, any insurance-related issuances, and other synthetic securitizations.

However, with regard to securitization vehicles that cannot satisfy each criteria, the Division makes clear, in boldface, that it is open to discussions with securitization sponsors to consider the facts and circumstances of their structures with a view toward determining whether relief is available.

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Please do not hesitate to contact us with any questions.

October 16, 2012