CLIENT UPDATE

CFTC ISSUES INTERPRETIVE GUIDANCE AND REGISTRATION RELIEF TO SECURITIZATION VEHICLES, MREITS, AND BDCS

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In a series of recent letters, the Division of Swap Dealer and Intermediary Oversight ("Division") of the Commodity Futures Trading Commission ("CFTC") offers certain guidance and relief to securitization vehicles, mortgage real estate investment trusts ("mREITs"), and business development companies ("BDCs").

In a letter dated December 7, 2012, the Division provides examples regarding securitization vehicles that are not included within the definition of "commodity pool," no-action relief for certain securitization vehicles formed before October 12, 2012, and temporary relief from registration as a commodity pool operator ("CPO") to operators of securitization vehicles (the "December Securitization Letter").[1]

In a second letter dated December 7, 2012, the Division writes that it will not recommend enforcement action against the operator of an mREIT provided that the mREIT submits a claim for relief and satisfies certain criteria (the "mREIT Letter").[2]

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1 Available at http://www.cftc.gov/PressRoom/PressReleases/pr6453-12

2 Available at http://www.cftc.gov/PressRoom/PressReleases/pr6452-12

In a letter dated December 4, 2012, the Division offers relief from registration as a CPO to operators of BDCs that satisfy a de minimis threshold test and certain other requirements (the "BDC Letter").[3]

SECURITIZATION VEHICLES

The December Securitization Letter expands on a letter from the Division dated October 11, 2012 (the "October Securitization Letter" and together with the December Securitization Letter, the "Securitization Letters").[4] In the October Securitization Letter, the Division interpreted the definition of "commodity pool" [5] to exclude certain securitization vehicles; such securitization vehicles are generally those that are engaged in passive investment in and financing of financial assets, that receive only limited types of support from swap transactions, and as such qualify to use an alternative disclosure regime under Regulation AB[6] or an exemption from regulation under the Investment Company Act of 1940 (the "Investment Company Act").

October Securitization Letter Criteria for Exclusion

The criteria for excluding securitization vehicles from the definition of commodity pool announced in the October Securitization Letter are as follows:

- The issuer of the asset-backed securities is operated consistent with the conditions set forth in Securities and Exchange Commission (the "SEC") Regulation AB or Rule 3a-7 under the Investment Company Act ("Rule 3a-7"),[7] whether or not the issuer's security

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3 Available at http://www.cftc.gov/PressRoom/PressReleases/pr6442-12

4 Additional detail regarding the October Securitization Letter is available in our Client Update, *CFTC Issues Interpretative Guidance to Equity REITs and Certain Securitization Vehicles*, available at http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=e9067a99-e5c2-4346-9c58-9603c80df2f1

5 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.

6 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 (the "Securities Act") and the Securities Exchange Act of 1934.

7 17 CFR 270.3a-7 (as of Apr. 2012). Rule 3a-7 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

offerings are in fact regulated pursuant to either regulation,[8] such that the issuer, pool assets, and issued securities satisfy the requirements of either regulation;

- The issuer's activities are limited to passively owning or holding a pool of receivables or other financial assets,[9] which may be either fixed or revolving,[10] that by their terms convert to cash within a finite time period[11] plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to security holders;
- 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;

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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 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; (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 the criteria in the second bullet point of this section of this memo.

8 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.

9 The term "financial asset" as used in the October Securitization Letter does not include transactions whereby an entity obtains exposure to an asset that is not transferred or otherwise part of the asset pool.

10 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.

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

- 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
- 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.

December Securitization Letter Examples of Excluded Securitization Vehicles

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 (i) the use of swaps is no greater than that contemplated by Regulation AB and Rule 3a-7, (ii) such swaps are not used in any way to create an investment exposure, and (iii) the securitization vehicle complies with the requirement that its activities are limited to the holding of financial assets.

The December Securitization Letter provides the following examples of securitization vehicles that are excluded from the definition of commodity pool:

- A standard asset-backed commercial paper conduit 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. Absent other factors, and so long as the investment is essentially in the financial assets in the vehicle and not in swaps, such vehicle would not be a commodity pool.
- 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.

  In the Division's example, such CDO is one in which financial assets are permitted to be traded up to 20 percent of the aggregate principal balance of all financial assets owned by the issuer per year for three years, interest rate swaps are used to convert certain fixed rate financial assets to floating, foreign exchange swaps are used to convert Euro-denominated assets to dollars, and none of such swaps are permitted to be terminated before the related hedged asset has been liquidated. That is, where (as in this example) the investment is essentially in the financial assets of the vehicle and not the swaps, and absent other factors, it will not be deemed a commodity pool.

- A covered bond transaction if the collateral pool (and the special purpose vehicle in a structured model) contains no commodity interests other than swaps which are used only for purposes permitted under Regulation AB, and covered bond holders are only entitled to receive payment of accrued interest and repayment of principal of their covered bonds, without any condition to payment based upon any swap exposure.

The Division also notes 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 CPO.

Securitization Vehicles that May Be Commodity Pools

The December Securitization Letter also explains that a securitization vehicle may be deemed to be a commodity pool, generally when it has exposure to swaps that are used to create investment exposure (e.g., the payment to investors is affected by swaps in a way other than to enhance credit, or to swap interest rates or currencies, each as permitted under Regulation AB).

Examples of securitization vehicles that may be deemed to be commodity pools are as follows:

- A CDO structure that permits a 5 percent bucket for synthetic assets consisting of swaps instead of having 100 percent of its holdings be comprised of financial assets.

  Note that in this example it is possible that, given the small size of the bucket, the operator of such securitization vehicle may be exempt from registration pursuant to the de minimis test under section 4.13(a)(3) of the Regulations under the Commodity Exchange Act.[12]

- A repackaging vehicle[13] 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.

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12 Unless otherwise indicated, all section references are to the Regulations.

13 Repackaging vehicles are those special purpose entity vehicles that permit clients to acquire tailored exposure to a variety of asset classes and risk profiles through a single instrument (e.g., a transaction combining unrelated credit, interest rate, and maturity components not currently available packaged together in the marketplace).

In the Division's example, where 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, such repackaging vehicle may be a pool because the investors are obtaining a significant component of their investment upside or downside from the related swaps.

Additional examples of repackaging vehicles that may be deemed to be commodity pools include a repackaging vehicle that acquires a three-year bond, issues a tranche of notes and uses swaps to extend the investment experience of the bond to four years, or a repackaging vehicle that pairs a three-year bond with a swap to provide inflation rate protection.

The Division notes generally that if 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 and enters into a swap with its affiliate pursuant to which the swap counterparty provides credit support for the interest and principal sufficient to obtain AA pricing of the trust's notes. Here, the securitization vehicle may be a commodity pool because the facts and circumstances indicate that the swap is a significant aspect of the investment.

No-action Relief for Certain Securitization Vehicles Formed Before October 12, 2012

The Division will not recommend enforcement action for failure to register as a CPO against any operator of a securitization vehicle that satisfies the following criteria:

- The issuer has 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;
- The issuer has not and will not issue new securities on or after October 12, 2012; and
- The issuer shall provide an electronic copy of the following items within five business days of a request from the CFTC or any division or office thereof:
  - the most recent disclosure document used in connection with the offering of the related securities,
  - all amendments to the principal documents since issue,
  - the most recent distribution statement to investors, and

- if the issuer's securities were offered relying on Rule 144A under the Securities Act, a copy of the information that would be provided to prospective investors to satisfy Rule 144A(d)(4).

If the issuer does not provide such required information, it must demonstrate that it cannot obtain such documents through reasonable commercial efforts.

Failure to comply with the criteria described in the December Securitization Letter will result in the issuer's inability to rely upon the terms of the relief.

Temporary No-action Relief for Securitization Vehicles

In light of the Division's continuing dialogue with the securitization industry, the Division will not recommend enforcement action for failure to register as a CPO against the operator of any securitization vehicle unable to rely upon the terms of the Securitization Letters until March 31, 2013.

Relief under the December Securitization Letter is self-effectuating and does not require any notice or filing with the CFTC.

Finally, with regard to securitization vehicles that cannot satisfy the criteria in either Securitization Letter, the Division makes clear 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.

MORTGAGE REAL ESTATE INVESTMENT TRUSTS

mREITs are entities that own direct or indirect interests in mortgages on real estate or other interests in real property, often using interest rate swaps, swaptions, caps, floors, or collars to hedge interest rates, foreign exchange swaps to transform income, or certain credit default swaps to hedge the risk of default on their mortgage-backed securities holdings. With respect to mREITs that invest in futures and/or options, or that use swaps, the Division finds that such mREITs are properly considered commodity pools and, absent relief from the Division, an mREIT operator would be required to register as a CPO.

However, according to the mREIT Letter, the Division will not recommend enforcement action against the operator of an mREIT that (i) submits a claim for relief and (ii) satisfies the following criteria:

- Limits the initial margin and premiums required to establish its commodity interest positions to no more than 5 percent of the fair market value of the mREIT's total assets;

- Limits the net income derived annually from its commodity interest positions that are not qualifying hedging transactions to less than 5 percent of the mREIT's gross income;
- Interests in the mREIT are not marketed to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures, commodity options, or swaps markets; and
- Either:
  - The company has identified itself as a "mortgage REIT" in Item G of its last U.S. income tax return on Form 1120-REIT, or
  - The company has not yet filed its first U.S. income tax return on Form 1120-REIT, but has disclosed to its shareholders that it intends to identify itself as a "mortgage REIT" in its first U.S. income tax return on Form 1120-REIT.[14]

Although the relief is not self-executing, materially complete claims by eligible CPOs to perfect the relief will be effective upon filing. The claim of no-action must:

- State the name, main business address, and main business telephone number of the mREITs for which the relief is being claimed;
- Be electronically signed by a person authorized to bind the mREIT; and
- Be filed with the Division via email to dsionoaction@cftc.gov with the subject line "mREIT" before December 31, 2012 (for an mREIT in operation as of December 1, 2012), or, for an mREIT that begins to operate after December 1, 2012, within 30 days after it commences operation as a mREIT.

BUSINESS DEVELOPMENT COMPANIES

BDCs are closed-end investment companies that have elected to be regulated under the Investment Company Act, and which are exempt from registration under the Investment Company Act. Accordingly, the exclusion from the definition of CPO available to registered investment companies pursuant to section 4.5 does not apply to BDC operators.[15] Therefore, absent relief from the Division, a BDC operator that trades commodity futures, commodity option contracts, or swaps ("Commodity Interests") would likely be required to register as a CPO.

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[14] The Division notes that nothing in the MREIT Letter should be construed as foreclosing the ability for an mREIT to rely upon any letter issued by the Division should the mREIT satisfy the criteria set forth therein.

[15] Unless otherwise indicated, all section references are to the Regulations.

However, in light of the existing BDC regulatory regime, the Division will not recommend enforcement action for failure to register as a CPO against any operator of a BDC, provided that it (i) submits a claim for the relief, and (ii) satisfies the following criteria:

- The BDC has elected to be treated as a BDC under section 54 of the Investment Company Act, and continues to be regulated by the SEC as a BDC;
- The BDC will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the Commodity Interest markets; and
- The BDC satisfies either of the following threshold tests:
  - The BDC uses Commodity Interests solely for bona fide hedging purposes within the meaning and intent of sections 1.3(z)(1) and 151.5 ("bona fide hedging transactions"); provided that, with respect to Commodity Interest positions that are not bona fide hedging transactions, the aggregate initial margin and premiums required to establish such positions do not exceed 5 percent of the liquidation value of the BDC's portfolio (after taking into account unrealized profits and unrealized losses on any such contracts), but, in the case of an option that is in-the-money at the time of purchase, the in-the-money amount may be excluded in making such computation, or
  - The aggregate net notional value of Commodity Interest positions that are not used solely for bona fide hedging purposes, determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the BDC's portfolio (after taking into account unrealized profits and unrealized losses on any such positions it has entered into).

Although the relief is not self-executing, materially complete claims by eligible BDCs to perfect the relief will be effective upon filing. The claim of no-action must:

- State the name, main business address, and main business telephone number of the BDC for which the relief is being claimed;
- Be signed by a person authorized to bind the BDC (which may be effected by attaching a signed pdf statement from the CPO of the BDC); and

- Be filed with the Division via email to dsionoaction@cftc.gov with the subject line "BDC" before December 31, 2012 (for BDCs in operation as of December 1, 2012), or, for a BDC that begins to operate after December 1, 2012, within 30 days after it commences operation as a BDC.

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Please do not hesitate to contact us with any questions.

December 14, 2012