



The CFTC's Interpretive Letters Regarding Securitizations, REITs and the Definition of "Commodity Pool"

In two interpretive letters issued on October 11, 2012 (collectively, the "Interpretive Letters"),¹ the Division of Swap Dealers and Intermediary Oversight (the "Division") of the Commodity Futures Trading Commission (the "CFTC")² gave guidance as to which securitization vehicles (each hereinafter, an "SV") and which real estate investment trusts (each hereinafter, a "REIT") may enter into swaps and yet fall outside of the definition of "commodity pool"³ under the Commodity Exchange Act (the "CEA")⁴ as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

The possibility that REITs and SVs might be characterized as commodity pools arises primarily because Dodd-Frank amended the definition of "commodity pool" to include enterprises that are operated for the purpose of trading in swaps.⁵ Historical guidance as to what constitutes a "commodity pool" is somewhat sparse. However, whether or not an enterprise may constitute a commodity pool by reason of its entering into derivatives may matter a great deal to the enterprise and persons associated with it because, among other things:

- commodity pools and the persons operating them are subject to regulation by the CFTC including, without limitation, the requirement that such persons register as commodity pool operators;⁶ and
- an entity that is not a commodity pool may, subject to certain requirements, avail itself of the end-user exception from the mandatory clearing of swap transactions; a commodity pool may not.⁷

¹ CFTC Letter No. 12-14, Interpretation, October 11, 2012, Division of Swap Dealers and Intermediary Oversight, "Request for Exclusion from Commodity Pool Regulation for Securitization Vehicles" (the "Securitization Letter"); and CFTC Letter No. 12-13, Interpretation, October 11, 2012, Division of Swap Dealers and Intermediary Oversight, "Request for Interpretation of the Definition of 'Commodity Pool' under Section 1a(10) of the Commodity Exchange Act" (the "REIT Letter").

² The CFTC's interpretations relate to swaps and not to the security-based swaps that are subject to regulation by the Securities and Exchange Commission. This is generally the case with the CFTC's guidance.

³ The Interpretive Letters also address the same question with respect to "pool," as defined in CFTC regulation 4.10(d), a term the CFTC considers to be substantially identical to "commodity pool" under the CEA. See Securitization Letter at 2; REIT Letter at 3.

⁴ 7 *U.S.C.* 1, *et seq.*

⁵ The definition of "commodity pool," contained in § 1a(10) of the CEA, includes any "investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests," which now include, among other things, any swap. Under CEA § 1a(10)(B), the CFTC, "by rule or regulation, may include within, or exclude from, the term 'commodity pool' any investment trust, syndicate, or similar form of enterprise if the Commission determines that the rule or regulation will effectuate the purposes" of the CEA.

⁶ See generally Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11252 (February 24, 2012).

Market participants may find the narrowness of the relief afforded by the Interpretive Letters concerning; the letters appear to leave open the possibility that many SVs and REITs not typically considered heretofore to constitute commodity pools may be subject to regulation as such. The Interpretive Letters are significant not only because of their specific determinations but because they indicate the fact-intensive nature of the inquiry that the CFTC will likely make in future determinations as to whether entities entering into swaps (including SVs and REITs not expressly covered in the Interpretive Letters) constitute “commodity pools.”

Taken together, the Interpretive Letters may be understood to indicate that the CFTC will be less likely to determine an entity is operated for the purpose of trading in swaps, and therefore less likely to find that an entity constitutes a commodity pool, to the extent that:

- the entity enters into swaps not in order to take a market view but rather to hedge or mitigate risks from its primary business and, in the case of a securitization, to alter the payment characteristics of the SV’s cash flows;
- the entity is operated in accordance with regulations that limit the nature of the swaps that the entity may transact; and
- there is no reasonable basis to expect that swaps will contribute materially to the profits or income (or loss) of the entity or of its stakeholders.

I. **The Securitization Letter**

In the Securitization Letter, addressing requests for interpretation made by the American Securitization Forum and the Securities Industry and Financial Markets Association, the Division rejected the premise that an entity could constitute a commodity pool only if its “principal purpose” is to trade in commodity interests.⁸ The Division likewise rejected the assertion that the factors set out in a leading case interpreting the term “commodity pool,” Lopez v. Dean Witter Reynolds, Inc., 805 F.2d 880 (9th Cir. 1986), should be dispositive.⁹ Rather, the Division found, whether or not an entity constitutes a commodity pool depends on an evaluation of “the facts and circumstances presented in their entirety.”¹⁰

The Division “tend[ed] to agree that certain entities that meet certain of the criteria you identify are likely not commodity pools.” These include SVs that:

- do not have multiple equity participants;
- do not make allocations of accrued profits or losses; and

⁷ Under § 2(h)(7)(C)(i) of the CEA, a commodity pool constitutes a “financial entity.” Only an entity that is not a “financial entity” may take advantage of the exceptions for end-users (provided by § 39.6 of the CFTC’s regulations) from the requirement that swaps be cleared. See End-User Exception to the Clearing Requirement for Swaps; Final Rule, 77 Fed. Reg. 42560, 42590 (July 19, 2012).

⁸ Securitization Letter at 3.

⁹ See Securitization Letter at 4. The Lopez court found that the following factors indicated the existence of a commodity pool: an investment organization in which the funds of various investors are solicited and combined into a single account for the purpose of investing in commodity interests; common funds used to execute transactions on behalf of the entire account; participants sharing pro rata in accrued profits or losses from commodity trading; and transactions being traded by a commodity pool operator in the name of the pool rather than in the name of any individual investor. See Lopez v. Dean Witter Reynolds, Inc., 805 F.2d at 884.

¹⁰ Securitization Letter at 4.

- 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.¹¹

At the same time, the Division found “overly broad” the request for “relief for entities operating to some extent under any covered bond statute, entities involved in collateralized debt obligations, entities involved in collateralized loan obligations, any insurance-related issuances, and any other synthetic securitizations.” The descriptions provided to the Division of such entities “do not preclude the issuer or, in the case of a covered bond, the related covered pool from being a commodity pool.”¹²

The Division went on to find that an SV is “substantively distinguishable”¹³ from, and will not constitute, a commodity pool if it conforms to the following criteria:

- the issuer of the asset-backed securities is operated consistent with the conditions set forth in Regulation AB,¹⁴ or Rule 3a-7,¹⁵ whether or 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 entity’s activities are limited to passively owning or holding a pool of receivables or other financial assets (either fixed or revolving) 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 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; 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.¹⁶

The Securitization Letter notes that the Division remains “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.”¹⁷

II. The REIT Letter

In the REIT Letter, addressing a request for interpretation made by the National Association of Real Estate Investment Trusts (“NAREIT”), the Division determined that certain REITS, known as equity REITS, fall outside the definition of “commodity pool.”

¹¹ Securitization Letter at 4.

¹² Securitization Letter at 4.

¹³ Securitization Letter at 5.

¹⁴ 70 Fed. Reg. 1506 (January 7, 2005). Regulation AB sets out detailed rules addressing registration, disclosure and reporting requirements for asset-backed securities.

¹⁵ 17 CFR 270.3a-7. Rule 3a-7 sets out the requirements for issuers of asset-backed securities not to constitute investment companies for purposes of the Investment Company Act of 1940.

¹⁶ Securitization Letter at 4-5.

¹⁷ Securitization Letter at 5-6.

In the REIT Letter, as in the Securitization Letter, the Division stated that the term “commodity pool” may apply to entities other than those whose “principal purpose” is to trade in commodity interests: “there may be entities whose primary business focus may be outside the commodity interest sphere, yet may still have a significant exposure to those markets, which may implicate the Commission’s concerns regarding both customer and market protection.”¹⁸

The Division determined that an equity REIT does not constitute a commodity pool if the REIT:

- primarily derives its income from the ownership and management of real estate and uses derivatives for the limited purpose of mitigating exposure to interest rate or currency fluctuation risk;
- is operated so as to comply with all of the requirements of a REIT election under the Internal Revenue Code, including the requirements that
 - at least 75 percent of the equity REIT’s annual gross income must be derived from qualifying real estate related sources (the “75 Percent Test”); and
 - at least 95 percent of an equity REIT’s annual gross income must consist of items that would satisfy the 75 Percent Test plus other passive income such as interest and dividends (the “95 Percent Test”); and
- has identified itself as an equity REIT in its last U.S. income tax return 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 and effectuates its stated intention.¹⁹

The Division’s determination was based,²⁰ in part, on the representations by NAREIT that, among other things:

- equity REITs are understood by market participants to constitute operating companies rather than investment pools;
- the use of derivatives by equity REITs is limited to activities supporting the primary focus of real estate ownership and operation through a reduction in the cost of capital;
- the limited use of derivatives by equity REITs is further enforced through the Internal Revenue Code, under which a “qualified REIT hedging transaction” is limited to those transactions entered into:
 - in the normal course of business primarily to manage the risk of interest rate, price, or currency fluctuations related to the carrying of qualifying real estate assets; or
 - primarily to manage the risk of currency fluctuations with respect to any qualifying income under the 75 Percent Test and the 95 Percent Test; and
- if income is derived from a transaction that is not a “qualified REIT hedging transaction” under the Internal Revenue Code, it is “nonqualifying income,” which, in order for an entity to maintain its status as a REIT, cannot exceed 5% of the REIT’s annual gross income.²¹

¹⁸ REIT Letter at 4.

¹⁹ REIT Letter at 4-5.

²⁰ REIT Letter at 5.

²¹ REIT Letter at 2-3.

Author

James E. Schwartz
New York
(212) 336-4327
jschwartz@mofocom

Contacts

Larry Abrams
New York
(212) 336-4113
labrams@mofocom

Chrys A. Carey
New York
(202) 887-8770
ccarey@mofocom

David H. Kaufman
New York
(212) 468-8237
dkaufman@mofocom

Anna T. Pinedo
New York
(212) 468-8179
apinedo@mofocom

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