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Highlights From Recent CFTC Guidance On ILS Registration

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On Dec. 18, 2014, the U.S. Commodity Futures Trading Commission issued a no-action letter (CFTC Letter 14-152) providing relief from commodity pool operator (CPO) registration for operators of certain insurance-linked securities (ILS) issuers. As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and CFTC regulations promulgated thereunder, there had been some uncertainty as to whether an ILS issuer could fall within the newly expanded definition of "commodity pool" to the extent that the underlying risk transfer contract could be considered a "swap." The CFTC no-action letter was issued in response to a Securities Industry and Financial Markets Association request that was formally made in August 2014 after many months of discussions with the staff of the CFTC.

Background

The Commodity Exchange Act defines a "commodity pool" as "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in commodity interests" and defines a "commodity pool operator" as a person "engaged in a business that is of the nature of a commodity pool ... and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests."

In the context of a typical ILS transaction, the operator would likely be the insurance manager or the administrator. Absent an exemption, a CPO must register with the CFTC and comply with other CPO obligations under applicable regulations.

The Dodd-Frank Act expanded the definition of "commodity interests" to include swaps, and as a result, risk transfer contracts structured as swaps in ILS transactions became subject to regulation as commodity interests, and ILS issuers potentially became subject to regulation as commodity pools.

Section 1a(47) of the CEA defines a "swap," among other things and subject to various exclusions, as an agreement "that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of

an event or contingency associated with a potential financial, economic, or commercial consequence."

This broad definition of swaps potentially covers insurance contracts. The CFTC has acknowledged that the legislative history of the Dodd-Frank Act does not reveal any congressional intent to have "traditional insurance contracts" included in the expanded "swap" definition. In 2012, the CFTC promulgated a nonexclusive safe harbor exemption for insurance contracts that meet certain conditions.[1] If a particular risk transfer contract does not qualify for the safe harbor, a careful analysis based upon facts and circumstances would need to be undertaken to determine if the contract is at risk of being characterized as a "swap" and, likewise, a "commodity interest."

To the extent that a risk transfer contract between the ILS issuer and the cedent could be considered a "swap," the ILS issuer may fall within the definition of "commodity pool," and, absent an exemption, the operator of the ILS issuer would be required to register as a CPO.

The CFTC's recent no-action relief allows operators of ILS issuers that have risk transfer contracts that are "swaps" to rely on CFTC Regulation 4.13(a)(3) for an exemption from CPO registration, subject to certain enumerated conditions.

Requirements for Exemption

In order to qualify for the exemption, Regulations 4.13(a)(3)(i), (ii), and (iii) must be satisfied, namely that:

- Interests in the pool are exempt from registration under the Securities Act of 1933, and such interests are offered and sold without marketing to the public in the United States;

- The pool at all times meets a de minimis test pursuant to which either (x) the margins, premiums and required minimum security deposit for retail forex transactions does not exceed 5 percent of the liquidation value of the pool's assets after giving effect to unrealized profits or losses; or (y) 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 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses; and

- The operator of the ILS issuer 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).

In addition, as set forth in the CFTC's no-action letter, the ILS issuer must be operated such that:

- There is no active or discretionary management of assets and liabilities (i.e., the collateral and the risk transfer contract);

- The collateral held by the ILS issuer must be in the form of:

  - Cash;
  - Puttable debt issued by the International Bank for Reconstruction and Development, the European Bank for Reconstruction and Development, or Kreditanstalt fur Wiederaufbau;
  - Any U.S.- or EU-regulated money market 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;
  - Other assets that are "highly liquid" as defined by CFTC Regulation 1.25(b)(1) (i.e., convertible into cash within one business day without material discount in value); or
  - Any other eligible collateral approved by the CFTC;

- The collateral held by the ILS issuer must either have a maturity date that is on or before the termination date of the underlying risk transfer contract or be convertible to cash upon demand by the ILS issuer;

- The ILS issuer must maintain practices to monitor the collateral regularly (up to weekly, depending on availability of pricing sources) and report any shortfall of such collateral under 100 percent of the reinsurance limit to the CFTC, the cedent and the ILS holders;

- The payment obligations of the ILS issuer to the cedent and the ILS holders must be secured by eligible collateral (as described above), and the security interest of the ILS holders must be subordinate to that of the cedent;

- The ILS issuer must maintain the collateral so that it is available to be distributed in the form of cash or in kind to the cedent at the time a payment becomes due under the underlying risk transfer contract; and

- The ILS issuer must be subject to arrangements that protect the collateral in the event of insolvency of the ILS issuer, including restricting the business activities of the ILS issuer, restricting incurrence of additional debt, restricting mergers or asset sales, maintaining an independent board of directors, maintaining a separate corporate identity from the cedent, and obtaining no-petition covenants from ILS holders.

In addition to the foregoing conditions, an operator of an ILS issuer that is seeking to rely on this exemption from CPO registration must file a notice of eligibility with the National Futures Association

through its electronic exemption filing system. The notice must provide (1) the name and contact information of the person claiming the exemption and the name of the pool for which it is claiming the exemption and (2) the section number pursuant to which the operator is filing the notice (in this case, Regulation 4.13(a)(3)) and a representation that the pool will be operated in accordance with the requirements thereunder. Such eligibility notice must be reaffirmed annually.

Moreoever, operators of ILS issuers relying on this exemption must comply with the record-keeping and reporting requirements set forth in Regulation 4.13, which include (1) keeping books and records prepared in connection with its activities as a pool operator for a period of five years from the date of preparation, (2) keeping such books and records readily accessible during the first two years of the aforementioned five-year period and making such books available for inspection upon the request of the CFTC, the U.S. Department of Justice or any other appropriate regulatory agency, and (3) submitting to special calls as the CFTC may make to demonstrate eligibility for and compliance with the applicable criteria for exemption.

Practical Implications

Most of the foregoing conditions are standard in ILS transactions and, therefore, sweeping changes to ILS structures that use swaps will likely not be required. Of course, the preponderance of ILS transaction structures to date have relied upon risk transfer contracts that are reinsurance contracts, and these structures should not be affected. However, there are a few points to highlight.

The CFTC's no-action letter does not help clarify the definition of a "swap" or in any way change the insurance safe harbor originally promulgated in 2012. For better or worse, an issuer still must rely on the existing guidance for determining whether a particular risk transfer contract is a swap.

The no-action letter should not have an impact on any outstanding catastrophe bond transactions. The exemption provided for in the letter is only available for transactions on a prospective basis. In addition, since the promulgation of the rules relating to swaps under the Dodd-Frank Act, the risk transfer contracts in most catastrophe bond transactions have been structured to either fit within the insurance safe harbor or meet characteristics of traditional insurance contracts. As a result, in many transactions there has not been the need for the operator of the ILS issuer to register as a CPO. For recent transactions where the underlying risk transfer contract was structured as a swap, the operators have complied with the CPO registration requirements.

As noted above, ILS issuers relying on this CPO registration exemption are required to make notice filings with the CFTC (which must be reaffirmed annually) and maintain books and records for a five-year period after the inception of the transaction. The typical catastrophe bond has a risk period of approximately three years, and so provisions will need to be made at the inception of the transaction for the administrator to maintain these records for the required period of time, even if the underlying transaction has terminated and the underlying catastrophe bonds are no longer outstanding.

Certain changes will also need to be made to the manner in which the underlying collateral is managed. As described above, the collateral must be monitored regularly, which in certain circumstances may mean that the monitoring needs to be done weekly, in contrast to the current market standard of monthly monitoring.

Furthermore, ILS issuances that invest collateral in investments other than IBRD/EBRD/KfW notes or money market funds with U.S. dollar-denominated underlying investments must ensure that the

investments are “highly liquid” and convertible into cash within one business day (or be separately approved by the CFTC).

This new exemption will have the most impact on sponsors seeking to structure ILS transactions using a swap contract as the underlying risk transfer contract as opposed to a reinsurance contract having the characteristics of traditional insurance. Prior to the enactment of the Dodd-Frank Act, sponsors of catastrophe bond transactions who were indifferent as to whether the underlying risk transfer contract was treated as reinsurance (typically certain sponsors outside of the United States) would often structure the risk transfer contract as a swap. This became less common after the adoption of the Dodd-Frank Act due to the need for the operator of the ILS issuer to register as a CPO. Now, in light of the CFTC’s no-action relief, swaps may be used in ILS transactions with fairly minimal regulatory burden.

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[1] For more information regarding the insurance safe harbor, see Mayer Brown’s Sept. 6, 2012, memorandum, which can be found at http://www.mayerbrown.com/files/uploads/Documents/PDFs/2012/September/CFTCandSECinsurancevswapsfullarticle.pdf.

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