New Dodd-Frank Rules Regarding Swaps, the Insurance Safe Harbor and Commodity Pools: Implications for Cat Bonds, Sidecars, ILWs and Other Insurance-Linked Securities

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How Did We Get Here?

How Did We Get Here?

- Genesis, Chap. 29 – forwards or options?
- Pascal/de Fermat, Bernoulli, Bayes, Galton, Black/Scholes
- 1972 - 1982 – rise of financial futures
- 198_? – back-to-back loans – IRS
-

How Did We Get Here?

- 1980s - 90s – huge diversification
- Decision to express in notional
- P&G/Gibson, etc., – "The Devil's in the Derivatives" – BT entered into CFTC and SEC (?) consent orders
- Legal Uncertainty
  - Gaming/bucket shop concerns
  - Securities law concerns
  - Futures regulatory concerns
- Commodity Futures Modernization Act-2000
- Insurance law concerns – NYS Ins. Dept. letters

How Did We Get Here?

- 2000s – no yield but mortgage yield
- Mortgage bubble
- The swaps worked
- Dodd-Frank – regulatory kitchen sink
  - Commodity Exchange Act – soup to nuts: registration, reporting, conduct, disclosure . . . and unforeseen consequences
  - Securities Laws
  - But a swap is not insurance – Dodd-Frank Act 722(b)

Consequences of Transacting in Swaps

Overview of Dodd-Frank Derivatives Provisions

- Title VII of the Dodd-Frank Act (DFA) imposes a comprehensive regulatory regime for swaps
  - Registration Requirements
    - Swap Dealers (SDs) and Security-Based Swap Dealers (SBSDs)
    - Major Swap Participants (MSPs) and Major Security-Based Swap Participants
  - Substantive Regulation of Swaps Activities
    - Mandatory clearing and trade execution requirements
    - Margin requirements for uncleared swaps
    - Recordkeeping and data reporting requirements
    - Internal and external business conduct standards
- Authority for implementing swaps regulation divided between CFTC (swaps) and SEC (SBSs)
- Under proposed CFTC guidance, extraterritorial reach is generally limited to swap transactions with "US persons"

Substantive Regulation of Swaps Activities

- Mandatory clearing and trade execution (applies to all market participants, subject to limitations on extraterritoriality)
  - CFTC's first proposed clearing designation: broad array of interest rate products in USD, GBP, EUR, JPY and certain index CDS
  - Exemptions for non-financial end-users and certain affiliates, captive finance subsidiaries
- Margin requirements for uncleared swaps (required to be collected by SDs, MSPs)
  - For financial counterparties, limited or no unsecured threshold amounts permitted, depending on counterparty type
  - Unsecured thresholds permitted for non-financial counterparties
  - Still in proposed form

Substantive Regulation of Swaps Activities (continued)

- Swap data recordkeeping (everyone, subject to ET limitations) and reporting (generally the counterparty that is the registered swap entity), large trader reporting, position limits (subject to disposition of a recent court ruling that vacated the CFTC's rule)
- Business conduct standards apply to SD/MSPs
  - With counterparties
    - Includes enhanced protections for "Special Entities," such as ERISA plans and municipalities
  - Internally
    - Includes chief compliance officer, recordkeeping, risk management policies, documentation standards

Swap Entity Definition

- CFTC and SEC adopted a joint final rule defining "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant" and "eligible contract participant" (May 23, 2012)
- A SD or SBSD is a person who engages in any of the following activities:
  - Holding oneself out as a dealer in swaps or SBS;
  - Making a market in swaps or SBS;
  - Regularly entering into swaps or SBS as an ordinary course of business for one's own account; or
  - Engaging in any activity causing oneself to be commonly known in the trade as a dealer or market-maker in swaps or SBS

Swap Entity Definition (continued)

- Exclusions exist for interaffiliate swaps, swaps connected with loan origination and if the person does not enter into swaps as part of a regular business
- Indicia of dealer status
  - Profit through providing liquidity
  - Accommodating demand or facilitating interest
  - Structuring and advice
  - Regular clientele and active solicitation
  - Acting as a market-maker on an organized exchange
- In contrast, a "swap for the purpose of **hedging**, absent other activity, is unlikely to be indicative of dealing."

SD Definition – *De Minimis* Threshold

- Persons engaged in more than a *de minimis* amount of **dealing** in swaps or SBS over the course of a measurement period beginning on October 12, 2012 must register as SDs or SBSDs with the CFTC or the SEC, respectively
- During an initial phase-in period, the *de minimis* threshold for SDs will be:
  - $8B notional in swaps; or
  - $25M notional in swaps with "Special Entities," which include
    - Federal agencies;
    - States, State agencies, cities, counties, municipalities, or other political subdivisions of a State;
    - Employee benefit plans, as defined under ERISA;
    - Governmental plans, as defined under ERISA; and
    - Endowments, including endowments that are organizations described in section 501(c)(3) of the Internal Revenue Code

SD Definition – *De Minimis* Threshold (continued)

- The *de minimis* threshold for SBSDs during the phase-in period will be:
  - $8B in CDS that are SBS; or
  - $400M non-CDS SBS
- After the phase-in period, the *de minimis* thresholds are scheduled to be reduced from $8B to $3B for both swaps and CDS that are SBS; and from $400M to $150M for non-CDS SBS (the $25M threshold for swaps with Special Entities will remain)
  - No clear timeframe for phase-in period; expected to be some time after issuance of staff reports, but both CFTC and SEC have adopted an outer limit of 5 years
  - Possible that final *de minimis* threshold could be $3B as scheduled, or could be higher or lower

SD Definition – *De Minimis* Calculation

- A person is deemed not to be an SD/SBSD so long as the notional amount of swap/SBS positions **connected with dealing** activities and entered into **during the measurement period** does not exceed the *de minimis* threshold
  - Measurement period commences on October 12, 2012 (the "Swap Definition Effective Date"), *i.e.*, 60 days after Federal Register publication of the swap definition rule, and will expand into a rolling 12-month period
  - Swaps or SBSs entered into prior to the Swap Definition Effective Date do **not** count for purposes of the *de minimis* test
  - Thus, SD/SBSD registration generally will not be required by the Swap Definition Effective Date, but by the end of the 2nd calendar month after the end of the month in which the *de minimis* threshold is exceeded
  - Swap/SBS dealing transactions are **aggregated** with those of commonly-controlled affiliates, *i.e.*, companies that (directly or indirectly) control, are controlled by, or are under common control with such person
- SDs may register earlier

MSP Definition

- MSP is a non-SD that meets any of the following criteria:
  - Maintains a "substantial position" in swaps for any of the major swap categories, not including positions held for hedging or mitigating commercial risk
  - Outstanding swaps create "substantial counterparty exposure" that could have serious adverse effects on the financial stability of the US banking system or financial markets
  - A financial entity that is highly leveraged, not subject to US bank capital requirements and maintains a "substantial position" in any category of swaps
- A person can be a "vicarious" MSP if it guarantees or is otherwise liable for another entity's swap obligations
- "Substantial position" and "substantial counterparty exposure" are measures of **uncollateralized** exposures plus add-ons for potential exposure
  - Regulators expect that there will be very few MSPs, but market participants may need to monitor positions

Cross Border Applicability of Swaps Regulation

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Extraterritoriality of US Swaps Regulation Under DFA

- DFA Sec. 722(d)
  - "The provisions of [the CEA] relating to swaps that were enacted by [Title VII of the DFA] shall not apply to activities outside the United States unless those activities—

    ''(1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or

    ''(2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this Act . . . "

- DFA Sec. 772(b)
  - "No provision of [the Securities Exchange Act of 1934] that was added by [DFA Title VII], or any rule or regulation thereunder, shall apply to any person insofar as such person transacts a business in security- based swaps without the jurisdiction of the United States, unless such person transacts such business in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate to prevent the evasion of any provision [added by DFA Title VII]."

Overview of Cross-Border Applicability of Swaps Regulation

- On June 29, 2012, the CFTC released its proposed guidance regarding the cross-border application of the swaps provisions of DFA Title VII
- Defines US-facing transactions for purposes of determining SD/MSP registration
  - Non-US entities look **only** at US-facing transactions
- Lays out scheme for extraterritorial application of substantive regulations
- Key Aspects
  - Definition of US person
  - *De minimis* calculation for non-US SDs
  - MSP threshold calculations for non-US MSPs
  - Lays out approach to "substituted compliance" regime, i.e., deference to home country regulation in certain areas
  - Certain transaction-level requirements apply if one of the parties to a swap is a US person

What is the Evolving Definition of a US Person?

(as modified by the 12 Oct. temporary relief)

- Any natural person who is a US resident
- Any corporation, partnership, LLC, trust, association, joint-stock company, fund or any similar enterprise (A) that is organized or incorporated under US law ~~or has its principal place of business in the US~~, ~~or (B) the direct or indirect owners of which are responsible for liabilities of the enterprise and one or more of such owners is a US person~~
- Any individual account (discretionary or not) with beneficial owner described here
- ~~Any commodity pool, pooled account, or collective investment vehicle (whether or not organized in the United States) that is directly or indirectly majority-owned by US persons~~
- ~~Any commodity pool, pooled account, or collective investment vehicle the operator of which would be required to register with the CFTC as a commodity pool operator~~
- A pension plan for the employees, officers or principals of a US legal entity, unless it is exclusively for foreign employees ~~with its principal place of business in the United States~~
- Any estate or trust, the income of which is subject to US income tax regardless of source

US Person Definition (CFTC proposal) (continued)

- CFTC proposed guidance states that a non-US branch or agency of a US person (*e.g.*, the European branch of a US bank) "generally" would be covered by the definition of a US person
  - ***Non-US Branches of SDs***. Non-US entities would be permitted to exclude swap transactions with non-US branches of a **registered** US SD from the *de minimis* calculation
  - ***US Branches***. Under single entity theory, it appears a US branch of a non-US bank is not a US person for purposes of *de minimis* threshold calculations
- Proposed guidance states that a non-US affiliate or subsidiary of a US person would not be a US person, *even if* all swap-related obligations of such affiliate or subsidiary were guaranteed by a US person

SD Definition – *De Minimis* Calculation for Non-US Entities (CFTC proposal)

- The non-US entity includes **only** swaps with US persons (other than non-US branches of US SDs) **and**, if applicable, swaps with non-US counterparties under which the non-US entity's obligations are guaranteed by a US person
- Aggregates swaps of non-US affiliates under common control
- Excludes swaps of US affiliates
- Excludes inter-affiliate swaps under majority control

MSP Calculation for Non-US Entities (CFTC proposal)

- ***General Rule***. As with the SD *de minimis* calculation, a non-US person would only include swaps with US persons in its MSP threshold calculations (*i.e.*, substantial position and substantial counterpart exposure)
- ***Non-US Branches***. Swaps with non-US branches of all US persons must be included (*i.e.*, no special carve-out for non-US branches of registered US SDs)
- Also include swap positions facing US persons where the non-US entity guarantees another non-US person's obligations to the US person
- Exclude positions where the non-US person's obligations are guaranteed by a US person

Regulation of Registered Non-US SDs

- The CFTC proposes to divide substantive swaps regulations conceptually into (i) "Entity-Level Requirements," which apply to a SD or MSP on a firm-wide basis and (ii) "Transaction-Level Requirements," which apply to an individual swap
- Entity-Level Requirements
  - capital adequacy; chief compliance officer; risk management; swap data recordkeeping; swap data reporting; physical commodity swaps reporting
- Transaction-Level Requirements
  - clearing and swap processing; margining and segregation for uncleared swaps; trade execution; swap trading relationship documentation; portfolio reconciliation and compression; real-time public reporting; trade confirmation; daily trading records; external business conduct standards

Regulation of Registered Non-US SDs

- ***General Rule.*** Non-US SDs and MSPs would be required to comply with all Entity-Level Requirements, subject to the potential availability of “substituted compliance” with home-country law. Compliance with Transaction-Level Requirements generally would only be required for swaps with US person counterparties, excluding non-US branches of US persons.
- ***Guarantees.*** Transaction-Level Requirements (except external business conduct) apply for swaps with non-US counterparties if the performance of the non-US counterparty is guaranteed (or otherwise supported) by a US person.
- ***Conduits for US Persons.*** Transaction-Level Requirements also would apply to the swap transactions of a non-US SD with another non-US person that is a “conduit” for a US person.

Substituted Compliance

- The Proposed Guidance would permit non-US SDs and MSPs, under certain circumstances, to conduct business in compliance with home country regulations without satisfying additional US law requirements
  - Requires CFTC comparability determination
  - Comparability determinations would be made on a requirement-by requirement basis (upon application)
  - Application for comparability determination may be submitted by a non-US SD applicant, group of applicants from the same jurisdiction, or non-US regulatory authority
- Proposed Exemptive Order would permit delayed compliance date.
  - Requires submission of compliance plan

Regulation of Non-US Persons Who are Not SDs or MSPs

- ***Swaps Between Non-US Persons.*** Where a non-US person enters into a swap with another non-US person outside the US and neither counterparty is required to register as a SD or MSP, the swap generally would not be subject to swap regulations arising under DFA Title VII.

- ***Swaps Between a US Person and Non-US Person.*** Under the Proposed Guidance, swaps involving at least one party that is a US person would be subject to Title VII requirements relating to clearing, trade-execution, real-time public reporting, large trader reporting, SDR reporting, and recordkeeping (i.e., those swap provisions that apply to counterparties other than SDs and MSPs).

Insurance vs. Swaps Overview

Distinguishing Insurance vs. Swaps under Dodd-Frank

- Regulation of swaps under Title VII of Dodd-Frank
  - Definition of swap under Section 721(a) includes contracts that provide for payments dependent on the occurrence or extent of a contingency associated with a potential commercial consequence
  - Regulatory line drawing – Under Sections 722(b) and 767, the CFTC and SEC regulate swaps and security-based swaps (SBS), respectively, which "**may not be regulated as an insurance contract under the law of any State**"
  - Distinguishing insurance vs. swaps
    - The CFTC and SEC have recognized that nothing in the legislative history of Dodd-Frank suggests that Congress intended for traditional insurance products to be regulated as swaps
    - CFTC/SEC rules issued in July 2012 (effective October 12, 2012) provide a non-exclusive "**Insurance Safe Harbor**" to prevent products regulated as insurance from being treated as swaps

The Insurance Safe Harbor

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The Insurance Safe Harbor – Overview

- The "**Insurance Safe Harbor**" rules were issued in July 2012 (**Rule 3a69-1** under the Securities Exchange Act and **Rule 1.3(xxx)(4)** under the Commodity Exchange Act) to provide a non-exclusive basis for exclusion from the swap/SBS definition.
- The Insurance Safe Harbor has four components:
  - Product Test
  - Provider Test
  - Enumerated Products
  - Grandfather Clause

Insurance Safe Harbor – Basic Requirements

- Generally, in order to qualify for the Insurance Safe Harbor, an agreement, contract or transaction must satisfy **both the Product Test and the Provider Test**.

- However, if an agreement, contract or transaction is an **Enumerated Product** or is covered by the **Grandfather Clause**, then it **only needs to satisfy the Provider Test**

Insurance Safe Harbor – The Product Test

- An agreement, contract, or transaction satisfies the Product Test if:
  - It requires the beneficiary to have an **insurable interest** and carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction; and
  - It requires such **loss** to occur and to be proved, and that any payment or indemnification therefore be **limited to the value of the insurable interest**; and
  - It is **not traded**, separately from the insured interest, on an organized market or over the counter; and
  - For financial guaranty insurance, any acceleration of payments triggered by payment default or insolvency is at the sole discretion of the insurer

Insurance Safe Harbor – The Provider Test

- An agreement, contract or transaction satisfies the Provider Test if it is:
  – Provided by a person that is **subject to supervision by the insurance commissioner** (or similar official or agency) of any U.S. state or the federal government, and such agreement, contract or transaction is **regulated as insurance** under applicable law *(see below for special requirements for reinsurance and non-admitted insurance)*; or
  – Provided directly or indirectly by the federal government or any state government, or pursuant to a statutorily authorized program thereof

Provider Test – Special Requirements for Reinsurance

- An agreement, contract or transaction of **reinsurance** (including a retrocession) satisfies the Provider Test if:
  - The ceding insurer satisfies the Provider Test (using the reinsurance Provider Test in the case of a retrocession); and
  - The reinsurer is not prohibited by applicable state or federal law from offering such agreement, contract, or transaction to the ceding insurer; and
  - The agreement, contract, or transaction to be reinsured satisfies the Product Test or is an Enumerated Product; and
  - Except as otherwise permitted under applicable state law, the total amount reimbursable by all reinsurers for such agreement, contract, or transaction does not exceed the claims or losses paid by the ceding insurer

Provider Test – An Ambiguity Regarding Reinsurance

- There is an ambiguity as to whether a contract of reinsurance can satisfy the Provider Test:
  - by satisfying **either** the generic first prong or the reinsurance-specific third prong, or
  - **only** by satisfying the reinsurance-specific third prong
- The language and logic of the rule suggests that either prong is available, but there is a footnote in the adopting release that suggests otherwise
- This issue can be outcome-determinative for reinsurance provided by US reinsurers to non-US cedents

Provider Test – Special Requirements for Non-Admitted Insurance

- In the case of non-admitted (surplus lines) insurance, an agreement, contract or transaction satisfies the Provider Test if the insurer is either:
  - Qualified under the eligibility criteria for non-admitted insurers under applicable state law; or
  - **Located outside the US** and listed on the Quarterly Listing of Alien Insurers ("white list") maintained by the International Insurers Department of the National Association of Insurance Commissioners

Enumerated Products

- The following enumerated products **are excluded** from the swap/SBS definition if offered by a provider that satisfies the Provider Test, **without having to satisfy the Product Test**:
  - surety bonds
  - fidelity bonds
  - title insurance
  - life insurance
  - health insurance
  - long-term care insurance
  - property and casualty insurance
  - annuities
  - disability insurance
  - private mortgage insurance
  - reinsurance of any of the above (including retrocessions)

Grandfather Clause

- An agreement, contract or transaction entered into on or before the October 12, 2012 effective date of the new rules will be excluded from the swap/SBS definition if it satisfied the Provider Test at the time it was entered into, without having to satisfy the Product Test

Safe Harbor Is Non-Exclusive

- The Insurance Safe Harbor is non-exclusive
  - That means that an agreement, contract or transaction that fails the applicable tests is not necessarily a swap or SBS
  - An agreement, contract or transaction that does not fall within the Insurance Safe Harbor requires further analysis of the applicable facts and circumstances to determine whether it is insurance, and thus not a swap or SBS
- However, satisfying the Insurance Safe Harbor will provide a high degree of certainty that an agreement, contract or transaction is not a swap or SBS subject to Title VII of Dodd-Frank

Non-traditional Products

- Products **not** on the Enumerated Products list:
  - GICs, synthetic GICs, funding agreements, structured settlements, deposit administration contracts, immediate participation guaranty contracts, ILWs and cat bonds
- Rationale given in the adopting release:
  - These products do not receive the benefit of state guaranty funds
  - Their providers are not limited to insurance companies
  - CFTC/SEC received little detail on the sale of these products
  - CFTC/SEC "do not believe it is appropriate to determine whether particular complex, novel or still evolving products are swaps or security-based swaps in the context of a general definitional rulemaking. Rather these products should be considered in a facts and circumstances analysis."

Commodity Pools Issues

How Did We Get Here?

- Section 721(a)(5) of the Dodd-Frank Act added a new definition of “commodity pool” to the Commodity Exchange Act (CEA):

  “The term “commodity pool” means any **investment trust, syndicate, or similar form of enterprise** operated for the **purpose of trading in commodity interests**, including any—

  (i) commodity for future delivery, security futures product, **or swap…”**

- Note this new definition is based on a definition in a pre-existing CFTC regulation, but adds swaps

More Dodd-Frank Mischief

- Section 721(a)(6) of the Dodd-Frank Act expanded the definition of "commodity pool operator" (CPO) to add those that invest in non-security-based swaps

"The term "commodity pool operator" means any person—

(i) engaged in a business that is of the **nature of a commodity pool, investment trust, syndicate, or similar form of enterprise**, 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**, including any—

(I) commodity for future delivery, security futures product, or **swap**…"

The Joint Swap Product Definition Triggers an Examination of These Changes

- The CFTC and SEC released their joint rule defining “swap” and this triggers an examination of these changes and the realization that securitization and a variety of arrangements are at risk of being commodity pools and related parties may be commodity pool operators or commodity trading advisers with unexpected and, in some cases, unwelcome results

Special Notes about Legacy and Non-US Securitizations

- Note that these changes are NOT just prospective – i.e., legacy securitizations may be affected and, if so, are likely to face more complicated questions on how to comply
- “Trading” need not be a principal purpose. A sufficient trading purpose may be present (at least in the view of the CFTC Staff) even if there is only a single swap
- Also note that the extra-territorial application of these provisions is unclear – i.e., non-US securitizations may be affected and the jurisdictional “reach” of the CFTC is quite broad - use of jurisdictional instrumentalities – but international harmonization (if and when obtained) may curb this reach

Extraterritorial Impact of CPO Regulation

- Even one US investor in a commodity pool located outside the US can trigger registration of the non-US advisers if the commodity pool enters into various transactions on US commodities exchanges
- No general exemption exists for non-US pools and their non-US operators other than exemption when trading is limited to foreign futures and options and US participation is limited
- Exemption (Regulation 4.13(a)(4) on which many non-US CPOs had relied was rescinded by the CFTC earlier this year
- Other exemptions and conditions in no-action letters are difficult to meet

Consequences

- Section 9 of the CEA (7 USC §13) provides that it is a felony punishable by a fine of up to $1MM or imprisonment for up to 10 years or both for willful violations of the CEA
- Section 22 of the CEA (7 USC §25) provides that a person who violates the CEA or who willfully aids, abets, counsels, induces or procures such violation shall be liable for actual damages caused by such violation to any person in connection with …an interest or participation in a commodity pool

More Consequences

- Related parties may have to register. Specifically, any (there can be more than one) CPO or commodity trading adviser (CTA), unless exempt, will have to register and meet related requirements
- CPO/CTA registration is burdensome and imposes regulatory requirements that will be difficult for securitization issuers to satisfy
- Even if the CPO is exempt from registration requirements, a commodity pool will be a “covered fund” subject to the Volcker Rule restrictions (if the proposed Volcker regulations are adopted in their current form).

The Lopez Factors

- *The* court in the *Lopez* case outlined four factors for an "investment trust"/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 share *pro rata* in accrued profits or losses from the commodity interests trading
  - the transactions are traded by a commodity pool operator in the name of the pool rather than in the name of any individual investor

So Where Are We Now?

- Both the ASF and SIFMA requested broad exemptive relief from the CFTC in respect of securitization vehicles, including those which issue asset-backed securities and insurance-linked securities
- In response, the CFTC Staff issued an interpretation letter, No.12-14, and a related no-action letter, No.12-15, both on October 11, 2012

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Recent CFTC Interpretation Letter

- In Letter No.12-14, the CFTC's Division of Swap Dealer and Intermediary Oversight (Division) states it is required to evaluate the facts and circumstances presented in their entirety and determine whether a pooled investment vehicle possessing such characteristics should properly be considered to be a commodity pool
- In attempting to make such an evaluation based on the characteristics presented by the ASF and SIFMA, the Division stated that it "tended" to agree that certain securitization entities are likely not commodity pools, such as securitization entities that do not have multiple equity participants, do not make allocations of accrued profits or losses, 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
- Although the *Lopez* factors are useful, they are not dispositive

Recent CFTC Interpretation Letter

- The Letter No.12-14 concludes that, based on an evaluation of the facts and circumstances presented regarding securitization entities and their issuance of asset-backed securities, the Division has determined that certain securitization vehicles should not be included within the definition of "commodity pool" and its operator(s) should not be included within the definition of "commodity pool operator."
- Specifically, the Division determined that the applicable criteria for exclusion are that:
  - The issuer of the asset-backed securities is *operated consistently with the conditions* set forth in Regulation AB, or Rule 3a-7, 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;

Recent CFTC Interpretation Letter – Criteria (Cont'd)

- The entity's activities are limited to passively owning or holding a pool of receivables or other financial assets—fixed or revolving—that by their terms convert to cash within a finite 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 those 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 issuer'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.

Recent CFTC No-Action Letter

- In Letter No.12-15, the Division grants temporary and conditional registration no-action relief for certain "Swap Persons," (as defined therein), including commodity pool operators (CPOs) and commodity trading advisers (CTAs) who became such solely as a result of their involvement with swaps.
- The relief under Letter No.12-15 includes parties to securitizations that may be, or have become, CPOs or CTAs as a result of their participation in securitization transactions, but that will expire on **December 31, 2012** (or upon earlier registration by a related Swap Person)

Much Uncertainty Remains

- Entities potentially affected include issuers of Insurance-linked Securities, Synthetic Securitization, ABCP conduits, ABS, CLOs, project issues, bond repackagings and others as well as their related parties
- ASF/SIFMA today submitted additional CFTC request letters:
  a) In the case of ASF and SIFMA, seeking to exclude legacy structured finance transactions and for an additional extension of time for registration for persons who need to register due to swap-related activities
  b) In the case of SIFMA, seeking broad exemptive relief for ILS

ASF/SIFMA Letter on Legacy Transactions

- Seeks exemption for any entity formed prior to 10/12/12 that has entered into swaps and that:
  - Is a limited purpose entity that issued securities to finance the acquisition and holding of cash or synthetic financial assets;
  - Will not have issued additional securities after 10/11/12;
  - Has and will have no commodity interests other than swaps; and
  - At closing or last issuance, its securities issued to third parties (excluding sponsor) are primarily "fixed-income securities" (as defined in ICA Section 3a-7(b)(2))

CFTC Comments on ILS

- CFTC advised ASF/SIFMA on October 11, "your request for relief for….any insurance-related issuance….is overly broad and does not provide assurances that the related entities….would not properly be considered a commodity pool."
- CFTC October 11 letter providing relief for certain "asset-backed securities" was not helpful
  - Entity's activities must be limited to "passively owning or holding a pool of receivables or other financial assets….that by their terms convert to cash within definite time period…."
- CFTC 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 be properly considered a commodity pool…."

SIFMA Letter to CFTC

- Request for interpretive guidance or other relief regarding ILS transactions that do not meet the safe harbor as a result of
  1) the cedent’s primary regulator being outside the United States (the “Provider” test)
  2) the terms of the underlying risk transfer contract do not meet the “Product” test
     - Industry loss, parametric, modeled loss triggers
     - Use of derivative contract forms
- Also, the letter requests grandfathering of outstanding transactions
- Another industry participant letter was submitted last month focused on similar requests for relief

Where Does This Leave the ILS Market and Deals in the Pipeline?