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Capital Relief Trades: Structuring considerations for synthetic securitizations (a three-part series providing a US and UK perspective)

Part one: Navigating US insurance and swap regulations

By Curtis A. Doty, Julie A. Gillespie, Larry R. Hamilton, Carol A. Hitselberger and Matt F. Kluchenek

Why Are US Banks Interested in Synthetic Securitizations?

A US bank may be interested in a synthetic securitization for a variety of reasons, including risk mitigation through the sharing of credit risk with investors or financing assets that cannot easily be sold or transferred in a traditional securitization. However, the primary reason for engaging in a synthetic securitization is typically the release of capital.

Under the US capital rules,[1] banks are able to reduce risk-based regulatory capital required for residential mortgage and other loan portfolios by converting exposures from wholesale or retail exposures to securitization exposures. This is due to the fact that the risk-weight under the US capital rules for typical senior securitization exposures is 20 percent, while the risk-weight for most other exposures is 100 percent for banks using the standardized approach.[2] That means a senior securitization exposure can have required capital of 1/5 the amount required for holding a position in the unsecuritized loans. This result makes sense given that credit risk has actually been transferred in typical securitization transactions. However, in this regard, not all securitizations are treated equally, at least not under the US capital rules.

Operational Requirements under US Capital Rules

The operational criteria for traditional securitizations under US capital rules differ from those under the Basel framework in a way that can create a significant relative disadvantage to US banks. The operational criteria for traditional securitizations under the US capital rules require that the underlying exposures not be on the transferring bank's consolidated balance sheet under GAAP.[3] In contrast, the Basel framework requires, among other requirements, that a traditional securitization include a transfer to third parties of a "significant credit risk associated with the underlying exposures," but does not require that the underlying exposures be removed from the transferring bank's balance sheet.

Unlike the operational criteria for traditional securitizations under US capital rules, the operational criteria for synthetic securitizations under the US capital rules do not require off balance sheet treatment (but do require some transfer of credit risk in the underlying exposures). As a result, engaging in a synthetic securitization and recognizing the use of a credit risk mitigant to hedge underlying exposures provides a potential means of capital relief.

Because a synthetic securitization does not remove the underlying assets from the balance sheet of the transferring bank, the bank will look to the rules regarding credit risk mitigation to determine the resulting capital treatment of the exposure it holds in relation to the transferred tranche of credit risk. This normally will be a zero risk-weight if the exposure is secured by financial collateral (i.e., cash on deposit including cash held by a third-party custodian or trustee) or it will be a risk-weight corresponding to the risk weight for the counterparty providing the guarantee or credit derivative, if that counterparty is an "eligible guarantor"[4] under the US capital rules.

As an initial matter, in order to constitute a "synthetic securitization," as defined in the US capital rules, a transaction must meet the following requirements:

1. All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties through the use of one or more credit derivatives or guarantees;
2. The credit risk associated with the underlying exposures has been separated into at least two tranches that reflect different levels of seniority;
3. Performance of the securitization exposures depends upon the performance of the underlying exposures; and
4. All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities).[5]

In addition, the bank must also satisfy the operational requirements for synthetic securitizations,[6] including that the credit risk mitigant is one of the following three options: (1) financial collateral, (2) a guarantee that meets all criteria as set forth in the definition of "eligible guarantee"[7] (except for the criteria in paragraph (3) of the definition) or (3) a credit derivative that meets all of the criteria as set forth in the definition of "eligible credit derivative"[8] (except for the criteria in paragraph (3) of the definition of "eligible guarantee."

Because the operational criteria for synthetic securitizations recognize guarantees and credit derivatives as permissible forms of credit risk mitigants, those structuring a US capital relief trade (CRT)[9] structured as a synthetic securitization typically will find themselves debating between a guarantee or a credit derivative, and this decision will involve a number of regulatory considerations, including compliance with insurance regulations, swap regulations, the US risk retention rules and the Volcker Rule. Below, we discuss a number of the legal structuring considerations relevant to a typical CRT structured as a synthetic securitization. The discussion is intended to highlight the primary legal structuring considerations that may be encountered in doing a CRT in the United States, but such considerations may not apply to all structures, and a CRT may give rise to additional legal, regulatory and accounting considerations not discussed in this article.

Insurance Regulatory Issues

One of the more challenging issues in structuring a CRT is navigating between avoiding insurance regulation on the one hand, and swap regulation on the other.

In the case of insurance regulation, the analysis is complicated by the fact that in the United States the business of insurance is primarily regulated at the state level, so whether a guarantee is an "insurance contract" subject to state insurance regulation will be a question of the applicable state's law—and how that law is interpreted by the state's insurance regulatory authorities. A further complication is determining which states' laws may apply to a transaction. Generally, insurance regulatory jurisdiction in the United States is based upon where the insurance contract (or putative insurance contract) is solicited, negotiated, issued and/or delivered.

Taking New York state as a representative example, an "insurance contract" is defined in N.Y. Ins. Law § 1101(a)(1) as any agreement or other transaction whereby one party, the "insurer," is obligated to confer a benefit of pecuniary value upon another party, the "insured" or "beneficiary," dependent upon the happening of a fortuitous event[10] in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event. Under N.Y. Ins. Law §1101(a)(3), a CRT structured as a guarantee will face potential regulation as an insurance contract if made by a warrantor, guarantor or surety who is engaged in an "insurance business," which, as discussed below, is further defined in the New York insurance .

There is also a more specific definition of "financial guaranty insurance" in N.Y. Ins. Law § 6901(1)(a), which includes, among other things, a surety bond, insurance policy or, when issued by an insurer or any person doing an insurance business (as defined below), an indemnity contract, and any guaranty similar to the foregoing types, under which loss is payable, upon proof of occurrence of financial loss, to an insured claimant, obligee or indemnitee as a result of various events, one of which is the failure of any obligor on or issuer of any debt instrument or other monetary obligation to pay principal or interest due or payable with respect to such instrument or obligation, when such failure is the result of a financial default or insolvency.

Under N.Y. Ins. Law § 1101(b)(1)(B), whether a guarantor is engaged in an insurance business depends on whether it is "making, or proposing to make, as warrantor, guarantor or surety, any contract of warranty, guaranty or suretyship as a vocation and not as merely incidental to any other legitimate business or activity of the warrantor, guarantor or surety .... " The most recent interpretive authority for when a guaranty is not conducted "as a vocation" but is "merely incidental" is a 2003 opinion issued by the Office of General Counsel of the New York State Insurance Department.[11] Under the reasoning articulated in that opinion, an "incidental" guaranty includes a guaranty by a parent company of a subsidiary's obligations, a personal guaranty by a shareholder of a closely-held corporation's obligations and a loan guaranty offered by a cooperative corporation to its owner-members for a nominal fee. By contrast, where a guaranty is provided to unrelated third parties, covers obligations of unrelated parties and is provided for a risk-based fee, that seems more like a "vocation"—and if a special purpose entity (SPE) provides the guaranty as its sole function, that would seem even more like a "vocation."

The consequence of a contract falling within the above definitions of "insurance" or "financial guaranty insurance," or of being a guaranty that is conducted as a vocation and not merely incidental to any other legitimate business or activity of the guarantor, is that the guarantor could be deemed to be engaged in an unauthorized insurance business and therefore subject to civil, and theoretically even criminal, penalties.

Notwithstanding the above, arguments could be made as to why a guaranty may not be insurance under applicable state law. For example, if a CRT does not require the beneficiary or protection buyer, as applicable, to own the underlying exposures, the instrument would generally not meet one of the defining characteristics of insurance, which is that the beneficiary have an insurable interest in the underlying exposures.[12]

In addition, in cash collateralized CRTs, the guarantor arguably does not have any future obligation to confer a benefit of pecuniary value, because it has satisfied all of its obligations upon the furnishing of cash collateral and has no future payment obligations. It should be noted, we are not aware of any insurance department having approved of such interpretation, and those structuring CRTs will need to consult with insurance counsel in applicable jurisdictions.

Swap Regulatory Issues

DODD FRANK AND COMMODITY POOL REGULATION

A CRT transaction documented as a swap will need to navigate potential regulation as a swap.[13] Moreover, the form in which the risk transfer instrument is documented is not dispositive. Therefore, even if a CRT transaction is documented as a financial guaranty rather than a credit default swap or other derivative, those structuring the transaction should still evaluate the possibility of swap characterization and whether compliance with the CEA is advisable. One also should consult the applicable rules promulgated thereunder by the Commodity Futures Trading Commission (CFTC).

If the CRT transaction is documented as a swap, a host of regulatory implications follow. For example, the parties will need to consider potential registration (or a potential exclusion or exemption therefrom) as a swap dealer, introducing broker, a commodity pool operator (CPO) or, for managed transactions, a commodity trading advisor (CTA). In addition, the parties will need to address the uncleared margin, trade reporting, and recordkeeping obligations under the Commodity Exchange Act, among other things.

In the context of securitizations, the most common registration trigger is that of a CPO, which functions as a sponsor or operator of a commodity pool (e.g., an SPE that enters into swaps). The CPO either itself makes trading decisions for the commodity pool or engages a CTA to do so.

Generally, a commodity pool is an enterprise in which funds contributed by a number of persons are combined, or pooled, for the purpose of trading commodity interests—which are defined to include swaps, OTC options, futures contracts, options on futures contracts, retail off-exchange forex transactions, and retail commodity transactions—or investments in another commodity pool. In many CRTs, the provider under the swap, guarantee or other loss sharing arrangement will be an SPE. Because the SPE will have received funds for the purpose of engaging in a swap transaction or a transaction potentially characterized as a swap transaction, the SPE may be characterized as a commodity pool.[14]

The CFTC has issued a number of no-action letters relating to securitization structures that use swaps. In particular, in CFTC No-Action Letter 14-111,[15] CFTC staff found that an SPE that holds an interest in a swap creating synthetic exposure to the risk of mortgage loans held or securitized by Fannie Mae and Freddie Mac would be considered a commodity pool. CFTC staff stated that, absent relief, the GSEs operating the SPEs would be required to register with the CFTC as CPOs.[16] The GSEs were seeking to avail themselves of the exemption under CFTC Rule 4.13(a)(3), but the transactions presented a significant question under the "marketing" prong of the exemption because the principal return-generating assets of the SPEs would be swaps. In the no-action letter, which is discussed further below, staff granted no-action relief from CPO registration provided that the GSEs and their SPEs complied with the requirements set forth in Rule 4.13(a)(3), as construed in the letter, and numerous other conditions discussed in the letter (not all of which are discussed in this article). In a subsequent letter, CFTC No-Action Letter 14-152, CFTC staff provided similar relief to operators of insurance-linked securities issuers.

Under Rule 4.13(a)(3), an operator can claim exemptive relief from the CPO registration requirements if a pool meets certain conditions relating to marketing, commodity interest exposure and investor qualification. More specifically, the following conditions must be satisfied on a pool-by-pool basis for those pools for which the operator claims the Rule 4.13(a)(3) exemption:

i. **Not marketed to the public –** interests in the pool must be exempt from registration under the Securities Act of 1933 and must be offered and sold without marketing to the public in the United States;[17]
ii. **Commodity interest exposure –** the pool must engage in a sufficiently limited amount of commodity interest trading (i.e., satisfy a *de minimis* test discussed below);
iii. **Sophisticated investors –** the pool operator must reasonably believe at the time of investment that each investor in the pool meets certain sophistication criteria; and
iv. **Marketing of the pool –** investments in the pool must not be marketed as a vehicle for trading in a commodity interest exposure.

In addition, certain requirements apply with regard to investor disclosure, notice filing with the National Futures Association (and updating and renewal of the notice), books and records, and submission to special calls from the CFTC to demonstrate eligibility and compliance with the exemption criteria.

As noted above, a condition for the exemptive relief from CPO registration under Rule 4.13(a)(3) is that the pool must engage in a sufficiently limited amount of commodity interest trading. For this purpose, a pool is considered to have a sufficiently limited commodity interest exposure if, at the relevant times, it meets one of the following *de minimis* tests: (a) the aggregate premiums are less than or equal to 5 percent of the liquidation value of the pool's portfolio; or (b) the aggregate net notional value of the pool's commodity interest positions is less than or equal to 100 percent of the liquidation value of the pool's portfolio (Notional Value Test). Here, liquidation value is to be determined after taking into account any unrealized profits and losses on commodity interest positions that the pool has entered into.[18] The notional value of an uncleared swap is the amount reported by the reporting counterparty as the notional amount of the swap under Part 45 of the CFTC's regulations.[19]

In No-Action Letter 14-111, CFTC staff addressed the application of the Notional Value Test to a credit default swap between a GSE and an SPE. Under the facts considered in the letter, note proceeds were used to collateralize the SPE's obligations to make payments of principal to noteholders and payments in respect of credit events to the GSE. In that letter, staff found that the Notional Value Test was satisfied because:

i. the GSEs (as operators of the SPEs) had represented that the notional amount[20] of the swap between the SPE and the GSE (as counterparty) would not exceed the amount of collateral raised from the SPE's sale of notes;
ii. collateral would be invested in certain short-term, highly liquid[21] assets with limited market risk; and
iii. the notional value of the swap would be reduced when defaulting mortgages exited the pool and the assets held by the SPE would be liquidated to pay credit coverage to the GSE, thereby reducing the collateral in the same amount as the notional value reduction.[22]

With respect to the marketing prong, CFTC staff noted that a facts and circumstances analysis must be applied and that factors enumerated in the context of revisions to another CPO-related rule were useful in interpreting the marketing prong of Rule 4.13(a)(3). For the GSE's proposed transactions, CFTC staff found it significant that the swap transaction would "serve as the conduit for exposure to the mortgage credit risk of assets actually held by a counterparty to said swap, and the terms of the swap will not be a source of investment returns or losses beyond those directly correlated to the underlying mortgage loans, as there is no leverage embedded in the terms of the swap."[23]

In summary, although a no-action letter cannot be relied upon by persons not addressed by the letter, those structuring CRT transactions may consider applying the reasoning articulated in the CFTC's no-action letters when determining whether the Rule 4.13(a)(3) exemption might be available to a CRT transaction involving swaps. In particular, parties may be able to structure their CRT transaction to comply with the Notional Value Test and, in placing securities to investors, observe the manner of offering and investor qualification conditions of Rule 4.13(a)(3). It should be noted that a more nuanced facts and circumstances analysis will apply to the marketing prong, including rigorous evaluation of the terms of the swap and other features of the CRT transaction that may affect investor returns and losses. But with the interpretive guideposts provided by the no-action letters and other CFTC guidance, counsel may be able to conclude with sufficient comfort that the CRT transaction, if marketed in accordance with the associated offering documentation, complies with the marketing prong of Rule 4.13(a)(3).

CHARACTERIZATION OF CREDIT LINKED NOTES AND SIMILAR CONTRACTS AS "SWAPS" OR OTHER COMMODITY INTERESTS

CRT transactions often use credit-linked notes (CLNs) or similar contracts that provide loss protection similar to credit default swaps and other derivative contracts, but are issued in the form of securities having debt-like characteristics. Such instruments may be able to meet the criteria of the "hybrid instruments" exclusion under the Commodity Exchange Act (CEA) for instruments that are predominantly securities. Under the CEA, a ''hybrid instrument'' is defined as "a security having one or more payments indexed to the value, level, or rate of, or providing for the delivery of, one or more commodities," and Section 2(f) excludes from CFTC jurisdiction "a hybrid instrument that is predominantly a security." Section 2(f) states that, a hybrid instrument shall be considered to be predominantly a security if the following characteristics are met:

A. "the issuer of the hybrid instrument receives payment in full of the purchase price of the hybrid instrument, substantially contemporaneously with delivery of the hybrid instrument;
B. the purchaser or holder of the hybrid instrument is not required to make any payment to the issuer in addition to the purchase price paid under subparagraph (A), whether as margin, settlement payment, or otherwise, during the life of the hybrid instrument or at maturity;
C. the issuer of the hybrid instrument is not subject by the terms of the instrument to mark-to-market margining requirements; and
D. the hybrid instrument is not marketed as a contract of sale of a commodity for future delivery (or option on such a contract) subject to this Act."

In addition, the credit-linked notes or similar instruments may be able to meet the criteria of an exclusion from the definition of "swap" that is applicable to "any note, bond, or evidence of indebtedness that is a security, as defined in section 2(a)(1) of the Securities Act of 1933."

For more information about the topics raised in this article, please contact any of the following lawyers:

Curtis A. Doty
+1 212 506 2224
cdoty@mayerbrown.com

Julie A. Gillespie
+1 312 701 7132
jgillespie@mayerbrown.com

Lawrence R. Hamilton
+1 312 701 7055
lhamilton@mayerbrown.com

Carol A. Hitselberger
+1 704 444 3522
chitselberger@mayerbrown.com

Matthew F. Kluchenek
+1 312 701 8798
mkluchenek@mayerbrown.com

The authors appreciate the assistance of Paul Forrester, a partner at Mayer Brown, and Harjeet Lall, an associate in the London office of Mayer Brown.

Endnotes

[1] References to sections of the US capital rules are to Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks (Regulation Q), 12 CFR §217 (2013) [hereinafter "Regulation Q"].

[2] As a result of the Collins Amendment under Dodd Frank, the standardized approach will be the binding constraint even for most banks subject to the advanced approaches.

[3] §217.41(a)(1) of Regulation Q.

[4] See definition of "Eligible guarantor" in §217.2 of Regulation Q.

"Eligible guarantor means:

(1) A sovereign, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home Loan Bank, Federal Agricultural Mortgage Corporation (Farmer Mac), a multilateral development bank (MDB), a depository institution, a bank holding company, a savings and loan holding company, a credit union, a foreign bank, or a qualifying central counterparty; or

(2) An entity (other than a special purpose entity):

(i) That at the time the guarantee is issued or anytime thereafter, has issued and outstanding an unsecured debt security without credit enhancement that is investment grade;

(ii) Whose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees; and

(iii) That is not an insurance company engaged predominately in the business of providing credit protection (such as a monoline bond insurer or re-insurer)."

[5] See definition of "Synthetic Securitization" in §217.2 of Regulation Q.

[6] See §217.41(b) of Regulation Q for a full description of all operational criteria for synthetic securitizations.

[7] See definition of "Eligible guarantee" in §217.2 of Regulation Q:

"*Eligible guarantee* means a guarantee that:

(1) Is written;

(2) Is either:

(i) Unconditional; or

(ii) A contingent obligation of the US government or its agencies, the enforceability of which is dependent upon some affirmative action on the part of the beneficiary of the guarantee or a third party (for example, meeting servicing requirements);

(3) Covers all or a pro rata portion of all contractual payments of the obligated party on the reference exposure;

(4) Gives the beneficiary a direct claim against the protection provider;

(5) Is not unilaterally cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary;

(6) Except for a guarantee by a sovereign, is legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced;

(7) Requires the protection provider to make payment to the beneficiary on the occurrence of a default (as defined in the guarantee) of the obligated party on the reference exposure in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment;

(8) Does not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure;

(9) Is not provided by an affiliate of the national bank or Federal savings association, unless the affiliate is an insured depository institution, foreign bank, securities broker or dealer, or insurance company that:

(i) Does not control the national bank or Federal savings association; and

(ii) Is subject to consolidated supervision and regulation comparable to that imposed on depository institutions, US securities broker-dealers, or US insurance companies (as the case may be); and

(10) For purposes of §§3.141 through 3.145 and subpart D of this part, is provided by an eligible guarantor."

[8] See definition of "Eligible credit derivative" in §217.2 of Regulation Q:

"*Eligible credit derivative* means a credit derivative in the form of a credit default swap, nth-to-default swap, total return swap, or any other form of credit derivative approved by the OCC, provided that:

(1) The contract meets the requirements of an eligible guarantee and has been confirmed by the protection purchaser and the protection provider;

(2) Any assignment of the contract has been confirmed by all relevant parties;

(3) If the credit derivative is a credit default swap or nth-to-default swap, the contract includes the following credit events:

(i) Failure to pay any amount due under the terms of the reference exposure, subject to any applicable minimal payment threshold that is consistent with standard market practice and with a grace period that is closely in line with the grace period of the reference exposure; and

(ii) Receivership, insolvency, liquidation, conservatorship or inability of the reference exposure issuer to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and similar events;

(4) The terms and conditions dictating the manner in which the contract is to be settled are incorporated into the contract;

(5) If the contract allows for cash settlement, the contract incorporates a robust valuation process to estimate loss reliably and specifies a reasonable period for obtaining post-credit event valuations of the reference exposure;

(6) If the contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of at least one of the exposures that is permitted to be transferred under the contract provide that any required consent to transfer may not be unreasonably withheld;

(7) If the credit derivative is a credit default swap or nth-to-default swap, the contract clearly identifies the parties responsible for determining whether a credit event has occurred, specifies that this determination is not the sole responsibility of the protection provider, and gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event; and

(8) If the credit derivative is a total return swap and the national bank or Federal savings association records net payments received on the swap as net income, the national bank or Federal savings association records offsetting deterioration in the value of the hedged exposure (either through reductions in fair value or by an addition to reserves)."

[9] Capital relief trades are sometimes referred to as "capital release transactions" or "credit risk transfer" (also shortened to "CRT"). As noted by Richard Robb in "*What's in a Name?*", the term "CRT" can be particularly confusing for US market participants because such term is also used to refer to credit risk transfer deals involving housing collateral issued by the United States GSEs. Structured Credit Investor, 2018 Guide to Capital Relief Trades, p. 6.

[10] "Fortuitous event" means any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party. N.Y. Ins. Law § 1101(a)(2).

[11] Office of General Counsel Opinion No. 03-01-45 (January 23, 2003), available at

http://www.dfs.ny.gov/insurance/ogco2003/rg030145.htm. The functions of the former New York State Insurance Department were assumed by the New York Department of Financial Services on October 3, 2011.

[12] See, for example, the above quoted definition of "financial guaranty insurance" under the N.Y. Insurance Law which requires "proof of occurrence of financial loss, to an insured claimant, obligee or indemnitee" as a result of any of the events enumerated in the statute. In addition, the "insurance safe harbor" regulations issued by the SEC and CFTC under Dodd-Frank, in order to delineate the boundary between insurance contracts and swaps, (i) require the beneficiary of an insurance contract to have an insurable interest and carry the risk of loss with respect to that interest continuously throughout the duration of the contract and (ii) limit the beneficiary's entitlement to payment to the amount of actual loss that occurs and is proved.

[13] In certain cases, it may be possible to conclude that the risk transfer contract is a security-based swap or aggregation of security-based swaps. Security-based swaps are subject to a different regulatory regime than swaps. For example, the commodity pool issues discussed in this section would generally not be present for an SPE that enters into security-based swaps but not swaps. Further discussion of security-based swaps is beyond the scope of this article.

[14] Certain commodity pool regulations remain applicable even if the CPO qualifies for exemption from registration. For example, under CFTC Regulation 4.20, a CPO must operate its pool as an entity cognizable as a legal entity separate from that of the CPO, the CPO must receive funds in the pool's name, and the CPO may not commingle property of the pool with that of any other person.

[15] A no-action letter is a written statement by the staff of a Division of the CFTC or its Office of the General Counsel that such staff will not recommend that the CFTC commence enforcement action for failure to comply with a specific provision of the Commodity Exchange Act or CFTC regulations. It binds only the staff of the Division that issued it or the Office of the General Counsel with respect to the specific fact situation and persons addressed by the letter, and third parties may not rely upon it. CPOs wanting to rely upon the staff letter must first meet the conditions of relief, which include filing a notice with the CFTC Division of Swap Dealer and Intermediary Oversight.

[16] CFTC No-Action Letter 14-111, at 7.

[17] CFTC staff have addressed harmonizing this condition with the JOBS Act of 2012, which eliminated the prohibition against general solicitation in the SEC's Regulation D and Rule 144A. See CFTC Staff Letter 14-116 (Sept. 9, 2014). The CFTC subsequently proposed a codification of this relief.

[18] CFTC Regulation 4.13(a)(3)(ii).

[19] See "Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions – CPO/CTA: Amendments to Compliance Obligations," August 14, 2012.

[20] The CFTC staff stated that, if the stated notional amount of a swap is leveraged in any way or otherwise enhanced by the structure of the swap or the arrangement in which it is issued, the threshold calculation would be required to be based on the effective notional amount of the swap rather than on the stated notional amount.

[21] In CFTC No-Action Letter 14-152, the corresponding condition utilized the definition of "highly liquid" set out in CFTC Regulation 1.25(b)1), which states: "Investments must be 'highly liquid' such that they have the ability to be converted into cash within one business day without material discount in value."

[22] In No-Action Letter 14-111, the CFTC noted that when conducting the Notional Value Test, it was *not* reducing the liquidation value of the assets held by the SPE by the amount owed to the SPE's note holders because where the SPE was required to pay coverage to a GSE due to a default event in the underlying pool of mortgages, the SPE's obligation to repay the note holders the principal and interest on the notes was equally reduced.

[23] CFTC No-Action Letter 14-111, at 10.