Clients&FriendsMemo

The Application of Commodity Pool Rules to Insurance Linked Securities

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The Dodd-Frank Act's expansion of the definition of "commodity pool" to include any form of enterprise operated for the purpose of trading in "swaps," coupled with the Commodity Futures Trading Commission ("**CFTC**") and the Securities and Exchange Commission ("**SEC**") recently adopted an expansive definition of the term "swap" for purposes of the Dodd-Frank Act and the Commodity Exchange Act, creates uncertainty regarding whether issuers of insurance linked securities ("**ILS**") are commodity pools that would require the registration of commodity pool operators ("**CPO**") and commodity trading advisors ("**CTA**") with the CFTC.

Expansive Definition of Swap

On July 10, 2012, pursuant to a joint release ("**Joint Release**") the CFTC and the SEC adopted final rules, which became effective on October 12, 2012, broadly defining the term "swap" to include, in addition to those contracts commonly known as swaps (including interest rate swaps, floors and caps, currency swaps and credit default swaps), *"any agreement, contract or transaction that provides for any purchase, sale, payment or delivery..... that is dependent on the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence."* This expansive definition will encompass a broad array of contracts including those customarily underlying cat bond and other ILS transactions, unless such contracts are specifically not considered swaps under the rules or are otherwise exempt. Also, it should be noted that there is no general grandfathering provision to protect existing contracts.

Insurance Not Considered Swaps

The Joint Release states that "the Commissions do not interpret this clause [the definition of a "swap"] to mean that products historically treated as insurance should be included within the swap...definitions." Since the expanded definition of a swap would generally encompass every insurance and reinsurance contract, the rules provide a non-exclusive safe harbor from being a swap for an insurance product that meets *any* of the following three exemptions:

- Product Safe Harbor. The contract is provided in accordance with the "provider test" (as discussed below) and meets the following requirements:
    - the beneficiary has an insurable interest and bears the risk of loss on that interest continuously through the duration of the agreement;
    - the loss occurred and is proven;
    - all payment on the loss is limited to the value of the insurable interest;
    - the agreement is not traded separately from the insured interest, on an organized market or over-the-counter; and
    - for financial guarantee insurance, only if, after a payment default under the insured obligation or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer.
- Enumerated Product . The contract is provided in accordance with the "provider test" and is a surety bond, a fidelity bond, life insurance, health insurance, long-term care insurance, title insurance, property and casualty insurance, an annuity, disability insurance, insurance against default on individual residential mortgages, or reinsurance (including retrocession) of any of these products.
- Existing Transaction Grandfathering. The existing insurance agreement was entered into before the effective date of the final rules and was provided by an entity that meets the "provider test."

Insurance Provider Test

All of the exemptions described above require that the "provider test" be met. A person satisfies the "provider test" if any of the following apply:

- It is subject to supervision by the insurance commissioner of any state or by the federal government, and the applicable agreement, contract or transaction is regulated as insurance under applicable state or federal law.
- In the case of reinsurance, the person is providing the agreement to another person that is eligible under the provider test, provided, that the offering entity is not prohibited by applicable state or federal law from offering such agreement to the offeree, the agreement, contract or transaction to be reinsured falls under the product safe harbor or the enumerated product safe harbor and the total reimbursable amount by all reinsurers under such agreement contract or transaction does not exceed the losses or claims paid by the cedant, unless otherwise permitted by applicable state law.

- In the case of non-admitted insurance, the offering entity is located outside of the US and listed on the National Association of Insurance Commissioners' Quarterly Listing of Alien Insurers, or meets the eligibility criteria for non-admitted insurers under applicable state law.
- It is the US government, any state government or any US or state agency or instrumentality, or a statutorily authorized program of any of these.

Whether cat bond and other ILS transactions will be able to qualify for the insurance safe harbor will depend in part on whether the cedants in the transactions are subject to supervision by any state or by the federal government. If structured and documented properly, most reinsurance transactions with cedants that are subject to supervision by any state or by the federal government should be able to qualify for the insurance safe harbor. However, transactions with cedants that are not subject to state or federal supervision will not be able to qualify for the insurance safe harbor. In fact the Joint Release states "the Commissions believe that insurance products should fall outside the swap or security-based swap definitions only if they are offered by persons subject to state or Federal insurance supervision or by certain reinsurers."

It should be noted that the Joint Release confirms the insurance safe harbor is non-exclusive and none of the conditions implies or presumes that an agreement, contract or transaction that does not meet any of the safe harbor's requirements is a swap and that such arrangements will require further analysis of the applicable facts and circumstances to determine whether it is insurance, and thus not a swap. The Joint Release also points out that weather derivatives or catastrophe swaps, which assume all or part of the risks contained in a portfolio of property and casualty insurance policies, as well as any agreements labeled as "reinsurance" or "retrocession" but is executed as a swap or security based swap or otherwise structured to evade Title VII of Dodd-Frank, would not satisfy the insurance safe harbor and would be treated as swaps subject to regulation.

Recent CFTC Interpretation Letter

In a CFTC Interpretation letter (CFTC Letter No. 12-14) issued on October 11, 2012, the Division of Swap Dealer and Intermediary Oversight issued a determination that certain securitization vehicles should not be included within the definition of "commodity pool" and its operator should not be included within the definition of "commodity pool operator". This explicit exclusion is limited to issuers of "asset-backed securities" that are operated consistent with the conditions of Regulation AB of the Securities Act of 1933 or Rule 3a-7 of the Investment Company Act of 1940. Cat bonds and other ILS typically do not operate under and do not satisfy the conditions of "asset-backed securities" under Regulation AB or Rule 3a-7 and thus are unlikely to be covered by the explicit exclusion provided in the CFTC Interpretation letter. However, in addition to the explicit exclusion, the CFTC also indicated that they "tend to agree that certain entities that meet certain of the criteria [ASF] identified are likely not commodity pools, such as securitization vehicles 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 specific maturity date." This suggests that the explicit exclusion identified by CFTC is not the exclusive method for which a securitization transaction must satisfy to not be considered a commodity pool. Further to that point, the Division stated:

"As for securitization vehicles that cannot satisfy all the criteria stated above, the Division notes that we remain open to discussion 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, or where not sufficiently assured, whether other relief might be appropriate under the circumstances, such as where a fund might be treated as an exempt pool."

With respect to the requests made in the application for the CFTC Interpretation letter to cover several other types of securities, the Division stated "Other sorts of financings or investments, however, based on the descriptions you have provided, do not preclude the issuer.....from being a commodity pool. Thus, your request for relief for .....entities involved in.....*any insurance-related issuances*.....is overly broad and does not provide any assurance that the related entities or a portion of their assets, operations, or activities would not properly be considered a commodity pool."

The Division also issued a "no action" letter on October 11, 2012 giving persons who become CPOs and CTAs solely because of their swap activity, and associated persons thereof, until December 31, 2012 to file the appropriate applications for registration.

Pursuit of No-Action Relief for ILS

In order to obtain certainty regarding whether typical cat bond and other ILS transactions that do not meet the insurance safe harbor are to be regulated as commodity pools (and therefore require the presence of a CPO and CTA that are registered with the CFTC and subject to regulation and compliance), it may be advisable for the ILS industry to seek specific exemptive or "no action" relief from the CFTC and, in connection with that process, seek to meet with the staff and possibly the commissioners of the CFTC to explain the ILS market and their related products. It may be the case that the CFTC staff is not sufficiently knowledgeable about the ILS and cat bond markets. With sufficient information, it may be possible that the staff may conclude that the CFTC does not have an interest in regulating the ILS market, at least with respect to transactions involving cedants who might not meet the insurance provider test, but are otherwise subject to substantial regulation in recognized jurisdictions. If the ILS industry decides that pursuing no-action relief is the proper course, we believe it is critical to reach out to the CFTC and submit the request as soon as possible, because we understand that the CFTC has been and will continue to be flooded with

requests from many different parties and industries with respect to the swaps and other new regulations.

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If you have any questions or wish to discuss the foregoing, please contact one of the following attorneys:

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