

# Clients & Friends Memo

## CFTC Issues No-Action Relief for Amended Legacy Swaps between SDs and SPVs

April 1, 2015

On March 31, 2015, the Division of Swap Dealer and Intermediary Oversight (the “**Division**”) of the Commodity Futures Trading Commission (the “**CFTC**”) issued no-action relief regarding compliance with certain of its swap regulations, including, but not limited to, business conduct and swap trading relationship documentation requirements for swap dealers (“**SDs**”), in connection with swaps entered into by structured finance special purpose vehicles (“**SPVs**”) prior to October 10, 2013 (“**Legacy SPV Swaps**”).<sup>1</sup> The relief was granted in response to a request by the Structured Finance Industry Group (“**SFIG**”). Cadwalader represented SFIG in connection with the request.

### BACKGROUND

SPVs that are formed to issue obligations in structured finance transactions commonly enter into swaps to hedge risks associated with such obligations. In order to limit the credit risk assumed by the SPV, Moody's, S&P and Fitch (each a “**rating agency**”) have developed criteria designed to isolate the credit risk of a swap counterparty (“**Delinking Criteria**”), which enables the rating agencies to assign a credit rating to the obligations of the SPV based solely on the quality of the underlying assets in (and structural features of) the SPV, without accounting for the SPV's credit exposure to its counterparty under the swap.

Among other things, the Delinking Criteria require an SPV's counterparty to take certain actions within a designated time period (in many cases 30 days or less) following the occurrence of a credit ratings downgrade with respect to such counterparty (each a “**remedial action**”). These remedial actions generally include posting collateral to the SPV, obtaining a guarantee and/or novating the swap to an entity that satisfies certain criteria established by the rating agency. Certain remedial actions may also require actions to be taken by the SPV as well as the counterparty.

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<sup>1</sup> See CFTC Letter No. 15-21, available at: <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/15-21.pdf>.

Generally, Legacy SPV Swaps are outside of the scope of the regulations applicable to swaps under Title VII of Dodd-Frank (*i.e.*, because they were entered into before compliance with the relevant rules was required). However, in order to effect actions that may be necessary to remediate a credit ratings downgrade, a Legacy SPV Swap may need to be amended in ways that would cause the swap to be treated as a “new swap” and thus cause the transactions to become subject to such regulations.

At the time the Legacy SPV Swaps were entered into, compliance with the relevant CFTC business conduct and documentation requirements under Dodd-Frank was not necessary because such requirements did not exist or did not apply to the transactions. As a result, the trading documentation for such Legacy SPV Swaps generally does not contemplate such requirements. SPVs are generally structured for particular purposes and reflect legal requirements at the time of formation; they may not be able to take actions not specifically authorized and may be subject to broad restrictive covenants and other provisions in their constitutive documents. It can thus be difficult – and in some cases, impossible – for an SD to comply with the business conduct and documentation requirements with respect to the Legacy SPV Swaps because the SPV will not take the necessary actions.

## RELIEF GRANTED

The relief provided by the Division is limited to the following regulations (collectively, the “**Specified Regulations**”):

- § 23.402(b) and (c) (KYC requirements);
- § 23.430 (verification of ECP status);
- § 23.431(a)-(b) (disclosures of material information);
- § 23.432 (clearing disclosures);
- § 23.434 (suitability);
- § 23.502(b) (portfolio reconciliation);
- § 23.504(b)(4)-(6) (swap trading relationship documentation); and
- § 23.701 (initial margin segregation notification).

The Division has stated that it will not recommend the CFTC take enforcement action against an SD for a failure to comply with any of the above Specified Regulations in connection with a Legacy SPV Swap, provided that:

1. The Specified Regulations apply to the SD or the Legacy SPV Swap solely as a result of one or more remedial actions taken in accordance with the applicable Delinking Criteria of one or more nationally recognized rating agencies that have rated one or more of the SPV's obligations in response to an actual or reasonably anticipated withdrawal, qualification, and/or downgrade of the credit ratings of the original counterparty to the Legacy SPV Swap; and
2. Any remedial action taken in accordance with the applicable Delinking Criteria does not alter the material economic terms of the Legacy SPV Swap.

### FURTHER CONSIDERATIONS

Participants in the securitization market will need to continue to monitor how the regulation of derivatives under Title VII of Dodd-Frank and other new domestic and international requirements affects their transactions. The no-action relief provided by the Division applies only to swaps entered into before October 10, 2013; all other securitization swaps are unaffected by the relief granted in the letter. Going forward, SDs will continue to face practical difficulties in their efforts to ensure compliance with new and forthcoming derivatives regulations when transacting with securitization vehicles. In fact, many SDs have already found themselves needing to rethink how standard practices in swap regulatory compliance can be best tailored to the particular issues facing securitization vehicles. We expect this to be a compliance challenge where SDs will have to continue to be creative and willing to implement non-standard solutions.

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