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CLE Paper

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Commodity Financing – Legal Issues for Common Structures

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I. **Introduction**.

This paper explores various commodity financing structures, including gas or electricity prepayment, securitization and notes issuances, structured commodity financing, and secured lending, as well as their use of derivatives to mitigate attendant risks. Some of these financing structures have traditionally been used before, some are emerging due to changes in legal requirements, and some are driven by market moves, such as in interest rates and treasury yields.

There are many varieties of commodity financing structures, but the unifying characteristic among all of them is the presence of some type of a valuable commodity at the core of a transaction that is being used as a security or collateral to obtain the most economic form of financing. Structured commodity financing ("***SCF***") transactions are designed to assist commodity traders and commodity producers to transform "commodities in space (logistics), in time (storage), and in form (processing)" and to perform some form of arbitrage that will enhance commodity value.[2] SCFs vary in complexity and typically require analysis of Federal and State regulations,[3] market practices involving physical commodities,[4] commodity derivatives,[5] bankruptcy,[6] securities laws,[7] banking regulations, tax and securitization and creation of security interests.[8]

Below we discuss the more commonly used types of SCFs and address some of the typical legal issues attendant to these structures with the focus on commodity hedging and commodity derivatives analysis.

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[2] *See* The Economics of Commodity Trading Firms, Trafigura, Craig Pirrong, Professor of Finance, Bauer College of Business University of Houston, 2014, *see at* https://www.bauer.uh.edu/centers/uhgemi/casedocs/The-Economics-of-Commodity-Trading-Firms-2.pdf

[3] *E.g.*, California State Air Resources Board ("***CARB***") with respect to environmental commodities, such as California Carbon Allowances ("***CCAs***"), or the Regional Greenhouse Gas Initiative ("***RGGI***") States, or Texas ERCOT regulations.

[4] *E.g.*, the International Swaps and Derivatives Association ("***ISDA***"), the NAESB, EEI, various general commodity terms and conditions.

[5] *See* the Commodity Exchange Act, 7 U.S.C. § 1a *et seq*, as amended ("***CEA***"), and the Commodity Futures Trading Commission ("***CFTC***") regulations, 17 C.F.R. §1 *et seq* ("***CFTC Regulations***").

[6] *See* 11 U.S.C *et seq*, (the "***Bankruptcy Code***").

[7] *See* the Securities Act of 1933, 15 U.S.C. § 77a *et seq.*, the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.*, and the Investment Company Act of 1940, 15 U.S.C., § 80a-1 *et seq.*, (collectively, the "***Securities Laws***").

[8] *See* the Uniform Commercial Code, ("***UCC***").

II. **Business Rationale for Commodity Financing**.

The term "commodity" is generally used in two separate but overlapping ways: (a) in its plain English meaning of a physically deliverable and primarily agricultural "commodity" (*e.g.*, pork bellies),[9] and (b) as a term of art – as defined in the CEA and includes agricultural products, energy, base metals and precious metals mass-produced and delivered in bulk quantities as well as financial commodities, such as interest rates or indices and various events and services that typically are traded as futures contracts.[10] Usually, the place of a commodity's production or processing is different from its place of consumption; therefore, commodity trade finance often aims to bridge gaps between the two destinations and the time between purchase and sale.

There are also very significant costs associated with producing or extracting commodities, carrying receivables, marketing and transporting commodities, meeting futures commission merchants' and swap dealers' margin and credit support calls for hedging of commodities, refining and storing commodities; and these costs are usually either short-term or long-term. Commodity producers and traders normally do not have sufficient free capital to cover these costs and therefore routinely reach to third parties to finance their operations.[11]

The key feature of commodity trade finance is that it is typically secured by the underlying commodity or the revenue stream produced by this commodity – which usually is the most valuable asset. This means that the commodity itself serves as collateral for the financing, which can help businesses obtain more favorable financing terms. Therefore, the critical component in SCF is provision of "security interests,"

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[9] "**Commodity**. Noun - com·mod·i·ty kə-ˈmä-də-tē, plural – "commodities." Synonyms of commodity" 1: *an economic good*: such as: a: a product of agriculture or mining agricultural commodities like grain and corn; b: an article of commerce especially when delivered for shipment "reported the damaged commodities to officials"; c: a mass-produced unspecialized product "commodity chemicals, commodity memory chips"; 2 a: *something useful or valued* "that valuable commodity, patience" also: thing, entity. b: *convenience, advantage* "… the many commodities incidental to the life of a public office …" —Charles Lamb; 3: *a good or service whose wide availability typically leads to smaller profit margins and diminishes the importance of factors (such as brand name) other than price*; 4: *one that is subject to ready exchange or exploitation within a market* "… stars as individuals and as commodities of the film industry."—Film Quarterly; 5 obsolete: *quantity, lot*," *available at* https://www.merriam-webster.com/dictionary/commodity

[10] The CEA defines the term "commodity" in § 1a(9) to include also intangible and non-deliverable commodities as further discussed below. For purposes of this paper, we generally refer to the term "commodities" in its common plain English use and where applicable, as a defined legal term.

[11] *See e.g.*, CFTC's description of various commodity financing structures in CFTC Letter 14-96 (July 25, 2014) https://www.cftc.gov/csl/14-96/download, and CFTC Letter No. 19-02 (Feb. 14, 2019).

securing collateral and the application of the relevant provisions of the Uniform Commercial Code (the "***UCC***"). Given that SCF is designed to meet either short-term or long-term costs and liabilities associated with specific commodities, the ultimate SCF facilities also match this duration and are either short-term (*e.g.*, a revolving line of credit) or a long-term facility (*e.g.*, an asset-backed security issuance). Likewise, related hedges and risk mitigation tools are typically designed to match financing terms.

Relative price stability,[12] scarcity of supply, growing demand and generally transparent global commodity markets make commodity financing amenable to these more complicated financing structures. Business cycles tend to drive the types of commodity financing that are most suitable for the economic environment; for example, rising interest rates make it more expensive to borrow, and as a result securitization structures may be more preferable, while in the environment of falling interest rates asset-based lending may be more advantageous. Likewise, in the environment of falling Treasury yields utilization of municipal bonds may be more attractive for *e.g.*, natural gas prepay deals as discussed below.

III. <u>**Types of Commodity Financing**</u>.

Commodity financing is probably the oldest form of financing since commodities have been traded for millennia.[13] Even though there are numerous types of commodity financing structures[14] (and there could be different terms used by different practitioners), these can be grouped in the following general categories:

A. *Asset-Based Lending facilities*.

Asset-based lending ("***ABL***") (also referred to as reserves based lending "***RBL***") facilities are the mainline financing option for many commodities marketing companies, particularly more mature companies. These facilities are typically revolving, and often provide for various forms of financing that is critical to the daily operation of these types of companies (*e.g.*, revolving credit loans, swingline loans, daylight overdraft loans, letters of credit and various other credit accommodations like bid bonds, performance bonds, bank guarantees and letters of indemnity). As an ABL facility, extensions of

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[12] That is not to say that commodity prices are never subject to some volatility, as was recently experienced with crude oil markets during COVID, cocoa earlier in 2024, natural gas during Hurricane Uri and agricultural commodities and fertilizer as a result of the Ukraine war.

[13] *See e.g.*, the Code of Hammurabi, § 1 *et seq.*, as amended, (1755-1750 D.C.), available at: https://avalon.law.yale.edu/ancient/hamframe.asp

[14] For example, depending on the type of commodity and the custom of trade, the following commodity financing tools can also be used (although these too are a variation on the structures generally outlined in this paper): "inventory financing arrangements," "factoring" or "sleaving" (*i.e.*, selling receivables as a credit solution), "commodity intermediation," use of "letters of credit" or "standby letters of credit," "parent company guarantees," "receivables discounting agreements," etc.

credit would be limited to the value of certain eligible assets (*e.g.*, inventory, receivables, eligible cash, forward book, etc.) multiplied by an applicable advance rate (*i.e.*, a "borrowing base").

A primary benefit of an ABL facility is that it allows a borrower to operate its business (buying, selling, storing, transporting and processing commodities) without obtained creditor consent for each transaction.

B. *Asset Backed Securities*.

An asset-backed security ("***ABS***") typically obtains favorable pricing (relative to ABL, *etc*.) by isolating the valuable commodities (or interests therein) from the bankruptcy or insolvency of the sponsor – the investors' credit analysis can focus primarily on the income stream of the assets. This is generally accomplished through legal structuring – one or more special purpose vehicles ("***SPV***") (also referred to as "special purpose entities" ("***SPE***")) are created, into which the financed assets, such as proved, developed and producing ("***PDP***") wellbore properties, are sold or contributed in a "true" sale or contribution. To address non-consolidation issues, the SPV borrower is structured as a "third party" relative to the sponsor, with market-accepted separateness criteria and usually one or more independent directors. The assets will typically continue to be managed by a sponsor-affiliate or third party (subject to termination for certain material events including bankruptcy and asset performance metrics), and many of these transactions are rated by statistical ratings organizations given that they are marketed principally to regulated investors who receive favorable capital treatment for investment grade-rated investments. ABS structures seek to minimize their impact on a sponsor's day-to-day business but often do create new workstreams and reporting items for the relevant executives.

There are a wide varieties of ABS transactions, including private placements (direct to investor), private 144A placements (indirect through a bank or other structuring agent to ultimate investors) and publicly issued securities. Moreover, there is an increasingly large private structured direct lending market, where investors may or not require a statistical rating on their loans, but seek to benefit from the other structural protections (and resulting increase in liquidity) provided by ABS lending techniques – we would distinguish these as a subcategory of ABL given their highly structured nature but lack of parent/sponsor recourse.

In the commodities space, we have seen ABS and ABS lending structures used for oil wellbore interests, natural gas, renewable energy credits, minerals (royalty streams), overriding royalty interests ("***ORRIs***"), volumetric production payments ("***VPPs***") and many others. Common issuance structures allow for multiple classes of notes, and can feature term and revolving or delayed draw obligations, which may be fixed or floating. ABS issuances always have to grapple with the degree of operator risk, so for commodities where there is a well-understood market capable of proper hedging and location of a suitable 'backup' operator, structures may be created and marketed with relative ease when compared to nascent markets (*e.g.*, carbon credits) where there may

be considerable focus on establishing a ratable and legally recognized security package and appropriate safeguards for lenders to avoid distressed outcomes.

Because ABS investors are solely relying on revenue streams coming from commodities (*e.g.*, PDP wellbore oil and gas assets), fluctuation in commodity prices is the risk at the core of ABS transactions; accordingly, typically a very substantial portion of the underlying commodity (asset) is usually hedged, and the hedges thus become a material structural element of ABS transactions. Depending on the terms of the ABS, hedges too may be transferred to the SPV.

C. *Prepayment Structures*.

Prepayment structure ("***Prepays***") transactions involve the issuance of tax-exempt bonds by a municipal public power agency to prepay for the future delivery of gas or electricity by a supplier. In exchange for the lump-sum prepayment, the supplier agrees to deliver the commodity to the municipal agency (or an intermediary) over a term of 20 to 30 years under a commodity forward agreement. This agreement is in effect a tax-exempt "loan" of the municipal bond proceeds to the supplier which is "repaid" over time by delivery of specified amounts of the commodity to the municipal agency/intermediary. In turn, the commodity is sold to local utilities each month at a discount to then-current commodity market prices. The discount reflects the value of the tax-exemption on the bonds used to prepay the supplier. Because the commodity is purchased by the local utilities at fluctuating market prices, the supplier (and / or the municipal agency / intermediary) will enter into a commodity hedge to provide a predictable cash flow to pay the debt service on the municipal bonds.

D. *Repos*.

A repo or repurchase (or reverse repurchase) transaction ("***Repo***") essentially binds two forwards – under the first forward a certain commodity is sold, and under the second, the same or similar commodity is purchased back. These transactions allow for pre-production financing and essentially constitute collateralized lending. Sometimes physical commodity repos may be converted into financial futures positions, such as under the exchange of futures for physicals ("***EFP***") on a commodity exchange.[15]

E. *Transactional Commodity Finance or Commodity Trade Finance*.

These structures are generally similar to ABL facilities, but normally relate to (and are secured by) one specific basket of commodities or a specific bespoke transaction and the borrower needs the lender to consent or agree to finance each separately taken commodity basket or a transaction; whereas an ABL facility typically relates to a

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[15] Commodity exchanges are referred to as "designated contract markets" ("***DCMs***") and are regulated by the CFTC under the CEA.

borrower's business more generally and allows free substitution of asset as long as the borrower is borrowing base compliant. Accordingly, commodity trade finance ("***CFT***") tend to be more short-term (within 1 year) in support of the sourcing, transportation and distribution of specific commodities (*e.g.*, a specific crop), and commodities that include, but are not limited to, financing instruments and products such as: documentary credits; standby letters of credit; documentary collections; bank guarantees; bid / performance bonds; financing of receivables or inventories (storage financing) or margin calls related to price-risk hedging transactions; various commodity options; tolling agreements; syndicated or club deal facilities; warehouse financing; revolving credit facilities; pre-export finance; *etc*.

IV. **Commodity Legal Considerations**.

A. *General Considerations*.

First and foremost, the terms used in SCF transactions must be consistent and refer to the same subject term for purposes of applicable law (*e.g.*, the Bankruptcy Code or the CEA or the UCC), and within specific transaction documents (*e.g.*, specific ABS documentation).

For example, the § 9-102(a)(14) of the UCC refers to "commodity account" as an account that is maintained by a "commodity intermediary," and § (15) refers to "commodity contract" as a "commodity futures contract" traded on a "board of trade designated as a contract market" or a "foreign commodity board of trade." Although generally aligned, the CEA does not use these terms and instead refers to futures commission merchants ("***FCMs***") instead of "commodity intermediaries," and to "contracts for future delivery" instead of "commodity futures contracts" and instead of "foreign commodity board of trade" to "foreign board of trade" ("***FBOT***"). As defined in the UCC, a "commodity intermediary" includes FCMs as well as other clearing entities, and "commodity contracts" includes options that may qualify as swaps so long as they trade on a DCM; however, the UCC does not define "swaps."

The Bankruptcy Code on the other hand, in § 101 refers to "commodity brokers"[16] in a much broader sense to include not only FCMs, but also "clearing organizations,"[17] "leverage transaction merchants," "commodity options dealers,"[18] "foreign futures commission merchants," and others. It also defines "forward contracts"[19] (as well as functionally defining the term "spot"), defines "repurchase agreements," as well as

[16] *Id* § 101(6).

[17] *Id* § 761(2), note that the CFTC defines these as "derivatives clearing organizations" ("***DCOs***").

[18] *Id* § 761(6).

[19] *Id* § 101(25).

"swap agreements"[20] and "swap participants."[21] The term "commodity contract,"[22] is defined differently as it is defined in the UCC and, as noted above, this term is not defined in the CEA and the CFTC regulations.

Further, the Securities and Banking Laws, as well as State laws and regulations also define these terms inconsistently. Thus, as the order of first priority, each SCF must ensure consistency of terms used and references throughout applicable transaction documentation.

B. *Underlying Commodity Considerations*.

1. Defining "Commodity" under the CEA

The term "commodity" is at the core of each SCF transaction, however, what is commonly understood to qualify as a "commodity," may or may not qualify as a "commodity" for CFTC's purposes.[23] Normally, all fungible and commonly traded in interstate commerce commodities that also serve as the underlier for futures contracts, such as natural gas, crude oil, as well as metals, and agricultural commodities – would qualify. Some commodities, however, may not qualify as "commodities" under the CEA (*e.g.*, diamonds, some unique or bespoke energy and agricultural commodities). If a certain commodity is not a "commodity" for the CEA's purposes, the CFTC will have no jurisdiction at all if such commodity is manipulated or fraud is committed with respect to such commodity. In an SCF that involves a non-"commodity" commodity, remedies and events of default provisions may be materially different as compared to a transaction involving "commodities" qualified under § 1a(9) of the CEA. For practical purposes, it is safe to assume that a given asset is a "commodity" if there are futures contracts on such commodity listed on a DCM.

There are numerous other considerations that should be analyzed, such as delivery points, grade, vintage, available storage, transportation, proven reserves, volatility of price, and liquidity of specific commodity markets. For example, a run-up in cocoa prices in the winter of 2024 had caused dramatic increases in margins for short positions, while the drop of crude process in 2020 during the COVID pandemic had caused dramatic increases of margin for long positions, and the war in Ukraine has contributed to general volatility of many commodities.

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[20] *Id* § 101(53B).

[21] *Id* § 101(53C).

[22] *Id* § 761(4).

[23] *See* § 1(a)(9) of the CEA.

2. Property and Property Rights

Typically, if a physical commodity qualifies as a "commodity" for CEA's purposes, it would normally qualify as some form of "property" or an "intangible property" and would be capable of being securitized and serve as collateral. For example, because of the ephemeral nature of some environmental commodities (*e.g.*, carbon credits or carbon offsets or a "green" attribute in a renewable energy certificate ("***REC***")), there remain some concerns as to what type of commodities these are – exempt or excluded.[24]

3. Individual State Considerations

There could be State-specific regulations applicable to extracting, owning, delivering, storing and trading of commodities within a specific State, *e.g.*, power traded in ERCOT in Texas, CCAs issued under CARB regulations in California, or the wellbore interests in the State of Alaska. It is imperative that the SCF be properly due diligenced (availability and quality of supporting documentation, files, engineer reports, etc.).

Further, even though the assets subject to SCF transactions would normally qualify as PDP assets , the ownership interest of these assets may take different forms, which is usually a matter of local State law (*e.g.*, operating or non-operating working interests, royalty interests, ORRIs, VPPs, leases, *etc*.).

C. *Collateral Considerations*.

1. The UCC

Ability to provide and have some form of a meaningful control over collateral (*i.e.*, the commodity itself) and "security interests"[25] on the underlying collateral, is at the heart of

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[24] It is generally recognized that because carbon credits can be delivered, consumed and retired, they would qualify as "exempt" commodities like other physically deliverable commodities even though you cannot physically touch carbon credits and they only exist as an accounting entry or a promise. Therefore, carbon credits may be traded as a "forward contract," and such forward contract will not otherwise be considered a "non-deliverable forward" (*i.e.*, an "***NDF***"), and consequently a "swap."

[25] A "security interest" is defined by the UCC to mean: "(35) "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. "Security interest" includes any interest of a consignor and a buyer of accounts, chattel paper, a payment intangible, or a promissory note in a transaction that is subject to Article 9. "Security interest" does not include the special property interest of a buyer of goods on identification of those goods to a contract for sale under Section 2-505, the right of a seller or lessor of goods under Article 2 or 2A to retain or acquire possession of the goods is not a "security interest", but a seller or lessor may also acquire a "security interest" by complying with Article 9. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer under Section 2-401 is limited in effect to a reservation of a "security interest." Whether a transaction in the form of a

all forms of SCF transactions. Note that for UCC's purposes, the term "goods"[26] is not synonymous with the term "commodities" as used in the CEA, although there is a significant overlap.

As noted above, the term "property" or whether the "commodity" underlier constitutes some form of a "general intangible"[27] have been differently interpreted and depending on the origins and the applicable law may be treated differently – and more importantly perfected – under the UCC.

2. Security Interests and CCAs

For example, CCAs issued under CARB regulation are not qualified as "property"[28] and there is additional language in CARB regulations[29] that may cast some uncertainty as to

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lease creates a "security interest" is determined pursuant to Section 1-203." *See* UCC §1-201(b)(35).

[26] The UCC defines "goods" as: "(44) "Goods" means all things that are movable when a security interest attaches. The term includes (i) fixtures, (ii) standing timber that is to be cut and removed under a conveyance or contract for sale, (iii) the unborn young of animals, (iv) crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes, and (v) manufactured homes. The term also includes a computer program embedded in goods and any supporting information provided in connection with a transaction relating to the program if (i) the program is associated with the goods in such a manner that it customarily is considered part of the goods, or (ii) by becoming the owner of the goods, a person acquires a right to use the program in connection with the goods. The term does not include a computer program embedded in goods that consist solely of the medium in which the program is embedded. The term also does not include accounts, chattel paper, commercial tort claims, deposit accounts, documents, general intangibles, instruments, investment property, letter-of-credit rights, letters of credit, money, or oil, gas, or other minerals before extraction." UCC § 9-102(a)(44).

[27] The UCC defines the term as: "(42) "General intangible" means any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software." *See* UCC § 9-102(a)(42). It has been suggested that certain "carbon credits" or "carbon offsets" may qualify as "general intangibles."

[28] § 95820(c) of CARB Regulations states: "A compliance instrument issued by the Executive Officer does not constitute property or a property right." However, California Chamber of Com. v. State Air Res. Bd., 10 Cal. App. 5th 604, 646–649 (2017) held that CCAs are a valuable private property right, despite seemingly contrary language in the CARB Regulation.

[29] § 95921(f)(1)(B) of CARB Regulations, states: "(f) General Prohibitions on Trading. (1) An entity may purchase and hold compliance instruments for later transfer to members of a direct corporate association. However, an entity cannot acquire allowances and hold them in its own holding account on behalf of another entity, including the following restrictions: (A) An entity may not hold allowances in which a second entity has any ***ownership interest***. [*emphasis added*](B) An entity may not hold allowances pursuant to an agreement that gives a second entity ***control over the holding or planned disposition of allowances*** while the instruments reside in the first entity's accounts, or control over the acquisition of allowances by the first entity [*emphasis added*].

whether a third-party creditor or a secured party may exercise control over collateral consisting of CCAs. It has been, however, generally accepted in the industry that the grant of a “security interest” over collateral, such as CCAs, is not the same as the “exercise of control” or acquiring a “beneficial interest” because such security interest must first be foreclosed on, and second, assuming that all other conditions are met (such as establishing an account on CITSS),[30] many additional steps must be taken before a secured party may have control over CCAs (*e.g.*, that may be included in the borrowing base for a ABL transaction).

These are just a few examples of situations when it is important to specifically analyze the types of “commodities” used as collateral in SCF transactions, the nature of pledged account structures and related evaluation of cash management.

D. *Commodity Pool Considerations*.

1. Defining “commodity pools”

Many commodity finance structures, especially ABS, involve the use of SPVs or SPEs which are created by a sponsor as a bankruptcy-remove vehicle (such as an LLC) that invests in certain assets (such as commodities transferred via a true sale) and that would typically enter into hedges (such as swaps or futures or options) to protect SPV’s investments from market volatility. The SPV will issue securities (*i.e.*, participation interests) to third-party investors. These types of investment vehicles generally meet the definition of a “commodity pool,” which is defined in the CEA as:

> (10) **Commodity pool** (A) In general. 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; (ii) agreement, contract, or transaction described in section 2(c)(2)(C)(i) of this title or section 2(c)(2)(D)(i) of this title; (iii) commodity option authorized under section 6c of this title; or (iv) leverage transaction authorized under section 23 of this title.[31]

Provisions specifying a date to deliver a specified quantity of compliance instruments, or specifying a procedure to determine a quantity of compliance instruments for delivery and/or a delivery date, do not violate the prohibition.”

[30] *See* Cal. Code regs. tit. 17 § 95830(a)(3): “[a]n entity cannot hold a compliance instrument until the Executive Officer approves the entity’s registration with ARB and the accounts administrator creates an account in the tacking system.”

[31] *See* § 1a(1) of the CEA; *also see* § 4.10(d) of CFTC Regulations.

2. Exempt "commodity pools"

Unlike "investment companies" (discussed below), a "commodity pool" need not register with the CFTC, but its sponsor – *i.e.*, a "commodity pool operator" ("***CPO***")[32] would be required to register with the National Futures Association ("***NFA***") or seek and qualify for an exemption from such registration. There are several exemptions from CPO registration, where § 4.13(a)(3) (also known as the "de minimis exception") is most commonly used. To qualify for this exemption the "commodity pool" must meet several conditions, which are: (a) exemption from registration under Securities Act of 1933 for pool's interests; (b) pool's derivatives positions do not exceed either 5% or 100% of its portfolio's liquidation value depending on the type of derivative; (c) participants in the pool are qualified (*e.g.*, "accredited investors); and (d) "participations in the pool are not marketed as or in a vehicle for trading in the commodity futures or commodity options markets."[33]

Even if conditions (a) through (c) are typically easily met, condition (d) – the "marketing condition" would usually warrant an additional consideration given that the hedges in an SPV are a critical risk mitigation component of an ABS structure. However, the CFTC recognizing that SPVs are usually for a specific commercial purpose – *i.e.*, commodity financing, have issued several no action letters stating that the staff of the CFTC would not initiate an enforcement action against the CPO for failure to register and for failure to meet condition (c) in § 4.13(a)(3) exemption.

3. Exempted CPOs and CTAs

For example, the staff of the CFTC "… has granted … no-action relief from registration as a CPO and CTA to the manager of an entity that owned mineral interests and royalty interests in crude oil and natural gas producing and non-producing properties and, in connection with those activities, entered into commodity interest transactions, such as futures, options or swaps, intended to hedge its exposure to commodity price risk.[34] In

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[32] A CPO is defined in the CEA as: "(11) **Commodity pool operator** (A) In general. 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; (II) agreement, contract, or transaction described in section 2(c)(2)(C)(i) of this title or section 2(c)(2)(D)(i) of this title; (III) commodity option authorized under section 6c of this title; or (IV) leverage transaction authorized under section 23 of this title; or (ii) who is registered with the Commission as a commodity pool operator." § 1a(11) of the CEA.

[33] § 4.13(a)(3) of CFTC Regulations.

[34] CFTC Letter No. 19-02 (Feb. 14, 2019).

that letter, the derivatives used were limited to instruments to hedge the underlying physical commodity assets, not to hedge the financing of the transactions."[35]

Further, the entity that would provide investment and hedging advice to the SPV would typically qualify as a "commodity trading adviser" ("***CTA***"),[36] which is also a category that must register with the CFTC. Normally, however, the CPO and the CTA are the same entity in an ABS transaction and such entity can also rely on a separate exemption from CTA registration.[37]

E. *Hedging Considerations*.

1. Using "swaps"

SCFs themselves (such as "repos" and some EMAs) may constitute a derivative, or integral components in these structures (such as hedges in an ABS) may qualify as derivatives. Generally, the term "derivatives" (which is not defined in the CEA of CFTC Regulations) is synonymous with the term "commodity interests"[38] and generally includes commodity swaps, OTC options, futures and options on futures.

Depending on the type of derivative used, different regulatory requirements will apply. For example, if commodity market risk is hedged in an ABS or ABL transaction with swaps,[39] the hedge provider acting in a dealer capacity will need to monitor its *de*

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[35] CFTC Letter No. 21-06 (March 23, 2021). We caution that only the entity on whose behalf the no-action letter was issued can rely on such letter; however, most market practitioners and ABS sponsors take a reasonable degree of comfort from these letters with respect to their own "commodity pools."

[36] CEA defines a CTA as: "(12) **Commodity trading advisor**. (A) In general. Except as otherwise provided in this paragraph, the term "commodity trading advisor" means any person who — (i) for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in — (I) any contract of sale of a commodity for future delivery, security futures product, or swap; (II) any agreement, contract, or transaction described in section 2(c)(2)(C)(i) of this title or section 2(c)(2)(D)(i) of this title [1] (III) any commodity option authorized under section 6c of this title; or (IV) any leverage transaction authorized under section 23 of this title; (ii) for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning any of the activities referred to in clause (i); (iii) is registered with the Commission as a commodity trading advisor; or (iv) the Commission, by rule or regulation, may include if the Commission determines that the rule or regulation will effectuate the purposes of this chapter." § 1a(12) of the CEA.

[37] *See* § 4.14(a)(5), which is available to exempt CPOs that provide commodity trading advice solely incidental to their activities as an exempted CPO.

[38] *See* § 1.3 of CFTC Regulations.

[39] *See* § 1a(47) of the CEA.

minimis swap dealer status (if unregistered as a swap dealer),[40] as well as position limits, documentation requirements (*e.g.*, ISDA conventions), disclosures, use of confidential material and non-public information, ability to pre-hedge, fulfill margining obligations (if applicable), etc. Given that all swaps must be reported to a swap data repository (and "***SDR***"),[41] if the hedge provider is not a registered swap dealer, the counterparties will need to mutually agree who will be sending the reports to the SDR.

2. Using "futures"

For some SCF transactions futures would be more appropriate. Given that it is a lot easier to establish and terminate futures positions – primarily because these are exchange-traded instruments that do not require bespoke documentation – hedging with futures would be more suitable for shorter-term deals and transactions where vintages and delivery terms for the underlying commodity may change quickly. As with swaps, the CEA and CFTC regulations impose many substantive requirements (*e.g.*, position limits[42] or intermediary regulations[43]) in addition to commodity exchanges' specific requirements. However, unlike with swaps, futures are traded through an FCM account and the trader will inevitably face potential bankruptcy exposure to the FCM[44] and ultimately to the DCO (*i.e.*, the clearing house).

3. Netting and Setoff

Note that for purposes of netting and set off, different types of hedging contracts, *i.e.*, OTC swaps,[45] swaps cleared through a DCO,[46] U.S. traded futures[47] as well as foreign

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[40] *See* § 1a(49) of the CEA.

[41] *See* § 1a(48) of the CEA.

[42] Note that both exchange-specific as well as Federal position limits apply to most physically deliverable commodities.

[43] There are numerous CFTC enforcement actions involving entities transacting in futures that inadvertently act as unregistered CTAs, CPOs, IBs, and FCMs. For example, a sponsor of an SPV in an ABS transaction may be considered a CPO, while a manager providing services under an EMA may be considered a CTA.

[44] Bankruptcy of an FCM poses additional challenges because in addition to the Bankruptcy Code, procedures provided in Part 190 of CFTC regulations should be considered (*see, e.g.*, MF Global or Peregrine bankruptcy proceedings).

[45] *See* § 1a(47) of the CEA.

[46] *See* Part 22 of CFTC Regulations. Cleared swaps are considered "commodity contracts" for purposes of § 761 of Chapter 11 of the Bankruptcy Code (*see* § 4d of the CEA).

[47] *See* § 4d(a) and 4d(b) of the CEA.

futures[48] must be analyzed separately since they generally cannot be netted and set off against each other.

F. *Structuring Issues*.

Given the wide variety of commodity finance structures, each must be analyzed specifically; for example a SPV may inadvertently qualify as a "commodity pool" or an "investment company," which would require analysis under the CEA and the Securities Laws.

1. Defining "treasury affiliates"

Depending on whether swaps are used to hedge commodity market risk (*e.g.*, with commodity basis swaps), or fluctuation of interest rates (*e.g.*, with interest rate swaps ("***IRS***")), or counterparty credit risk (*e.g.*, with credit default swaps ("***CDS***")), or foreign exchange risk (*e.g.*, with currency swaps), these swaps would need to be cleared through a DCO and if not cleared - margined if the hedge provider is a registered swap dealer.[49] However, there is an exemption from the clearing, SEF-trading and margining requirement if a counterparty to a swap qualifies as a "commercial end user."[50]

Many larger companies structure their treasury and risk management operations through a centralized affiliate within their corporate structure – the so called "treasury affiliate", *i.e.*, a captive financing company. These entities allow corporates the ability to manage their trading book on a centralized basis and thus more efficiently manage attendant market and regulatory risks.

2. Defining "commercial end users"

The definition of "commercial end user" carves out "financial entities,"[51] *i.e.*, financial institutions as well as the entities that are predominantly engaged in financial activities, and therefore not qualifying as "commercial end users." Captive finance companies clearly qualify by design as "financial entities" and therefore would not be eligible for the "commercial end user" exemptions. However, the CEA recognizing the use of these typical structures, provided in § 2(h)(7)(C)(iii) of the CEA an exemption for "treasury

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[48] *See* Part 30 of CFTC Regulations.

[49] Clearing and swap execution facility trading requirement applies to certain IRS and CDS not at this time to commodity or currency swaps.

[50] *See* § 2(h)(7)(c) of the CEA.

[51] Note that the term "financial institution" is defined in § 1a(21) of the CEA, while the term "financial entity" is defined in § 2(h)(7)(C)(iii) of the CEA.

affiliates" from the definition of a "financial entity" and therefore captive finance companies, under certain conditions may qualify as "commercial end users."[52]

3. Defining "eligible contracts participants"

As noted above, only ECPs can enter into swaps transactions. Ensuring an ECP[53] status for counterparties may be a challenge if an entity is an SPV that may not immediately meet the requisite asset test requirements (*e.g.*, for "commodity pools" – total assets must exceed $5 million, for corporates – total assets must exceed $10 million or net worth must exceed $1 million if it is using swaps to hedge).[54] After the Dodd Frank Act provisions relating to swaps became effective, many users of swaps realized that they will not be able to qualify as ECP; in response the CFTC had issued several no action letters addressing these unique situations.[55]

G. *Recharacterization Concerns*.

1. Qualifying "forwards"

Several SCF facilities may include components or as an entire transaction become recharacterized by the regulators if certain conditions are not met. For example, an SCF transaction, such as a prepay, may include a "forward" for delivery of *e.g.*, natural gas or electricity. Provided that both counterparties to this transaction are "commercial entities,"[56] and both intend to make and take delivery of physically-deliverable commodity (*i.e.*, an "exempt commodity"),[57] such transaction will most likely be recognized as a commercial transaction and not a derivative (*i.e.*, not a "commodity interest"[58]) and none of the Dodd Frank Act regulations will apply.

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[52] *See e.g.*, CFTC Letter 15-27 (May 4, 2015) https://www.cftc.gov/PressRoom/PressReleases/7169-15.

[53] § 1a(18) of the CEA defines the term "eligible contract participant."

[54] *See* § 1a(18) defining "eligible contract participant." *Also see*, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 FR 30596 (May 23, 2012).

[55] *See e.g.*, Staff Interpretations and No-Action Relief Regarding ECP Status: Swap Guarantee Arrangements; Jointly and Severally Liable Counterparties; Amounts Invested on a Discretionary Basis; and "Anticipatory ECPs", CFTC Letter No. 12-17 No-Action and Interpretation (Oct. 12, 2012).

[56] *See* definition of "eligible commercial entity" in § 1a(17) of the CEA.

[57] *See* § 1a(20) of the CEA.

[58] *See* § 1.3 of CFTC regulations defining "commodity interests."

If however, one of the criteria for a qualified "forward" is not met, *e.g.*, the commodity is not delivered because the trade is qualified as a "paper trade only" transaction, such transactions may be recharacterized as a "swap" and the structure of the entire transaction (*e.g.*, a prepay) will frustrated.

2. Imbedded optionality and "swaps"

Sometimes forwards may include terms that would provide for imbedded optionality (*e.g.,* volumetric optionality), or provisions allowing counterparties have an option to not take any delivery of a commodity at all in exchange of a cash payment,[59] such contract may be qualified as a "commodity trade option"[60] which is treated by the CFTC as a derivative – *i.e.*, a "swap".[61] Products Definitions address many situations when inclusion of optionality or other terms that allow financial settlement instead of a physical delivery would not convert these forwards into swaps.[62] Likewise, under the Bankruptcy Code, a "forward agreement" will be treated very differently from a "swap agreement." Energy management agreements ("***EMAs***") often include various forward agreement components that should be closely analyzed whether they may qualify as "swaps."

3. "Spots," VPPs and FTRs

Many other types of agreements may also be recharacterized; for example "spot" trades (*e.g.*, power traded in the day ahead market) may be recharacterized as "swaps" if these trades do not settle within two business days, or transportation or storage agreements may be also recharacterized as "swaps" if they cash settle. Virtual power purchase ("***VPPs***") agreements are typically qualified as "swaps" as are "financial transmission rights" ("***FTRs***") and certain other financial "forward capacity transactions," and "reserve or regulation transactions."[63]

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[59] *See* Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; "Mixed Swaps"; "Security-Based Swap" Agreement Recordkeeping, 77 FR 48208 (Aug. 13, 2012) ("***Products Definitions***").

[60] *See* Part 32 of CFTC Regulations; *also see* Commodity Options, 81 FR 14966, (Mar. 21, 2016).

[61] *See* § 1a(47) of the CEA.

[62] *See* Products Definitions.

[63] *See, e.g.*, Final Order in Response to a Petition From Certain Independent System Operators and Regional Transmission Organizations To Exempt Specified Transactions Authorized by a Tariff or Protocol Approved by the Federal Energy Regulatory Commission or the Public Utility Commission of Texas From Certain Provisions of the Commodity Exchange Act Pursuant to the Authority Provided in the Act, 78 FR 19880 (Apr. 2, 2013), *available at* https://www.cftc.gov/PressRoom/PressReleases/6546-13

4. Repos and prepays

Unless the formal characteristics of a repo are not strictly adhered to (*i.e.*, the forward counterparties must have the capacity and intention of taking and making a delivery of the underlying commodity and the delivery must actually happen, even for a brief moment), a repo may be also recharacterized as a "swap," or a secured lending transaction or some form of an option.[64]

The same concerns apply to the Prepays, which must qualify as *bona fide* "forwards" for delivery of a physical commodity (such as natural gas), even if the risks attendant to these structures are hedged with "swaps."

H. *Bank regulatory issues*.

1. Banks trading physical commodities

Banks and their holding companies (referred to collectively as "***banks***") are subject to broad and detailed rules governing their exposures to physical commodities. As a general rule, banks cannot transact in physical commodities.[65] There are, however, several exceptions to the general rule, which have the effect of permitting banks to participate in multiple types of commodities financing. First and foremost, banks are permitted to accept physical commodities as collateral for their extensions of credit. As a necessary corollary, banks are authorized to foreclose on, or otherwise take possession of, the collateral on default, subject to holding period limits. Second, banks largely can also transact in derivatives on physical commodities, provided the settlement is in cash or offset, rather than delivery or acceptance of the underlying physical commodity.[66] Third, depending on the bank, its capacity in the transaction, or the regulator, some level of physical delivery or acceptance authority may be available under generally applicable regulations or pursuant to authority granted on approval of a

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[64] A repo lacking legitimate economic business purpose may also be recharacterized as a fraudulent accounting procedure.

[65] These limitations do not typically apply to precious metals, as to which there is much broader authority to transact, stemming from the traditional roles of precious metals in banking. In addition, U.S. banks acting abroad have greater authority to transact in physical commodities. *See, e.g.*, 12 CFR § 211.10(a)(19).

[66] A national bank may engage in derivatives transactions with any underlying to hedge the risks arising from bank permissible activities. Some intermediation for customers is also authorized for national banks. They can transact customer-driven derivatives transactions, based on any underlying, that are any of: (i) cash-settled and either perfectly matched or portfolio-hedged; (ii) physically settled by transitory title transfer, and perfectly matched or portfolio-hedged; or (iii) physically hedged, and portfolio-hedged or hedged on a transaction basis. A national bank must provide prior notice to, and possibly receive a non-objection from, the OCC before commencing any such activity or extending the activity to new underlying assets. *See, e.g.*, 12 CFR § 7.1030.

specific application.[67] (In some transactions, banks may have authority to act as agent or fiduciary but not as principal).

Banks should also pay attention to bank supervisors' attitudes toward commodity transactions. After a period of allowing expansion of these authorities in the run-up to the financial crisis of 2007-9, regulators since then have been wary of such activities, which may result in heightened supervisory attention to such activities.[68]

2. The Volcker Rule

Certain special considerations apply to bank participation in physical commodity transactions. Banks in these markets should pay attention to the Volcker Rule.[69] The Volcker Rule largely prohibits banks from proprietary trading in "financial instruments" (quite broadly defined, and including many derivatives), and from sponsoring, managing, acting as a CPO or CTA in respect of, or investing in certain private investment funds. These prohibitions are subject to many exceptions, which in turn are subject to many operating and compliance conditions.

I. *Securities issues*.

1. SEC's Risk Retention Rule

Some structures, such as ABS, require a formation of an SPV that would be acting as an issuer or "securitizer"[70] of "asset backed securities." The Dodd Frank Act mandated

[67] With respect to bank holding companies, *see, e.g.*, The Royal Bank of Scotland plc, Order Approving Notice to Engage in Activities Complementary to a Financial Activity (March 27, 2008), at 9-10 (permitting a non-bank subsidiary of bank holding company to transact in physical commodities for which a derivatives contract had been authorized for trading on a U.S. futures exchange by the CFTC, or other commodities specifically authorized by the Federal Reserve, such as butane, ethane, natural gasoline, asphalt, condensate, boiler cutter, residual fuel oil no. 6, kerosene, straight run, marine diesel, naphtha, ethylene, paraxylene, styrene, and propylene).

[68] *See, e.g.,* Board of Governors of the Federal Reserve System, Advanced Noticed of Proposed Rulemaking, Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities, 79 Fed. Reg. 12,414 (Mar. 5, 2016) (a proposal, not yet finalized or promulgated, to limit substantially commodity transactions previously authorized for bank holding companies, and to steep, supplementary capital requirements on certain derivative or commodity positions).

[69] *See, e.g.* 12 CFR Part 248.

[70] § 15G(a)(3) of the Exchange Act defines "securitizer" as: "(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates as asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer…".

that the SEC and other financial regulators implement the risk retention rules for issuances of "asset backed securities" (the "***Risk Retention Rules***").[71]

The Risk Retention Rules promulgated by the Agencies generally apply the risk retention requirements of § 15G to a "***sponsor***"[72] of a "***securitization transaction***"[73] and require that the "sponsor" of a "securitization transaction" (or majority-owned affiliate of the sponsor) shall retain a certain economic interest in the credit risk of the "securitized assets"[74] in accordance with § § 246.4 through 246.10 (the "Base risk retention requirement" in § 246.3).[75]

The term "asset-backed security" is critical to the application of the Risk Retention Rules because these rules only apply if an "asset-backed security" is involved. The term "asset-backed security" is broadly defined in § 3(a)(79) of the Exchange Act as a:

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[71] Regulation RR, 12 C.F.R. § 244.1, *et seq*. *See also* Credit Risk Retention, 79 Fed. Reg. 77602 (December 24, 2014). The Risk Retention Rules were adopted jointly by the following U.S. governmental agencies (the "***Agencies***"): the SEC, the Department of the Treasury, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and the Department of Housing and Urban Development.

[72] The Risk Retention Rules define "***sponsor***" as a "person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." § 246.1 (Definitions). According to the Agencies, the definition of "sponsor" "substantively aligns with the definition of "***securitizer***" in section 15G of the Exchange Act, and means: "with respect to a securitization transaction, either: (1) The depositor of the asset-backed securities (if the depositor is not the sponsor); or (2) The sponsor of the asset backed securities." § 246.1 (Definitions).

[73] "***Securitization transaction***" means "a transaction involving the offer and sale of asset-backed securities by an issuing entity." § 246.1 (Definitions).

[74] "***Securitized asset***" means an "asset that: (1) Is transferred, sold, or conveyed to an issuing entity; and (2) Collateralizes the ABS interests issued by the issuing entity." § 246.1 (Definitions). Further, "***ABS interest***" is described as "(1) any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest of residual interest (with certain exceptions), payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity; and (2) does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that: (i) are issued primarily to evidence ownership of the issuing entity; and (ii) the payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity; and (3) Does not include the right to receive payments for services provided by the holder of such right, including servicing, trustee services and custodial services." § 246.1 (Definitions).

[75] *See* Adopting Release at 77609. The regulatory history to § 15G indicates that this section was designed to address the problems arising from misaligned incentives among the parties to securitization transactions, including issues resulting from the "originate to distribute" model of asset securitization, and to give securitizers a "strong incentive to monitor the quality of the assets they purchase from originators, package into securities, and sell." *See* S. Report No. 111-176, at 128 (April 30, 2010). The Adopting Release notes, in this regard, that "when… there is a lack of discipline in the credit origination process, securitization can result in harmful consequences to investors, consumers, financial institutions, and the financial system." *See* Adopting Release at 77604.

> …fixed-income or other security collateralized by any type of *self-liquidating financial asset* [emphasis added] (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend *primarily* [emphasis added] on cash flow from the asset, including –
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> (i) a collateralized mortgage obligation;
>
> (ii) a collateralized debt obligations;
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> (iii) a collateralized bond obligation;
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> (iv) a collateralized debt obligation of asset-back securities;
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> (v) a collateralized debt obligation of collateralized debt obligations;
>
> (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section… [76]

The term "***asset***" is defined as "a self-liquidating *financial* [emphasis added] asset (including but not limited to a loan, lease, mortgage, or receivable)."[77]

Therefore, a threshold requirement to the determination of whether Risk Retention Rules would apply to the Transaction depends on whether the Transaction qualifies as a "securitization transaction," *i.e.*, an offer and sale of "asset-backed securities" that are collateralized by "self-liquidating financial assets that … depend primarily on the cash flow from [such] assets." Thus, the qualification of an asset as a "self-liquidating financial asset" is the key to this analysis.

The Risk Retention Rules do not define the term "self-liquidating financial asset" but provide a non-exclusive list of examples of "self-liquidating financial assets" "…(including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on the cash flow from the asset…"[78] As follows from this list of examples, they all share the same characteristics – *i.e.*, they are financial assets where the payment obligation exists independently of and is not contingent upon any management or actions of the securitizer. In other words,

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[76] 15 U.S.C. § 78c(a)(79).

[77] *See* § 246.1 (Definitions). Similar definition is found in Rule 3a-7(b)(1) defining "eligible assets" for purposes of Investment Company Act of 1940 exemption for issuers of asset backed securities as: "*Eligible assets* means financial [emphasis added] assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designated to assure the servicing or timely distribution of proceeds to security holders."

[78] Risk Retention Rules, at 77653, *citing* 15 U.S.C. 78c(a)(79).

these assets perform on their own and generate the necessary income to pay back the initial investment and cost, amortize, retire or turn into cash,[79] *i.e.*, self-liquidate.

Accordingly, if an "asset-backed security" is not intended to securitize a "self-liquidating financial asset," the Risk Retention Rules will not apply. It is generally recognized that oil and gas assets, and other physical-commodity producing assets typically would not qualify as "self-liquidating financial assets" because, *e.g.*, oil wells do not produce crude oil by themselves – a manager must be involved with a team of highly-trained professionals. However, given the wide variety of how these oil and gas interests are held, a very detailed analysis of the nature of these assets will be necessary.

2. Exempted securities offerings

Other Securities Laws considerations would typically involve ensuring compliance with the terms of exempted offerings to institutional "accredited investors,"[80] such as under Rule 506 of Regulation D and Rule 144A for "qualified institutional buyers," or Regulation S for offshore sales of securities.

3. Investment Company Act exemptions

In addition, as noted above, some SPVs may qualify as "investment companies" for purposes of Investment Company Act,[81] and would typically seek to be exempted under § 3(c)(1), § 3(c)(7) and particularly § 3(c)(9).[82]

J. *General CFTC / Dodd Frank Compliance Considerations*.

We noted above, there are many instances in SCF transactions when it may be difficult to clearly identify whether a given instrument would qualify as a spot, as a forward, as a service agreement, or a swap or an option (*i.e.*, a derivative). None of the CEA (and specifically Dodd Frank Act) requirements apply to non-derivatives,[83] while transactions

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[79] The Risk Retention Rules at 77661, citing 15 U.S.C. 78o-11(a), provide a further examples discussing tender option bonds as self-liquidating assets: "The agencies continue to believe that tender options bonds are asset-backed securities under the definition in section 15G because they are securities collateralized by self-liquidating financial assets and the holders of the securities *receive payments that depend primarily on cash flow from the securitized assets*. [emphasis added] Therefore, the sponsors of the issuing entities with respect to tender option bonds are subject to section 15G and the credit risk retention rules."

[80] *See* § 230.501.

[81] 15 U.S.C. § 80-1 *et seq*.

[82] *See* § 3(c)(1) and § 3(c)(7) of the Investment Company Act.

[83] Note, however, that the CFTC retains general anti-fraud and anti-manipulation jurisdiction over all transactions in interstate commerce that involve derivatives under § 180.1 of CFTC Regulations. This means that even if no derivatives are involved in a given transaction, the CFTC

involving derivatives are fully regulated. In addition to clearing and margining requirements for swaps discussed above, there are many other compliance requirements that must be addressed. Usually, if one of the counterparties to a swap transaction is a registered swap dealer, the swap dealer will ensure compliance with the CEA and CFTC Regulations; there are some exceptions, however.

1. Position limits rules

In 2020 the CFTC expanded its positions limits rules to 25 physically deliverable commodities (such as crude oil and natural gas) that are traded as futures contracts or swaps (*i.e.*, the federal position limits rules in contrast to the specific commodity exchange position limits rules).[84] Each individual counterparty to a swap is not required to monitor its position limits not only for futures traded on commodity exchanges, but also for its OTC trades.

For swap dealers with a large book of commodity swaps, it becomes imperative that its counterparties provide the bona fide hedge language to allow swap dealers ability to rely on the pass-through hedge exemptions (provided that the counterparties are using these swaps for hedging purposes). From the end-user perspective, aggregation provisions of position limits rules may become a restraining factor in their overall operations if they trade large volumes of commodities.

2. Swaps reporting issues

Further, in the event at a swap dealer is not a counterparty to a swap, the counterparties will be required to mutually agree which one of them will serve as a "reporting counterparty" for swaps under CFTC swap reporting regulations.[85] Failure to report execution, amendment and termination of swaps (and OTC options) is a violation of the CEA. It takes a significant amount of time to set up an SDR reporting account and to report swaps in an SDR-acceptable format.

3. Margin rules

Regulatory margin rules[86] apply only to swaps where at least one of the counterparties is a registered swap dealer or a major swap participant (*i.e.*, "covered swap entities"

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will have the jurisdictional authority to prosecute for fraud and manipulation involving trades in physical commodities.

[84] *See* Position Limits for Derivatives, 86 FR 3236 (Jan. 14, 2021).

[85] *See* Part 43 and Part 45 of CFTC Regulations.

[86] *See generally,* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 636 (Jan. 6, 2016). The CFTC Margin Rule, which became effective April 1, 2016, is codified in part 23 of the Commission's regulations. 17 CFR 23.150 through 23.159, 23.161. In May 2016, the Commission amended the CFTC Margin Rule to add Regulation 23.160, 17 CFR 23.160, providing rules on its cross-border application. *See* generally Margin

"***CSEs***") and do not apply to swaps where both counterparties are non-CSEs or when one of the counterparties is a "non-financial end user".[87] Likewise, if a swap is cleared (*i.e.*, novated to a DCO), regulatory margin rules will not apply – hence they are also referred to as uncleared swap margin rules ("***USMR***"). If USMR applies to a given SCF transaction, the requirement to post and collect either initial margin ("***IM***") or variation margin ("***VM***") may significantly change the economics of a trade.[88]

a. Jurisdictional Matters

Generally, a stand-alone swap dealer registered with the CFTC that does not have a Prudential Regulator (as defined in § 1a(39) of CFTC Regulations),[89] will be required to follow CFTC margin and capital rules (§ 23.150 of CFTC Regulations). Likewise, an entity that is solely registered with the SEC and that does not have a Prudential Regulator will be required to follow only the SEC's capital and margin rules for security-based swaps ("***SBS***"). Thus, it is a critical step in the analysis to determine whether CFTC's, SEC's, or Prudential Regulators' capital and margin rules will apply because there are some significant differences between these regimes (most notably between SEC's on one hand and CFTC's and Prudential Regulators' on the other).

b. CSE's Counterparty Qualification

Next, it is necessary to determine if an CSE's counterparty is qualified as a "financial end user" (subject to USMR) or an "non-financial end user" (not subject to USMR). As noted above, SPVs should be specifically analyzed whether they would be qualified as "financial end users."

c. MSE Determination

If it is determined that USMR applies, the next key component of the analysis is whether material swap exposure ("***MSE***") of a counterparty (*e.g.,* the SPV) under the SCF

Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 FR 34818 (May 31, 2016).

[87] *See* § 23.151 "definitions." Note that "regulatory" margin rules are obligatory, in contrast with all other collateral and credit support arrangements between counterparties that are negotiated mutually, as, for example, would be the case with the Credit Support Annex to the ISDA Master agreement.

[88] *See* Part 23.150 of CFTC Regulations.

[89] *See* Sec. 1a(39) of the CEA, 7 U.S.C. 1a(39) (defining the term ''prudential regulator'' to include the Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; the Federal Deposit Insurance Corporation; the Farm Credit Administration; and the Federal Housing Finance Agency). The definition of prudential regulator further specifies the entities for which these agencies act as prudential regulators. The prudential regulators published final margin requirements in November 2015. *See* generally Margin and Capital Requirements for Covered Swap Entities, 80 FR 74840 (Nov. 30, 2015) ("***Prudential Margin Rule***"). The Prudential Margin Rule is substantially similar to the CFTC Margin Rule, including with respect to the CFTC's phasing-in of margin requirements.

transactions, such as ABS, exceeds the $8 billion in average month-end aggregate notional amount ("***AANA***") of uncleared swaps with the swap dealer counterparties. If its AANA does not exceed the $8 billion amount, then there will be no IM obligation and the counterparties will only be required to exchange the VM. It is very unlikely that the SPV will exceed the $8 billion in MSE.

There are other factors to consider in USMR analysis, such as application of SEC's margin rules, the impact of margin affiliates, the amount of VM if IM is not applicable.

d. VM Considerations

Even if IM may not be applicable, if a counterparty (*e.g.*, an SPV in an ABS transaction) is a "financial end-user," VM may apply. Because VM is intended to protect both counterparties, there are structures possible where a certain amount of collateral is posted to an escrow or in a deposit account and depending on the market move the VM will be deemed posted to one of the other counterparty (as a pre-paid amount of VM). If the valuation changes in the other direction, the payment will be deemed made to the other party. It is important that this amount is not qualified as "collateral" but as a pre-payment because there is risk that the regulator may consider this a tactic to evade the VM payment obligation. It is also possible to design a dynamic margin collateral annex or make a pre-paid arrangement that will fully pre-pay the VM obligations. There remains an issue of valuation events (*e.g.*, when the market for a given commodity has collapsed) when the pre-paid VM may not be sufficient.

e. IM Considerations

As noted before, for CFTC SD and prudentially regulated SDs and SBSDs, it is unlikely that a hedging swap with an SPV will exceed $8 billion in MSE, which means that only the exchange of VM will be required. With respect to SBSDs, however, there is no MSE limitation and the only practical limitation before the IM posting will be triggered is the $50 million threshold of credit exposure in addition to the $500,000 minimum transfer amount. The same threshold exists for CFTC and PR's UMRs. In sum, IM and VM considerations should be thoroughly analyzed, especially in ABS transactions.

As noted above, margin provided with respect to OTC uncleared swaps will be treated from a regulatory and bankruptcy perspective differently from the margin provided with respect to cleared swaps or futures contracts.

4. Cross-border issues

If any of the counterparties to swaps would not be qualified as U.S. persons, or if, for example, an SPV is established overseas (which is not uncommon), the SCF

transaction would need to be analyzed for potential cross-border compliance issues.[90] There are several CFTC enforcement actions involving commodity transactions partially or entirely based outside the U.S.[91]

K. *Fintech Issues*.

1. Cryptocurrency as a "commodity"

Not surprisingly, commodities have been involved with cryptocurrency and blockchain (distributed ledger technology "***DLT***") solutions almost since Bitcoin first hit the scene. To begin with, the CFTC has indicated that the use of certain cryptocurrencies in commodity-related transactions means that the cryptocurrency itself is trading as a "commodity," and courts have begun to agree. For example, in a case filed by the CFTC against a Ponzi-like scheme that was sold to investors as involving digital assets related to carbon assets, the CFTC alleged that Ethereum and Bitcoin, when used in this manner, are themselves commodities and requested summary judgment against the plaintiffs.[92] On July 3, 2024, the Northern District of Illinois approved the summary judgment, finding that "not only are Bitcoin and Ethereum commodities within the CFTC's jurisdiction, but also . . . 'two non-Bitcoin virtual currencies' [used the in the scam] qualify as commodities."[93]

The CFTC has been a consistent and persistent regulator and enforcement agency with regards to cryptocurrencies. As present CFTC Chairman Rostin Behnam informed the Senate Committee on Agriculture this summer, to date "the CFTC has brought over 135 digital commodity cases resulting in billions in penalties and restitution."[94] Chairman Behnam encouraged the Senate to support legislation that would fill regulatory gaps around digital assets, including cryptocurrencies, by specifically allocating enforcement responsibilities and funding to the CFTC, authorizing the CFTC to "require registrants to provide a comprehensive disclosure regime regarding a commodity token's structure, purpose, market-based characteristics and general risks," and supporting efforts by both

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[90] *See* Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants, 85 FR 56924 (Sept. 14, 2020).

[91] In addition, consider FCPA and AML potential implications.

[92] CFTC Charges Oregon and Illinois Residents and Florida Company in $44 Million Misappropriate in Ongoing Digital Asset and Commodity Futures Fraud, CFTC Press Release Number 8532-22, May 19, 2022, *available at*: https://www.cftc.gov/PressRoom/PressReleases/8532-22.

[93] *See* link to download Judge Mary Rowland's Memorandum Opinion and Order on this CFTC Press Release Number 8931-24: https://www.cftc.gov/PressRoom/PressReleases/8931-24.

[94] Testimony of Chairman Rostin Behnam Before the U.S. Senate Committee on Agriculture, Nutrition and Forestry's Hearing on the Oversight of Digital Commodities, July 10, 2024, *available at*: https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam48.

the CFTC and the Securities Exchange Commission to facilitate “strong, robust regulation of securities and derivatives markets.”[95]

Practically speaking, one of the main points of the CFTC’s perspectives on cryptocurrencies means that when cryptocurrency is being used by companies in transactions which, if made in dollars, would be deemed to be commodities transactions, then such cryptocurrency transactions actually are commodities transactions. Accordingly, not only should the companies that market, offer and support such transactions be properly registered with the CFTC, but such companies should ensure that all other rules, disclosures and customer rights and obligations are followed regarding such transactions, as well.

2. Commodities traded via blockchain platforms

In a related topic, commodities, and specifically physically deliverable “commodities,” also have commenced being traded via blockchain and DLT software-based platforms. Distinguished from cryptocurrency in that the blockchains running on these platforms have been custom-designed to provide a distributed ledger for transactional and recordkeeping purposes only, allowing for faster, more transparent and more secure commodity transactions. In this case, the digital blocks that are moved along the blockchain *represent* the underlying commodity and do not, in and of themselves, constitute commodities.

For example, certain solutions have been created to facilitate the trading of precious metals. This means that the blockchain platforms created for this kind of trading *represent* the underlying physical stores of precious metals. In other words, the digital blocks allocated to such physical stores contain identifying information associating the block with specific denominations within the physical metal stores, but these digital blocks are not intended to operate separately from the physical metals for these transactions. This means that all existing laws, rules and regulations apply that would apply to traditional physical metal custodying and transactions apply to these transactions and also govern what kinds of records need to be created, distributed, maintained and shared. Further, through the use of smart contracts that operate with the blockchain, the blockchain software platform can effectuate a variety of actions automatically, to ensure that the terms of commodity contracts are fulfilled.

V. **Conclusions**.

Even though commodity finance is age-old, SCF constantly changes and evolves with the changes in business environment, market practices and regulations. As the U.S. stands at the center of global commodity trade and finance, compliance with U.S. regulations remains at the heart of commodity traders’ successful business strategy.

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[95] *Id*.

C A D W A L A D E R

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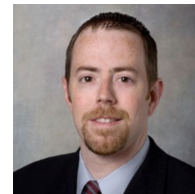

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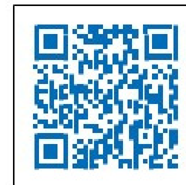

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