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Eileen T. Flaherty

CFTC Letter No. 17-02
No-Action
January 18, 2017
Division of Swap Dealer and Intermediary Oversight

Re: Request for Relief from CPO Registration for "A"

Dear :

This is in response to your letter dated January 5, 2017 to the Division of Swap Dealer and Intermediary Oversight ("Division") of the Commodity Futures Trading Commission ("Commission"), as supplemented by conversations with Division staff (the "Correspondence"). By your Correspondence, you request that the Division expand prior no-action relief granted to "A" by letter dated May 25, 2012 (the "2012 NAL"). Specifically, you request that the Division not recommend that the Commission take enforcement action against "A" for failure to register as a commodity pool operator ("CPO") in connection with its operation of "B" if, as detailed below, "C" agrees to provide "B" with what you describe as an "unfunded loan" backed by a guarantee from "D". This arrangement would supplement "C's" current % participation interest in "B" permitted under the 2012 NAL.

Background

As represented in your Correspondence, we understand the relevant facts to be as follows.

"A" is incorporated in the Netherlands and has its principal place of business in Amsterdam. "B" is a tax-exempt private limited liability company also incorporated in the Netherlands and managed exclusively by "A". "A" received from the Dutch Financial Markets Authority a license to manage "B" as its dedicated Alternative Investment Fund Manager.[1] You represent that none of "A's" directors, officers or employees is subject to a statutory disqualification set out in Section 8a(2) or 8a(3) of the Commodity Exchange Act, as amended (the "Act").[2]

[1] The license is restricted to managing "B" on behalf of "professional investors" as defined under the Alternative Investment Fund Managers Directive.

[2] 7 U.S.C. § 12a(2) or 12(a)(3). The Commission's website, www.cftc.gov, provides links to the Act.

"B's" business objective is to promote long-term local currency financing for borrowers in developing countries that do not have hard currency income. "B's" shareholders are comprised of most of the major development finance institutions in the world as well as a number of specialized microfinance investors. Generally all of these shareholders or their clients use hedging services provided by "B" to hedge their activities in providing local currency funding to emerging and frontier markets. You represent that "B's" shareholders do not invest in "B" for the primary purpose of obtaining an investment return, but rather invest in "B" as part of their respective mandates to promote sustainable economic development. The minimum investment in "B" is $ million.[3]

"B" generally enters into three kinds of transactions: (1) cross-currency swaps and other derivative transactions in connection with the provision of currency loans to borrowers in developing countries (the "Primary Book");[4] (2) currency swaps and forwards for portfolio diversification purposes (the "Trading Book"); and (3) cross-currency swaps and forwards to offset risks in the Primary Book (the "Hedging Book"). As of December 31, 2015, "B" had a gross notional principal amount of currency derivatives outstanding of $ billion in 50 currencies, including $ billion in the Primary Book.

"C" is the only shareholder/participant in "B" that is not a "non-United States person" as that term is defined in Commission Regulation 4.7(a)(l)(iv).[5] "C" is, however, a "qualified eligible person" as defined under Regulation 4.7.

"C" operates a microfinance industry cooperative that provides microfinance lenders with hedging instruments, including over-the-counter foreign exchange swaps, foreign exchange forwards and foreign exchange options, to encourage greater lending to microbusinesses (each a "Client Transaction"). When "C" enters into a Client Transaction, it offsets currency market risk by entering into a reverse matching hedge transaction with another counterparty -- generally "B" or a commercial bank.

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[3] Two shareholders satisfied the minimum investment requirement by pooling $ million each.

[4] "B" enters into Primary Book swaps primarily with shareholders that provide local currency loans to borrowers in developing countries, or directly to borrowers that borrow hard currency from the shareholders in order to provide these borrowers with the hard currency needed to repay the shareholder. In addition, "B" may enter into Primary Book swaps with lenders or borrowers in developing countries that are unrelated to "B's" shareholders, as long as "B's" mission and business principles are upheld, including development impact, additionality and non-speculation.

[5] 17 C.F.R. § 4.7(a)(l)(iv). Commission rules referred to herein are found at 17 C.F.R. Ch. 1 (2016). The Commission's website, www.cftc.gov, provides links to the Regulations.

Extension of 2012 NAL

In the 2012 NAL, the Division granted to "A" relief from registration as a CPO based upon, and subject to, among others, the following relevant facts: (1) "C's" investment in "B" does not exceed % of the total investment by all shareholders in "B"; (2) interests in "B" are offered and sold without any solicitation in the United States; (3) "B" does not actively seek additional US participants; and (4) "B's" participants are all sophisticated institutions that share a collective purpose of promoting sustainable economic development.

You state that since the issuance of the 2012 NAL "C" has significantly increased its hedging activity with "B" and, due to the 2012 NAL's limitation on its "B" investment, "C's" use of "B" as a swap counterparty is exceeding its proportionate capital contribution. In other words, "C's" hedging activity with "B" has used up a disproportionate portion of the capital "B" has available. "A" wishes to alleviate this discrepancy and provide "C" with the opportunity to utilize more of "B's" hedging services. Additionally, "D"[6] would like to have access to "B" local currency products and would like to realize this objective through "C".

As a means of providing "B" an additional capital safety net[7] such that "B" may expand its ability to enter into swaps with counterparties, "C" has proposed to provide to "B" up to four tranches of $ million in the form of what you describe as an unfunded loan ("Unfunded Loan"). In general, "C" would contractually agree to stand ready to provide "B" with additional capital under the Unfunded Loan in the event necessary. The Unfunded Loan would in turn be backed by a guarantee from "D" (the "Guarantee").[8] "D" would receive a fixed fee from "C" for its Guarantee, which you represent will not be linked to the profits or losses of "B".[9] You request that the Division modify the 2012 NAL to encompass the Unfunded Loan/Guarantee arrangement. The requested modification is necessary because the terms of the Guarantee could result in "C's" interest in "B" exceeding the % maximum permitted under the 2012 NAL under certain limited circumstances – specifically, in the event of a "B" liquidation.

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[6] "D" is the US government's development finance institution. It works to achieve its mission by providing investors with financing, political risk insurance, and support for private equity investment funds, when commercial funding cannot be obtained elsewhere.

[7] As of November 30, 2016, "B's" paid-in capital totaled $ million, including $ million in first loss capital contributed by the Dutch and German governments.

[8] The Guarantee would be provided to "C" rather than directly to "B" because "D" is precluded from directly supporting an entity that does not have at least % US participation.

[9] You represent that the applicable accounting rules governing the fund do not require "B" to record a capital contribution by "C" as a result of entering into the Guarantee. As discussed further below however, "B" would record a capital contribution by "C" if "B" called upon the Guarantee.

In support of your request, you note that as a general matter the Guarantee would not result in a change to the terms of the 2012 NAL. Under the terms of the Guarantee, only in the event of a "B" "liquidation event"[10] would "C's" equity interest in "B" increase, and then for only a limited period of time.[11] Should a liquidation event occur, "D" would be required to make payment under the Guarantee with respect to any "activated tranche(s)" and "C" would be issued "B" shares in return for such payment. The shares would be held by "C" for a 12-month period during which time "B" would unwind or terminate its swaps.[12]

Based upon the representations made in your letter, the Division believes that an extension of the 2012 NAL to cover the proposed Unfunded Loan/Guarantee is appropriate. Accordingly, the Division will not recommend that the Commission take enforcement action against "A" pursuant to Section 4m(1) of the Act for failure to register with the Commission as a CPO if, in addition to maintaining up to a % interest in "B" as permitted under the 2012 NAL, "C" provides to "B" the Unfunded Loan backed by the Guarantee. This position is, however, subject to "A's" continued compliance with all other terms of the 2012 NAL, which letter shall otherwise remain in full force and effect. Additionally, in the event of the occurrence of a liquidation event that would result in an increase in "C's" interest in "B", "A" must notify the Division of such event within 10 business days.

This letter, and the positions taken herein, represent the view of this Division only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission. The relief issued by this letter does not excuse "A" from compliance with any other applicable requirements contained in the Act or in the Commission's regulations thereunder. For example, "A" remains subject to all antifraud provisions of the Act. Further, this letter, and the relief contained herein, is based upon the representations made to the Division.

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[10] A "liquidation event" is defined as an event whereby % of "B" shareholders vote by special consent to a liquidation of "B" following the occurrence of a "liquidation trigger event." A "liquidation trigger event" is defined under swap documentation "B" enters into with its counterparties as either (a) "B's" ratio of total capital to risk weighted assets falling below % or (b) its tier one capital ratio falling below %.

[11] Payment under the Guarantee also could be required in the event "C" cancelled or "deactivated" all or a portion of the Unfunded Loan. Such an action would not, however, result in "C" obtaining additional shares in "B". "C" would have the option to deactivate all or a portion of the tranches of the Unfunded Loan quarterly. This would allow "D"/"C" to withdraw from and end its relationship with "B" in the event of a contractual or legal concern (e.g., failure to comply with the Corrupt Practices Law) or to withdraw or reduce its potential exposure to "B" in the event the Unfunded Loan/Guarantee arrangement was no longer needed to support "C" hedging positions of "B's" hedging services (e.g., "C's" use of "B's" services diminishes, swaps have matured, etc.).

[12] You state that the issuance of shares is required under Dutch law to place "C" in an economic position similar to existing shareholders during the 12-month liquidation period.

Any different, changed or omitted material facts or circumstances might render this letter void. The Division retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the relief provided in this letter, in its discretion. Finally, this letter does not create or confer any rights for or obligations on any person or persons subject to compliance with the Act that bind the Commission or any of its other offices or divisions.

If you have any questions concerning this correspondence, please feel free to contact Amanda Olear, Associate Director at 202-418-5283 or Lawrence Eckert, Special Counsel, at 646-746-9704.

Sincerely,

Eileen T. Flaherty
Director