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22 July 2011

File No. S7-16-11: Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping

Dear Ms. Murphy and Mr. Stawick:

The Loan Market Association (the "LMA") appreciates the opportunity to provide further comments to the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC," and together with the CFTC, the "Commissions") concerning the treatment of loan participations under the Wall Street Transparency and Accountability Act of 2010 ("Dodd-Frank")[1] in the Commissions' above-referenced joint proposed rules and proposed interpretations published on May 23, 2011 (the "Proposed Interpretations").[2]

We are grateful to the Commissions for their time and attention to our prior comment letter and to the comments of The Loan Syndications and Trading Association (the "LSTA"), each of which was submitted to clarify the status of loan participations under Dodd-Frank.[3]

We submit this letter following our meeting with the LSTA and the Commissions on May 26, 2011 to: (i) underscore the role of loan participations in the global syndicated loan market as a method for transferring loans on an unleveraged basis; (ii) describe the key features that

[1] Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Pub. L. 111-203 (July 21, 2010).
[2] 76 Fed. Reg. 29,818 (May 23, 2011).
[3] See Letter from the Loan Market Association (23 February 2011), *available at* http://www.sec.gov/comments/s7-16-10/s71610-151.pdf; Letter from the LSTA (January 25, 2011), *available at* http://www.sec.gov/comments/s7-16-10/s71610-136.pdf; and Letter from the LSTA (March 1, 2011), *available at* http://www.sec.gov/comments/s7-16-10/s71610-152.pdf.

distinguish loan participations from total return swaps; (iii) suggest that the Commissions' guidance in the Proposed Interpretations does not provide certainty that loan participations, when used as unleveraged transfer agreements, are excluded from regulation as "security-based swaps"; and (iv) propose a reformulation of the Commissions' interpretive guidance that will provide clarity to the global loan market and, at the same time, preserve the Commissions' robust ability to regulate swaps and security-based swaps.

Most importantly, we believe the portion of the Commissions' guidance that establishes a "true participation" requirement for exclusion from the "swap" and "security-based swap" definitions will add confusion and regulatory uncertainty to the global loan market by unintentionally characterizing the form of loan participation customarily used in Europe and Asia as a "security-based swap." Our proposed reformulation of the Commissions' guidance contained in this letter is intended to address this point. We also refer to the comment letter submitted by the LSTA on the date hereof (the "LSTA Letter"), which supplements and supports this letter.

Loan Participations Are Unleveraged Transfer Structures Used in the Global Loan Market

A loan participation is an important method of transfer that is customarily and frequently used in the global loan market. Each of our 23 February 2011 letter (the "February LMA Letter") and the LSTA's January 25, 2011 letter (the "January LSTA Letter") to the Commissions provided detailed background on the global syndicated loan market as well a description of the loan participation agreement (between a seller, or "grantor," and a buyer, or "participant.") This letter builds on those prior letters in order to highlight our central point regarding loan participations: both LMA-style and LSTA-style loan participations represent traditional methods of asset transfer that are economically and structurally distinct from swaps and do not give rise to the potential systemic risks posed by swaps.

Participants in the global loan market buy and sell *loans*, and the method by which the interests in the loans is transferred, whether by assignment or by participation, is ancillary to the underlying transaction. The election to settle a loan transaction by assignment or participation may be driven by a number of considerations,[4] and in many cases the form of transfer is not determined until after the trade date. Loan participation agreements simply evidence one of two principal methods of effecting a purchase and sale transaction in the loan market.

The goal of a loan participation is to transfer the economic interest in a loan held by a grantor to a participant. The legal framework of the LSTA-style participation is that the beneficial ownership interest in the underlying loan is transferred from the grantor to the

[4] Some of these considerations were outlined in the January LSTA Letter and include, among other things, (i) enabling an original (lead) bank to quickly and efficiently fund a borrower while allowing a syndicate of lenders to simultaneously share in the risk of the loan; and (ii) enabling an original lender to maintain a direct business relationship with the borrower while actively managing (and downsizing) its own risk exposure.

participant. Under an LMA-style participation, unlike under an LSTA-style participation, the legal framework provides that no beneficial ownership interest is transferred to the participant on the date of the participation. Instead, the LMA-style participation is legally interpreted as a contract between the participant and the grantor under which the grantor makes payments to the participant equal to those received by the grantor on the underlying loan. There are multiple reasons for the structure of the LMA participation, many of which originate from the unique nature of the European loan market and European credit agreements. Unlike credit agreements in the United States, which typically expressly permit and contemplate the transfer of underlying loans pursuant to a participation, European credit agreements generally do not contemplate the transfer of a beneficial ownership interest in the underlying loans other than by assignment. Because transfer restrictions and lender eligibility requirements have historically been more stringent in European credit agreements than in U.S. credit agreements, participation has been the only means by which many market participants are able to access the European loan market.

Notwithstanding their different legal interpretations, both LMA-style and LSTA-style loan participations share certain core features that distinguish these agreements from swaps and other derivative instruments. Specifically, these features distinguish loan participations from "total return swaps," which fall within the regulatory scope of Dodd-Frank.

The Grantor Owns the Underlying Loan and May Only Sell It Once

A key pillar of a loan participation is the grantor's actual ownership of the underlying loan. A grantor of a loan participation must represent to the participant that it owns the loan that is subject to the participation.

As discussed above, under an LSTA-style participation agreement, the grantor transfers "beneficial ownership" in the loan to the participant as of the closing date. Under an LMA-style participation agreement, beneficial ownership is not transferred for reasons described above, but the grantor both represents that it owns the loan and covenants that it will not sell, transfer or otherwise encumber the loan other than in favor of the participant.

Under both styles of participation agreement, these related provisions ensure that each loan participation interest is matched, on a one-to-one basis, to an underlying loan held by the grantor. This matching eliminates the possibility of systemic risk created by a synthetic or derivative structure that does not require ownership of the underlying loan. A grantor under a loan participation cannot sell a participation in an amount that is greater than the amount of the underlying loan held by the grantor. However, a swap counterparty is able to sell synthetic exposure to a loan multiple times even if the swap counterparty has no ownership interest in the loan, thereby potentially generating additional risk.

Participation Agreements Are Not Used to Gain Leveraged Exposure to Loans

The participant under a loan participation agreement pays the full purchase price for the loan on the transaction closing date. The grantor does not extend financing to the participant and the participant does not lever its purchase by posting collateral to secure a future obligation to pay the full purchase price. The loan market expects up-front payment of the full purchase price and both LMA and LSTA loan transfer conventions and documentation provide that the methodology for calculating the purchase price payable is the same whether the transaction settles by assignment or by participation. The equivalent calculation of the purchase price for an assignment or for a participation follows from the fact that assignments and participations are alternative loan transfer methods, and that participations are not used to gain leveraged exposure to an underlying loan.

Loan Participations vs. Loan Total Return Swaps

Total return swaps are specifically listed in Dodd-Frank's definition of "swap" as a type of transaction that will be regulated, and we recognize the Commissions' goal of ensuring that any interpretative guidance excluding loan participations from regulation as swaps under Dodd-Frank does not inadvertently extend to loan total return swaps. We believe the key features of loan participations described above can be applied to distinguish between loan participations and loan total return swaps in a manner that will allow the Commissions to preserve their ability to regulate loan total return swaps.

Overview of Loan Total Return Swap Structure

Under a loan total return swap, a "total return payer" agrees to make payments to a "total return receiver" equal to the total economic return derived from a "reference loan," including all amounts paid by the borrower to lenders under the reference loan, plus (or minus) any appreciation (or depreciation) in the value of the reference loan over the term of the swap. In consideration of these payments, the total return receiver agrees to pay to the total return payer a periodic fee (often based on a floating interest rate) as well as amounts equal to any depreciation in the value of the loan. The total return receiver typically delivers an initial amount of collateral to the total return payer to secure future payment obligations of the total return receiver. In addition, the parties exchange collateral payments during the term of the swap based on the fluctuating value of the reference loan: if the reference loan decreases in value, the total return receiver will typically be obligated to deliver additional collateral to the total return payer, and if the reference loan increases in value, the total return payer may be obligated to return a corresponding amount of collateral to the total return receiver. This ongoing collateral exchange is intended to support the parties' obligations to pay appreciation and depreciation amounts at the termination of the swap.

Ownership of the Underlying Loan and Lack of Leverage Distinguish Loan Participations from Loan Total Return Swaps

The key features of loan participations illustrate that loan participations and loan total return swaps are economically and legally distinct structures, and serve entirely different functions in the loan market.

First, loan total return swap documentation typically reflects that the total return payer has no obligation to own the reference loan. This illustrates the fact that a loan total return swap is generally treated as a synthetic derivative structure. While in practice total return payers may hold, or may cause a special purpose vehicle to hold, the reference loan, the total return payer always has the ability to create synthetic exposure by entering into total return swaps that reference loans that the total return payer does not own. This is in stark contrast to a grantor's contractual obligation under a loan participation to actually own the underlying loan, a requirement that effectively prohibits the creation of synthetic exposure.

Second, a loan total return swap is designed to allow the total return receiver to gain synthetic exposure to the reference loan on a levered basis, and is not used as a loan transfer mechanism. The total return receiver does not pay a "purchase price," as it is not purchasing the underlying loan. Instead, on the effective date of the swap, the total return receiver will typically post to the total return payer an amount of collateral equaling a percentage of the current value of the loan. As discussed above, over the life of the swap, the parties will exchange payments based on the fluctuating market value of the loan. To the extent the market value of the loan drops dramatically, the total return receiver may have an immediate obligation to post a significant amount of additional collateral to the total return payer. Under a loan participation, in contrast, the participant has paid the full purchase price of the loan on the closing date and therefore, while the value of the participant's investment will decrease upon any decline in the loan's value, the participant will have no obligation to post collateral with respect to the purchase price upon any such decline.

The Proposed Interpretations Do Not Provide Certainty that Loan Participations Are Excluded from Regulation as Security-Based Swaps

In the Proposed Interpretations, the Commissions have set out guidance reflecting that a loan participation that includes two features will not be interpreted as a "swap" or a "security-based swap." First, the loan participation must reflect that the purchaser is acquiring a current or future direct or indirect ownership interest in the related loan. Second, the loan participation must be a "true participation," which the Commissions define as a participation pursuant to which the participant acquires a beneficial ownership interest in the underlying loans.

LMA-Style Participation Reflects Current or Future Direct or Indirect Ownership Interest

We believe the first prong of the Commissions' guidance outlined above is satisfied under both LSTA-style and LMA-style participations. While LSTA-style participations reflect a current transfer of beneficial ownership interest in the underlying loan, we believe LMA-style participations reflect the transfer of a current indirect and future direct ownership interest by virtue of both the grantor's covenant not to transfer or encumber the loan and the "elevation" provision, described below, together with requirement of payment of 100% of the purchase price upon settlement.

As a general rule, under both LMA-style and LSTA-style loan participations, a participant may at any time request that the grantor use commercially reasonable efforts to cause the participant to become the legal owner, by assignment, of the underlying loan. This is referred to in the loan market as the right to request an "elevation" of the participant's position from participant to "lender of record."[5] While there may be circumstances where transfer restrictions contained in the relevant loan agreement or imposed by a specific transaction prevent a participant from becoming the lender of record under a credit agreement, a participant's right to request "elevation" necessarily requires the grantor to own the underlying loan at all times and is consistent with the basic function of the LMA-style loan participation agreement – to transfer the loan from grantor to participant. The participant's right to request a transfer of the loan by assignment, together with the grantor's representation that it owns the loan and covenant not to transfer or encumber the loan other than in favor of the participant, illustrate that the LMA participation is designed to transfer an ownership interest in the loan to the participant after effectiveness of the participation.

We note that, unlike a loan participant's right to request "elevation" and receive the loan by assignment from grantor, under a loan total return swap the total return receiver generally does not have a right to purchase the loan because the total return payer has no obligation to hold the loan. Although the total return receiver may have a right to bid to purchase the reference loan from the total return provider or from an affiliated entity at the market price upon the termination of the swap, that right is ancillary to the underlying transaction and is not reflected as an "elevation" of the total return receiver's position to the legal owner of the underlying loan. This is consistent with the primary function of total return swaps, which is to provide synthetic (as opposed to actual) exposure to a fixed income asset class.

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[5] While "elevation" rights are reflected in the vast majority of LMA-style and LSTA-style loan participation agreements, we note that this provision may be negotiated or removed to address transaction-specific considerations and, therefore, may not appear in a consistent form across global loan market transactions. For instance, it may be necessary for a lender to place timing restrictions on the participant's right to request an "elevation" in order to enable the lender to preserve a business relationship with the borrower for a specified period of time.

Finally, we believe that the grantor loan ownership representation combined with the grantor's agreement under an LMA-style participation not to sell or otherwise encumber the loan other than in favor of the participant, together with the payment of the full purchase price upon settlement, should also be viewed as an indication of the transfer of a current indirect ownership interest in the loan.

The "True Participation" Requirement May Exclude LMA-Style Participations

We believe the "true participation" feature of the Commissions' guidance outlined above may result in the unintentional characterization of LMA participations as "security-based swaps" which will cause unnecessary confusion in the global loan market.

As discussed above, European credit agreements typically do not contemplate the transfer of a beneficial ownership interest in the underlying loan by participation, and typically contain more stringent transfer restrictions and lender eligibility requirements than their U.S. counterparts. By virtue of these two unique features in European credit agreements, any regulatory requirement that participations reflect the transfer of beneficial ownership to qualify for exclusion from regulation as "swaps" would require a dramatic overhaul of the structure of European credit agreements and LMA participation agreements in order to permit loan market participants continued access to the European credit markets.

The "True Participation" Requirement is Not Supported by Dodd-Frank

On a more general level, we believe that any requirement of the transfer of beneficial ownership imposes a requirement on loan participations that is not supported by the statutory language of Dodd-Frank. The relevant portion of the definition of "swap" includes:

> "any agreement, contract, or transaction ... that provides ... for the exchange ... of 1 or more payments based on the value ... of 1 or more interest or other rates, ... instruments of indebtedness, ... or other financial or economic interests or property of any kind, ... and that transfers ... in whole or in part, the financial risk associated with a future change in any such value ... **without also conveying a current or future direct or indirect ownership interest in an asset** ... or liability that incorporates the risk so transferred ..."[6]

While Dodd-Frank's definition of a swap expressly excludes an agreement that conveys any current or future direct or indirect ownership interest in an asset, the Commissions' proposed "true participation" feature narrows the exclusion by requiring a *specific* and additional type of ownership interest – namely, a beneficial interest – to be transferred under a loan participation in order to exclude it from the definition.

* * *

[6] See Section 721(a)(47) of Dodd-Frank (emphasis added).

Finally, we refer the Commissions to the LSTA Letter and the LSTA's concerns that the "true participation" feature may be subject to varying interpretations, even with respect to LSTA-style participation agreements.

For the reasons outlined above, we believe the requirement of a transfer of beneficial ownership interest does not capture all loan participations, but instead describes only a subset of loan participations and excludes LMA participations entirely. As described above, the central, practical and functional features of all loan participations provide a clear standard for describing participations – those features distinguish loan participations from loan total return swaps and should form the basis of the Commissions' guidance.

<u>Proposed Modifications to Proposed Interpretations</u>

Drawing upon the core features of loan participations outlined above, we and the LSTA propose that the Commissions revise their guidance relating to loan participations in the Proposed Interpretations by providing that they do not interpret the "swap" and "security-based swap" definitions to include loan participations in which:

(i) the purchaser is acquiring a current or future direct or indirect ownership interest in the related loan or commitment;[7] and

(ii) the agreement pursuant to which the purchaser is acquiring such an interest:

(a) is a participation agreement that is, or any similar agreement of a type that has been, is presently, or in the future becomes, customarily entered into in the primary or secondary loan markets;

(b) requires the grantor to represent that it is a lender under, or a participant or sub-participant in, the loan or commitment;

(c) provides that the participant is entitled to receive from the grantor all of the economic benefit of the whole or part of a loan or commitment to the extent of payments received by the grantor in respect of such loan or commitment; and

(d) requires that 100% of the purchase price calculated with respect to the loan or commitment is paid on the settlement date.

[7] We have added the language "or commitment" to the Commissions' original guidance in order to clarify the fact that loan participations are entered into both with respect to outstanding loans and with respect to lenders' commitments to lend and fund letters of credit (*e.g.*, under a revolving credit facility.)

Conclusion

The global syndicated loan market needs further clarity regarding the Commissions' interpretation of the definitions of "swap" and "security-based swap" as applied to loan participations following the issuance of the Proposed Interpretations. As discussed above and in the LSTA Letter, we believe that the "true participation" feature of the Commissions' guidance unintentionally excludes many loan participations that are customarily entered into in the global loan market, and will have the effect of significantly hampering liquidity and increasing uncertainty in the global loan market. Further, we believe the proposed revision to the Proposed Interpretations set forth above will preserve liquidity in and provide clarity for the loan market without jeopardizing the Commissions' ability to effectively regulate loan total return swaps and similar derivative transactions.

We would be pleased to discuss any of the points addressed in this letter. If we can be of further assistance, please do not hesitate to contact me via email at clare.dawson@lma.eu.com or by telephone on 020 7006 2216. Alternatively my colleague Mike Johnstone may be contacted by email at mike.johnstone@lma.eu.com or by telephone on 020 7006 2267.

Yours faithfully

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