Memorandum

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"… Market participants should be able to determine with little doubt whether a loan-based product falls under SEC or CFTC jurisdiction."

An Overview of Dodd-Frank's Treatment of Loan-Based Swaps

By Jennifer Grady and John A. Clark

After two years of uncertainty, joint final rules[1] released by the U.S. Securities and Exchange Commission ("SEC") and the U.S. Commodity Futures Trading Commission ("CFTC") in July have provided important guidance for the loan market about the definitions of "swap," "security-based swap" and other key terms underlying the new derivatives regulatory framework required by the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] In this memorandum, we summarize the Final Rules' treatment of loan-based swaps — particularly, loan total return swaps ("LTRS") and loan credit default swaps ("LCDS").[3] The Final Rules confirm that single-name LTRS and LCDS will be regulated under the Dodd-Frank Act as so-called "security-based swaps" subject to SEC regulation. The Final Rules also provide a complex series of tests for determining whether an LCDS based on an index of loan or borrower names will be deemed a "security-based swap" or a CFTC-regulated "swap."

Even prior to the approval of the Final Rules, there was little question that LCDS and LTRS would be subject to regulation under Title VII of the Dodd-Frank Act. However, it was unclear until now whether certain types of LCDS and LTRS, particularly those referencing a basket or index of loans or borrowers, would be characterized as "security-based swaps" regulated by the SEC or "swaps" regulated by the CFTC. The Final Rules provide guidance regarding these definitional questions and reasonable certainty as to which regulator's rules will apply to various transactions.

Once published in the Federal Register, the Final Rules also will trigger the countdown to compliance dates for myriad other SEC and CFTC rules that affect LCDS and LTRS trading. Although the substance and compliance dates of many of the new regulations are not yet final, market participants should begin to familiarize themselves with the Dodd-Frank Act regime's general reporting, trading, margining and other compliance obligations that will affect LCDS and LTRS transactions.

STATUTORY BACKGROUND

In general, the Dodd-Frank Act bifurcates the universe of swap contracts subject to Title VII regulation between "security-based swaps" (under SEC oversight) and

1 Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Release No. 33-9338; 34-67453; File No. S7-16-11 (the "Final Rules").

2 Pub. L. 111-203 (July 21, 2010) (the "Dodd-Frank Act").

3 In a previous memorandum, we outlined the regulators' explicit exemption of industry-standard loan participations from the definition of a "swap" and regulation keyed to such a designation. See Jennifer Grady & John A. Clark, Clarity for Loan Participations Under Dodd-Frank, July 19, 2012, http://www.rkollp.com/newsroom-publications-241.html.

"swaps" (under CFTC oversight). The Dodd-Frank Act defines a "security-based swap" as a swap that is based on:

> "(I) an index that is a narrow-based security index…;
> (II) a single security or loan…; or
> (III) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer."[4]

The statutory definition above clearly provides that a swap based on a single loan will be classified as a "security-based swap," but it does not expressly include other types of loan-based transactions, including LTRS or LCDS based on multiple loans or borrowers. The commissions were largely silent regarding these definitional questions in their initial proposed rules.[5] Without clearer guidance from the commissions, the definitional ambiguities under the Dodd-Frank Act would have been problematic for many market participants — in particular, those using widely-traded swaps based on the standardized North American LCDS index (LCDX) and the standardized European LCDS index (iTraxx LevX).

In response to the Proposed Rules, The Loan Syndications and Trading Association ("LSTA") filed a comment letter with the regulators in July of 2011 highlighting the definitional concerns above and requesting that the commissions provide a clear set of definitions for loan-based swaps.[6] The LSTA argued that definitional certainty would be essential to enable market participants to prepare for the new regulatory environment and avoid legal disputes regarding the proper regulatory classification of a given contract.

LOAN TOTAL RETURNS SWAPS AND MASTER CONFIRMATIONS

The Final Rules confirm that an LTRS based on a single loan will be treated as a "security-based swap" and clarify that "an LTRS based on two or more non-security loans are swaps, and not security-based swaps."[7] The Final Rules note that the statutory definition nowhere refers to a transaction that is based on the total return of multiple loans and, accordingly, that the statute dictates that an LTRS on two or more loans is a CFTC-regulated "swap." We note that, as discussed below, this treatment differs from the regulators' guidance regarding LCDS referencing two or more loans.

In practice, counterparties desiring LTRS exposure to several loans typically document their trades under multiple individual confirmations subject to a single "Master Confirmation" agreement. In response to a concern raised by the LSTA (among others), the commissions clarified that each such transaction for which a separate confirmation is sent constitutes an individual instrument that must be analyzed independently to determine whether it is a security-based swap. Multiple individual transactions, whether LCDS or LTRS, under a single master agreement or master confirmation "would not constitute a Title VII instrument[8] based on one 'index or group' under the security-based swap definition but instead would constitute multiple Title VII instruments." Therefore, multiple single-name LTRS transactions documented using separate "supplemental confirmations" under a single "Master Confirmation" will be classified as security-based swaps.

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4 Section 761(a)(6) of the Dodd-Frank Act. Generally speaking, a "swap" under CFTC jurisdiction is any Title VII-regulated swap contract that is not a "security-based swap."

5 See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29818 (proposed May 23, 2011) (the "Proposed Rules").

6 Letter from R. Bram Smith, Executive Director, LSTA, July 22, 2011.

7 Final Rules, at 215 (emphasis added).

8 Final Rules, at 222 (footnote omitted).

SINGLE-NAME LOAN CREDIT DEFAULT SWAPS

As expected by market participants, the commissions confirmed that single-name LCDS, whether based on a single loan or a single borrower, will be classified as "security-based swaps" subject to SEC regulation. Loan market participants had widely anticipated this was the case, and the Final Rules ultimately cited both prongs (II) and (III) of the statutory definition to support this characterization.[9]

LOAN CREDIT DEFAULT SWAP INDEX TRANSACTIONS

As noted above, under the Dodd-Frank Act, "security-based swaps" include swaps that reference events relating to a single "issuer of a security" or the "issuers of securities in a narrow-based security index." This portion of the statutory definition is intended to capture credit default swap ("CDS") transactions in which certain credit events relating to the underlying issuer or issuers (e.g., bankruptcy or "failure to pay") trigger settlement obligations under the transaction. Market participants have debated whether LCDS transactions based on an index of loans or borrowers (rather than "issuers of securities") were intended by Congress to be considered "security-based swaps." In addition, even if an index LCDS could be considered a "security-based swap," the Proposed Rules did not explicitly describe when a loan index should be viewed as "narrow-based" for purposes of this classification. The LSTA's July 2011 comment letter sought clarity on these points, and while the commissions did not provide a straightforward test for index LCDS, they did address the ambiguities flagged by the LSTA by providing a discrete road map for index LCDS definitional determinations, which we summarize below.

"Issuers of Securities in a Narrow-Based Security Index" Includes Borrowers

The Final Rules confirmed, first, that LCDS transactions that are based on an index of loans or borrowers should be analyzed under prong (III) of the "security-based swap" definition even though neither loans nor borrowers are specifically referenced in the statutory language.[10] The Final Rules state that prong (III)'s reference to "issuers of securities in a narrow-based security index" includes "an index referencing loan borrowers or loans of such borrowers."[11] Likewise, the rules clarify that an index of loans or borrowers should be tested under the commissions' general rules for determining whether a CDS index of reference entities is "narrow-based."[12] Any borrower named in an index or the borrower of any loan named in an index would be treated as a reference entity for purposes of those rules, provided that, in such cases, any such borrower is an issuer of securities.[13]

As a result, in order to determine whether an LCDS index transaction will be classified as a swap or a security-based swap, market participants must analyze whether the index is classified as "narrow-based" by applying a series of tests provided by the commissions.

Defining "Narrow-Based"

The Final Rules include extensive tests designed to determine whether a CDS that references an index, including an index composed of borrowers or loans, is "narrow-based" for purposes of analyzing whether such a swap will be regulated as a "security-based swap." While the rules are lengthy and complex, below we summarize key concepts of the "narrow-based" tests for loan indexes.

In general, an index of loans or borrowers will be

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9 Final Rules, at 219-20.

10 Final Rules, at 246.

11 Rule 1.3(zzz)(1) under the CEA; rule 3a68-1a(a) under the Securities Exchange Act of 1934 ("Exchange Act").

12 See rule 1.3(zzz)(3)(iii) under the CEA and rule 3a68-1a(c)(3) under the Exchange Act (defining "reference entity" to include, inter alia, "an issuer of securities that is a borrower with respect to any loan identified in an index of borrowers or loans") (emphasis added).

13 In explaining their view that prong (III) applies to LCDS referencing loans, the commissions noted that most borrowers are "issuers of securities" on the basis that they are corporate entities that technically issue securities, even if only to one or a small group of shareholders. See Final Rules, at 248 n. 772. The commissions did not, however, provide guidance on how an index's named borrower (or the borrower of a named loan) should be analyzed in the (relatively unlikely) event that such a borrower is not an issuer of securities in any capacity.

characterized as "narrow-based" if it satisfies any one of four specified criteria:

Number and Concentration of Index Components: The first three criteria focus on the number and concentration of index reference entities (i.e., borrowers, in the case of indexes of loans or borrowers). An index will be deemed "narrow based" if:

- there are nine or fewer "non-affiliated"[14] reference entities;
- the swap's notional amount allocated to the single largest reference entity is weighted more than 30%; or
- the swap's notional amount allocated to any five "non-affiliated" reference entities is weighted more than 60%.[15]

Public Information Availability: The fourth criterion determines whether there is public information available regarding each reference entity of an index.[16] If public information is deemed unavailable with respect to a sufficient number of index reference entities, the index will be "narrow-based" and subject to SEC oversight. A borrower named in an index (or a borrower of a loan named in an index) will satisfy the "public information availability" test if it (or, in some cases, its affiliates) satisfies one or more sub-criteria, including the following:[17]

- It files reports pursuant to the Exchange Act or related regulations;
- The worldwide market value of its outstanding common equity (held by non-affiliates) is $700 million or more; or
- It has outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion.[18]

While the "public information availability" test generally requires each index reference entity to meet at least one of the public information availability criteria above, the test is subject to a de minimis exception — namely, as long as the reference entities that satisfy the test comprise at least 80% of the index's overall weighting, failure by any other component is disregarded, provided that any non-compliant reference entity comprises less than 5% of the index's weighting.[19]

The Final Rules include many other exceptions to the treatment of LCDS indexes discussed above, including special rules for transactions that are subject to mandatory physical or cash settlement.[20] Any party interested in the precise definitional treatment of an LCDS transaction that references an index of loans or borrowers should carefully review the Final Rules or seek the advice of counsel.

CONCLUSION

The SEC and CFTC's Final Rules defining key terms under the Dodd-Frank Act have confirmed the application of a few bright-line tests for determining the regulatory regime applicable to certain LTRS and LCDS products: single-name LTRS and LCDS are "security-based swaps" under the SEC's jurisdiction, LTRS referencing two or more loans are "swaps" subject to CFTC oversight, and multiple single-name LTRS

14 To avoid related entities named in an index from being counted as independent components, the Final Rules require that reference entities be "non-affiliated" for purposes of the number and concentration criteria. For guidance explaining "affiliation" in connection with these criteria, see part III.G.3(b)(ii) of the Final Rules.

15 See generally rule 1.3(zzz)(1) under the CEA and rule 3a68-1a(a)(1) under the Exchange Act.

16 The commissions stated that this criterion was included in order to prevent market manipulation and misuse of material nonpublic information. Final Rules, at 245.

17 This is an abbreviated list of criteria comprising the public information availability test for reference entities. The full list is defined under rule 1.3(zzz)(1)(i)(D) under the CEA and rule 3a68-1a(a)(1)(iv) under the Exchange Act. In addition, the regulators provided a broader "alternative" public information availability test, which is available for transactions executed between two "eligible contract participants" ("ECPs") under the CEA. The "alternative" test can be met if any component of an index satisfies certain additional criteria (e.g., if the reference entity makes information available to the public or to the ECPs pursuant to Rule 144(d)(4) under the Securities Act of 1933.) See generally rule 1.3(zzz)(1)(i)(D)(8) under the CEA and rule 3a68-1a(a)(1)(iv)(H) under the Exchange Act.

18 In its July 2011 letter, the LSTA noted that the public information availability test may be inappropriate for loan-based indexes in general because borrowers referenced in such indexes may be more likely to be "private" companies that are not required to publicly disclose financial or other information. While the commissions did not conclude that LCDS indexes should bypass the public information test, they stated that because the modified rule adds loans (other than revolving facilities) to the outstanding indebtedness criterion, indexes referencing private borrowers "may be more likely to satisfy the public information availability test." Final Rules, at 274.

19 See Final Rules, at 263.

20 See, e.g., part III.H of the Final Rules.

transactions documented on separate confirmations subject to a "Master Confirmation" are multiple "security-based swaps." As such, the rules provide a handful of clear answers to jurisdictional questions for the most basic loan-based swaps.

While there are no such bright-line tests for loan index swaps, the commissions have provided sufficient guidance to enable loan market participants to analyze such transactions. LCDS index products will be characterized as "swaps" or "security-based swaps" depending on whether they reference an index of borrowers (or loans relating to borrowers) that is deemed "narrow-based." The "narrow-based" criteria are lengthy, complex and subject to multiple technical exceptions, and include a "public information availability" test that requires at least some knowledge of borrowers' financial disclosures or capital-raising activities. Where the compositions of indexes periodically turn over or are refreshed, market participants will need to be aware that the definitional treatment of transactions referencing such indexes may need to be reconsidered at the time of each new index LCDS trade.

With the Final Rules in hand, market participants at last have a definitive framework for analyzing index LCDS, giving all loan-based swaps a measure of definitional clarity that had been lacking. In most cases, market participants should be able to determine with little doubt whether a loan-based product falls under SEC or CFTC jurisdiction. Identifying a product's regulator, however, is only the first step. The biggest challenge — preparing for compliance under the extensive Title VII regulatory framework — is yet to come.

QUESTIONS

If you have questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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