Memorandum

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Clarity for Loan Participations Under Dodd-Frank

By Jennifer Grady and John A. Clark

"To the relief of the loan market, the Final Rules clarify that loan participations commonly used in the secondary market will not be regulated as 'swaps.'"

Although the syndicated loan market was not a focus of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[1] the legislation introduced uncertainty regarding whether loan participations would be regulated as swaps. In response, loan industry organizations, including The Loan Syndications and Trading Association ("LSTA")[2] and the Loan Market Association ("LMA"),[3] urged regulators to clearly exclude industry-standard loan participations from swap regulation under the Dodd-Frank Act. As of July 10, 2012, both the U.S. Securities and Exchange Commission ("SEC") and the U.S. Commodity Futures Trading Commission ("CFTC") have approved joint final rules and guidance[4] defining "swap" and other key terms central to the Dodd-Frank Act's new derivatives regulatory scheme. To the relief of the loan market, the Final Rules clarify that loan participations commonly used in the secondary market will not be regulated as "swaps."

BACKGROUND

Title VII of the Dodd-Frank Act subjects "swaps" to an array of new regulations, and it defines "swap" broadly to include (among other things):

> "[A]ny 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,…[or] instruments of indebtedness,…and that transfers…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*…"[5]

Participants in the global secondary loan market, including the LSTA and the LMA, were concerned that the statutory "swap" definition could be interpreted to include certain participation agreements used to transfer loans, particularly "LMA-style" participation agreements. Unlike a standard "LSTA-style" participation agreement, which transfers a beneficial ownership interest in the underlying loan, an "LMA-style" participation agreement creates a debtor-creditor relationship under which the grantor is contractually obligated to make payments to the participant equivalent to

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

2 See generally Letter from R. Bram Smith, Executive Director, LSTA, Jan. 25, 2011; Letter from Elliot Ganz, General Counsel, LSTA, Mar. 1, 2011; and Letter from R. Bram Smith, Executive Director, LSTA, Jul. 22, 2011.

3 See generally Letter from Clare Dawson, Managing Director, LMA, Feb. 23, 2011; and Letter from Clare Dawson, Managing Director, LMA, Jul. 22, 2011.

4 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, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071012c.pdf (the "Final Rules").

5 Section 721(a)(47) of the Dodd-Frank Act (emphasis added).

the payments received by the grantor under the loan. A broad reading of the statutory "swap" definition, therefore, could include "LMA-style" participation agreements. The LSTA and the LMA submitted comments to SEC and CFTC staff highlighting these concerns and emphasizing the need for a well-defined exclusion for loan participations from the "swap" definition in order to facilitate the continued smooth functioning of the secondary loan market.

The SEC and CFTC initially addressed this issue in their May 2011 proposed swap product definitions and related guidance,[6] but that guidance created further confusion. The Proposed Rules excluded from regulation any "true participation" pursuant to which the participant acquires a current or future direct or indirect ownership interest in the underlying loan, and limited "true participations" to those agreements under which a participant acquired a "beneficial ownership interest" in the underlying loan. Consequently, the Proposed Rules likely would have classified all LMA-style loan participations as "swaps," since those participations do not transfer a beneficial ownership interest, and could have also created uncertainty for some modified LSTA-style participation agreements. In response to the Proposed Rules, the LSTA and the LMA urged regulators to reject the "true participation" concept in favor of economic and legal distinctions more suitable to distinguishing between loan participations and swaps.

THE FINAL RESULT

The Final Rules reflect, in large part, the LSTA and LMA suggestions. The regulators eliminated the "true participation" requirement while retaining, and explaining more clearly, the requirement that any excluded loan participation must reflect the transfer of a "current or future direct or indirect ownership interest" in an underlying loan or commitment. The regulators cited four characteristics that should be present in any loan participation that purports to effect such an ownership transfer:

- The grantor of the loan participation is a lender under, or a participant or sub-participant in, the loan or commitment that is the subject of the loan participation;
- The aggregate participation in the loan or commitment does not exceed the principal amount of such loan or commitment;
- The entire purchase price for the loan participation is paid in full when the loan participation is acquired, and is not financed; and
- The loan participation provides the participant all of the economic benefit and risk of the whole or part of the loan or commitment that is the subject of the participation.

The commissions stated that their guidance should "prevent disruption in the syndicated loan market for loan participations" and "enable [the global syndicated loan market] to continue operating as it did prior to the enactment of Title VII."[7] The regulators' statements should comfort loan market participants by evidencing their intent to avoid interfering with the traditional function of loan participations in the global loan market.

CONCLUSION

With the SEC and CFTC's release of the Final Rules defining "swaps," loan market participants now have clear regulatory guidance for distinguishing exempt loan participations from regulated "swaps" under the Dodd-Frank Act. While non-standard loan participation structures will continue to require careful analysis under the statute and related guidance, today's market-standard loan participation agreements now appear to be wholly excluded from swap regulation under the Dodd-Frank Act.

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6 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").

7 Final Rules, at 166.

QUESTIONS

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