Memorandum
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Dodd-Frank Crosses the Pond: Unintended Consequences for LMA-Style Loan Participations?

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If America and England are two nations separated by a common language, then the maxim surely applies to the separate (but inter-related) secondary bank loan markets that rely on transfer documentation and trading conventions independently developed in New York and London—and the similarly named but very different legal documents and structures used to transfer thousands of bank loans each day.

In both the US and Europe, the market uses a “participation agreement” to transfer the economic benefits and risks of a bank loan from a seller (the “grantor”) to a buyer (the “participant”). In the US, participation agreements are often modeled on templates published by The Loan Syndications & Trading Association (the “LSTA”) based in New York. In Europe (and often Asia), participation agreements are modeled on templates published by the London-based Loan Market Association (the “LMA”).

Under both LSTA and LMA-style participation agreements, the grantor remains the “lender of record” under the loan agreement, and passes to the participant all loan payments received by the grantor. Under both forms of participation agreement, a participant is often entitled to direct the grantor’s acts and decisions as a lender under the loan agreement.

Nonetheless, there are subtle differences in the structure of the two types of participation agreements, and those structural differences may lead to significantly different regulatory results under new (and potentially far-reaching) US legislation: Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.1 The application of the Dodd-Frank legislative paradigm to LMA-style participations may have significant consequences for participants in the European loan market. And it is not certain that participants in the US loan market using certain non-LSTA-style participation agreements will escape the reach of Dodd-Frank.

LOAN PARTICIPATION: LMA-STYLE AND LSTA-STYLE

In both markets, a participation agreement establishes a contractual relationship between the grantor and the participant, but does not put the participant in “privity” with the borrower or otherwise establish a contractual relationship between the participant and the borrower. A participation agreement does not give the

1 Pub. L. 111-203 (July 21, 2010), hereinafter called “Dodd-Frank” or “the Act.” Title VII is the Wall Street Transparency and Accountability Act of 2010.
conducting a study to determine the extent to which a private right of action should be extended to the types of conduct that Dodd-Frank authorizes courts to consider in SEC and US government actions. Despite the uncertainty, it is reasonable to anticipate that, if an LMA-style participation is a “security-based swap” under Dodd-Frank, then some LMA-style participations will be subject to challenge under US securities laws.

5 Provisions in Dodd-Frank that require rulemaking by the agencies will become effective no less than 60 days after the publication of the final rules, if later than July 16, 2011.

3 There are other forms of LMA participations: risk participation, funded/risk participation, and risk to funded participation. In practice, those forms are rarely used and they are not discussed in this memorandum.

2 The LSTA-style participation is intended to effect a “true sale” of the loan from the grantor to the participant and put the participant’s beneficial ownership interest in the loan beyond the reach of the grantor’s bankruptcy estate. See LSTA Market Advisory – Accounting for the Sale of Participations, available to LSTA members at http://lsta.org/content.aspx?id=7398.

4 This memorandum presumes that Dodd-Frank reaches at least some LMA-style participations, including those where one or both parties are US entities, although the extraterritorial reach of US securities laws is uncertain. Section 929P(b) of Dodd-Frank confers jurisdiction on US courts in antifraud actions brought by the SEC or the US government in either of two circumstances: (i) when a claim involves conduct within the US that “constitutes significant steps in furtherance of the violation even if the securities transaction occurs outside the US and involves only foreign investors”; or (ii) when a claim involves “conduct occurring outside the United States that has a foreseeable substantial effect within the United States.” These provisions of Dodd-Frank in effect limit the decision of the US Supreme Court in the so-called foreign-cubed case, Morrison v. National Australia Bank Ltd. (2010) (which circumscribed the extraterritorial reach of US securities laws) to private actions. Interpretation of the Dodd-Frank provisions on jurisdiction and their intersection with Morrison are subject to debate. Uncertainty is compounded by Section 929Y of Dodd-Frank, which charges the SEC with conducting a study to determine the extent to which a private right of action should be extended to the types of conduct that Dodd-Frank authorizes courts to consider in SEC and US government actions. Despite the uncertainty, it is reasonable to anticipate that, if an LMA-style participation is a “security-based swap” under Dodd-Frank, then some LMA-style participations will be subject to challenge under US securities laws.

For Dodd-Frank, the key structural and legal difference between an LSTA-style participation and an LMA-style participation is whether the grantor grants to the participant (i) an actual beneficial ownership interest in the loan, bare legal title of which will continue to be maintained and held by the grantor, or (ii) a derivative right to receive payments equivalent to those received by the grantor from a third party (the borrower).

IS AN LMA-STYLE PARTICIPATION A “SECURITY-BASED SWAP” UNDER DODD-FRANK?

Dodd-Frank—the US legislative response to the recent financial crisis—seeks, among many other things, to regulate and make transparent the formerly opaque over-the-counter derivatives market. Dodd-Frank becomes effective in July 2011, and ushers in a new framework for the regulation of over-the-counter derivatives.

Under Dodd-Frank, over-the-counter derivatives are generally categorized as “swaps,” “security-based swaps,” or “mixed swaps” (which are both swaps and security-based swaps). The term “swap” refers to a broad array of transactions, excluding a security-based swap. In relevant part, it 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

In contrast, the most commonly used form of LMA-style participation agreement (the “funded participation”), does not confer upon the participant a “beneficial ownership interest” in the loan, but rather creates a debtor/creditor relationship between the grantor and the participant, pursuant to which the participant lends to the grantor (at an agreed price) the money necessary for the grantor to satisfy drawing obligations to the borrower under the loan agreement, and the repayment under such “loan” by the grantor to the participant is limited to amounts that equal payments of principal, interest, and fees that the grantor receives from the borrower.
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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. …” (emphasis supplied)

This part of the “swap” definition focuses on an exchange of payments based on the value of a financial instrument that has the effect of transferring the financial risk without an associated transfer of the ownership interest in, or liability incorporating the financial risk under, such instrument.

An LMA-style participation provides for an exchange of payments (i) from the participant to the grantor—i.e., the purchase price of the loan and amounts equal to the future drawings under the underlying commitments, and (ii) from the grantor to the participant—i.e., amounts equal to the interest, fees and principal paydowns paid by the borrower to the grantor under the loan. The grantor of an LMA-style participation does not grant an ownership interest in the loan to the participant. The grantor often does not provide the participant with rights that would be signs of ownership (e.g., voting rights). Nor does the grantor convey the liability associated with the underlying loan, and the grantor remains obligated to the borrower to fund future drawings, even if the participant fails to fund the grantor under the participation agreement. In light of these features, an LMA-style participation may be found to satisfy the portion of the “swap” definition quoted above.

The term “security-based swap” refers to a transaction that is a “swap” and “is based on … a single security or loan, including any interest therein or on the value thereof …. ” If an LMA-style participation satisfies the portion of the “swap” definition above, then it would likely be characterized as a “security-based swap” because it refers to a single loan.

To make matters more complex, under Dodd-Frank, an LMA-style participation may be considered a “mixed swap.” As suggested by its name, a “mixed swap” has both security-based swap characteristics and swap characteristics. Dodd-Frank defines a “mixed swap” as a security-based swap that “also is based on the value of 1 or more interest … rates, … instruments of indebtedness, …other financial or economic interest … (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence….”

Under an LMA-style participation agreement, the grantor makes interest payments to the participant that mirror the interest received by the grantor from the borrower under the loan agreement. The grantor’s obligation to make this derivative interest payment may lead to the conclusion that the participation is “based on the value of 1 or more interest … rates.”

A better argument may be that any interest that the grantor is obliged to pay to the participant is an essential component of the underlying loan, and should not be considered an additional value-indicator. Accordingly, an LMA-style participation agreement would more likely be considered a “security-based swap” and not a “mixed swap.” However, at this stage in the development of the Dodd-Frank regulatory framework, the correct categorization is not free from doubt.

WHY DOES IT MATTER?

Dodd-Frank confers regulatory jurisdiction over (i) “swaps” to the Commodity Futures Trading Commission (“CFTC”), (ii) “security-based swaps” to the Securities and Exchange Commission (“SEC”), and (iii) “mixed swaps” to both the CFTC and the SEC.

Both the SEC and the CFTC will regulate issues related to eligible counterparties, information flow, and central clearing. However, unless the SEC and the CFTC regulations mesh perfectly—which as a practical matter

6 Another interpretational issue regarding loan-based swaps arises from the inclusion of “instruments of indebtedness” in the definition, and the omission of a reference to “loan” in the carve-out parenthetical. Presumably the legislative intent was not to make all loan-based swaps automatically mixed swaps. But this is far from certain.
is unlikely—any transaction involving a swap subject to
dual regulation by both agencies will be extremely costly
to create, maintain, transfer or terminate.

Assuming for the sake of argument that an LMA-style
participation is a security-based swap, the costs and
potential liabilities associated with transacting with
existing documentation would be great. This is because
Dodd-Frank (i) makes security-based swaps “securities”
for purposes of the US Securities Act of 1933 (“US
Securities Act”) and the US Securities Exchange Act of
1934 (“US Exchange Act”), and (ii) imposes additional sui
generis regulations. There are at least four noteworthy
consequences:

- First, transactions and activities in a security-based
  swap are now made subject to the antifraud and
  anti-manipulation provisions of the federal securities
  laws, including Section 10(b) of the US Exchange Act
  and Rule 10b-5 promulgated thereunder, as well as
  the related new provisions added by Dodd-Frank,
  including the new Section 9(j) of the US Exchange
  Act, and the rules to be promulgated by the SEC
  thereunder.7 If an LMA-style participation is subject
to these provisions, counterparties would be
  prohibited from entering into, elevating, transferring
  or terminating the participation, or possibly
  administering the participation at all,8 while in
  possession of material non-public information
  without first disclosing such information to the
  counterparty or confirming that the counterparty has
  access to the same information. Since the European
  loan market is largely a “private” market, with very
  little public information about borrowers or their
  loan agreements, it is difficult to conceive, at this
time, how parties could transact in loans based on
  public information only, except in the rare case
  where adequate information is publicly available. If
  parties are compelled to trade LMA-style
  participations “on the public side” due to the threat
  of antifraud liabilities under Dodd-Frank, then this
  change could impact a European borrower’s ability
to raise capital in the loan market, its disclosure
  obligations in the capital markets and the liabilities
  of its loan arrangers in the syndication process.
  These changes would likely send a wave of negative
economic feedback across the Pond into the US
  loan markets.

- Second, Dodd-Frank requires certain players in the
  security-based swap markets to be registered with
  and regulated by the SEC as security-based swap
  dealers and major security-based swap
  participants—without the benefit of a robust
  exemption for foreign entities as currently exists
  under Rule 15a-6 under the US Exchange Act for
  foreign broker-dealers. In addition, Dodd-Frank
  mandates central clearing and exchange trading in
  respect of some security-based swaps, and imposes
capital, margin, reporting, record keeping, position
  limits and business conduct requirements in respect
  of all security-based swaps (depending on the types
  of market participants). It is entirely unclear how
  these rules might be applied to LMA-style
  participations, or whether the rules are even capable
  of being so applied. If applied to LMA-style
  participations, these rules would be extremely
disruptive to the market, especially since LMA-style
  participations have always been considered a “cash”
  product.

- Third, the “sale” of a security-based swap, which
  includes entering into, terminating, amending or
  transferring the security-based swap, will be subject
to the registration requirements of Section 5 of the
  US Securities Act, unless both counterparties are
  “eligible contract participants” as defined in the US
  Commodity Exchange Act.9 For purposes of an

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7 On November 3, 2010, the SEC proposed a new Rule 9j-1 under the US Exchange Act, which would prohibit fraud, manipulation, or deception in connection with the offer, purchase or sale of, or the exercise of any right or performance of any obligation under, any security-based swap, or the avoidance of such exercise or performance.

8 Under proposed Rule 9j-1, it would seem that either party to the participation may be subject to antifraud liability if it fails to disclose material information in connection with the exercise of any right or performance of any obligation under the participation, or the avoidance of such exercise or performance. In effect, under this reading of the Rule the parties may be required to have access to the same information (unless immaterial, which is a highly uncertain concept at least in this context) throughout the life of the participation.

9 The definition of “eligible contract participant” is complex. In essence it includes a person that is, among other things and subject to additional conditions, (i) a financial institution, (ii) an insurance company (iii) an investment company, (iv) a commodity pool that has total assets exceeding $5,000,000, (v) a corporation, partnership or trust that if has assets exceeding $10,000,000 or (vi) has the credit support of a financial institution, insurance company, registered investment company, commodity pool or governmental entity, (vi) certain employee benefit plans, (vii) a governmental entity, supranational government entity, or department or agency of a government, (viii) a registered broker-dealer, (ix) a futures commission merchant, (x) a floor broker or trader, or (xi) an individual who has amounts invested on a discretionary basis exceeding $10,000,000. Many terms used in this definition are in turn defined terms under the US Commodity Exchange Act or other statutes.
LMA-style participation, this likely means that a party could not enter into, elevate, transfer or terminate an LMA-style participation unless both it and its counterparty were “eligible contract participants.” At the very least, grantors of LMA-style participations will need to ensure that their counterparties are “eligible contract participants” and obtain a contractual representation to that effect.

- Fourth, transactions and positions in security-based swaps will be subject to the same regulations applicable to securities under the US Exchange Act, such as margin, capital and books and records requirements applicable to registered broker-dealers. Some of these requirements may overlap or even conflict with the requirements (described above) to be adopted by the SEC by rulemaking prior to the effectiveness of Dodd-Frank.

IS IT CERTAIN THAT AN LSTA-STYLE PARTICIPATION IS NOT A SECURITY-BASED SWAP AGREEMENT?

Unlike an LMA-style participation, an LSTA-style participation does transfer a beneficial ownership interest in the loan. We assume that this transfer will be viewed as conveying an ownership interest and thus “failing” to qualify as a “swap” under the swap definition. On the other hand, “risk participations,” which are a form of participation used in the US secondary bank loan market that do not transfer to the participant a beneficial interest in the loan, more closely resemble total return swaps, and therefore may be more likely to be considered a security based swap.10

CONCLUSION

As Dodd-Frank evolves, LMA-style participations are in danger of being considered “security-based swaps” (or worse, “mixed swaps”) by US regulators. If the LMA-style participation is characterized as a “security-based swap,” its new status will lead to profound changes in the trading activities in the European loan market. The extent of such changes will depend on numerous factors, including (i) the changing notion of the extraterritorial reach of Dodd-Frank and the US securities laws, (ii) the SEC rulemaking applicable to security-based swaps, and (iii) the extent to which such rulemaking meshes with the existing (and new) rules to which loan market participants are otherwise subject.

European loan market participants should consider the effect Dodd-Frank may have on their activities and whether concerted action now, while the US regulators are still consulting on these reforms, is appropriate to obtain needed clarity on the reach and interpretation of key statutory definitions. Alternatively or in parallel, European loan market participants may debate whether the form of participation agreement used in the secondary loan market can proactively be modified to reduce the impact of Dodd-Frank on the very basic business of buying and selling loans.

10 The International Swaps and Derivatives Association, Inc. has already raised some concerns regarding this point; see Comment Letter on Securities and Exchange Commission proposed rulemaking regarding definitions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, File No. S7-16-10 (ISDA, Sept. 20, 2010) [http://sec.gov/comments/s7-16-10/s71610-24.pdf].
QUESTIONS
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