LSTA
ADVANCING THE CORPORATE LOAN MARKET

October 3, 2023

Via Electronic Submission

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: File No. S7-26-22: Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, Investment Company Act Release No. 34746

Dear Ms. Countryman:

The LSTA[1] appreciates the opportunity to submit additional comments on the proposed amendments to the rules for open-end management investment companies ("open-end funds")[2] regarding liquidity risk management ("LRM") programs and swing pricing (the "Proposed Rule").[3]

I. Introduction

We strongly believe, and reiterate,[4] that the proposed elimination of the less liquid investment category and categorizing such assets as illiquid is unnecessary and unwarranted and will harm retail investors. We urge the Securities and Exchange Commission (the "Commission") to reconsider this change, which would have material negative consequences for investors in open-end funds that invest in loans (and as noted by other commenters, would also impact funds utilizing a range of other investment strategies). These consequences include

[1] The LSTA is a not-for-profit trade association that is made up of a broad and diverse membership involved in the origination, syndication, and trade of commercial loans. The 600+ members of the LSTA include commercial banks, investment banks, broker-dealers, credit funds, mutual funds, insurance companies, asset managers, and other institutional lenders, as well as law firms, service providers and vendors. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans. Since 1995, the LSTA has developed standardized practices, procedures, and documentation to enhance market efficiency, transparency, and certainty. For more information, visit www.lsta.org.

[2] "Open-end funds" includes mutual funds and exchange-traded funds ("ETFs").

[3] *Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting*, Investment Company Act Release No. 34746 (Nov. 2, 2022) (the "Proposing Release").

[4] Letter from LSTA to File No. S7-26-22: Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting (Feb. 14, 2023) ("LSTA Letter"), https://www.sec.gov/comments/s7-26-22/s72622-20157336-325683.pdf.

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significant market disruption and fire sales in the loan market in the short term, and, in the long term, the elimination of a viable and useful investment product that has operated for more than two decades without issue. This proposed change would also significantly harm corporate borrowers. Accordingly, we strongly urge the Commission not to move forward with the Proposed Rule with respect to the elimination of the less liquid investments category.[5]

We support the Commission in strengthening liquidity risk management tools for open-end funds, and we believe the less liquid investments category can and should be retained, particularly with additional appropriate tools (i.e., 10% highly liquid investment minimum (HLIM) and the availability of ESAs). Open-end funds already have a robust set of liquidity risk management tools to effectively mitigate liquidity risk and meet investor redemption requests, even while investing significantly in less liquid investments. As noted in the LSTA Letter, we support the Commission's proposal to require that open-end loan funds maintain a HLIM of at least 10% of the fund's net assets.

In further support of enhancing liquidity risk management tools, the LSTA Letter discussed a potential new LRM tool – standardized expedited settlement arrangements ("ESAs")[6] – that would enhance the robust suite of existing tools[7] available to investment advisers to open-end loan funds in meeting redemption requests. This letter is intended as an update on LSTA's efforts to facilitate those arrangements.

We wish to advise the Commission that a standardized ESA has been developed by the LSTA and its interested members that would permit open-end loan funds to *settle sales of loans within three business days after the trade date* where an ESA exists between the fund and the buyer. While open-end loan funds have demonstrated an ability to meet redemptions in all market environments, this tool will further strengthen their ability to meet redemption requests, including in stressed market conditions. The presence of an ESA, however, may not operate to change how the investment is classified under the Proposed Rule because that would depend on facts and circumstances; therefore, we believe it is important to retain the less liquid investment category.

II. Comments

A. Standardized Expedited Settlement Arrangements Represent an Additional Tool Enhancing the LRM Toolbox.

1. Current Use of Expedited Settlement Mechanisms.

[5] *See* LSTA Letter at pp. 11-14 (discussing the significant harms that would be caused by eliminating the less liquid investment category).

[6] The Commission in parts of the Proposing Release referenced "contract for expedited settlement" and, as we will discuss further below, the standardized ESA is a broader more systematic tool.

[7] Open-end funds currently manage liquidity through, among other methods, sales of portfolio investments, cash buffers, lines of credit, and interfund lending.

Currently, as highlighted in the LSTA Letter, advisers can manage liquidity by agreeing with one or more of their counterparties that their loan sale will settle on an expedited basis, including in stressed conditions.[8] Expedited settlement arrangements enable funds to receive the cash from the sale of a loan in a shorter period as compared to a typical loan trade. Advisers can agree with their buyer counterparties at the time of the relevant loan trade that it will settle on an expedited basis. The parties will then settle the loan trade by one of two methods – (i) as an assignment or (ii) as a participation – and in either case the selling fund receives the cash from the loan sale within a short, certain timeframe, generally on or before T+3. Today, open-end loan funds do not typically have contractual arrangements in place; funds will request expedited settlement at the time of trade and the buyer will agree on a best-efforts basis. The ESA will enable expedited settlement on a far more systematic basis, providing for an additional, reliable LRM tool to meet redemption requests for open-end loan funds.[9]

As described in the LSTA Letter, when loan trades settle on an extended basis it is typically due to the need for the borrower to consent to the loan transfer. Most loan transfers require the borrower to consent to the transfer at the time of settlement by "assignment" (unless the buyer is an existing lender or an affiliate of an existing lender). Mechanically, a loan sale can settle quickly due to the ability to settle by participation. It is rare that borrower consent is required to settle a loan trade as a "participation."[10] So long as certain requirements are met, such as having a pre-agreed participation agreement in place, the seller of a syndicated loan can settle that trade with a buyer as a participation any time after it enters into the trade and without obtaining consent. Therefore, in an expedited settlement arrangement where the seller and buyer agree to the loan participation option at the time of trade, the open-end loan fund is contractually certain to receive the cash from the sale within the expedited time frame.

2. Standardized ESAs.

The LSTA has worked with its interested members to develop an ESA – standardized expedited settlement arrangement – designed for use when an open-end fund is selling loans to

[8] Indeed, the Commission is aware of this practice and included specific questions on how the proposed amendments to the rules may impact the use of contractual expedited settlement. *See, e.g.,* Proposing Release at Questions 17 and 18.

[9] We recognize that there may be circumstances in which advisers may take an ESA into account when classifying assets; this determination will depend on the facts and circumstances and the adviser's liquidity management procedures. However, as an optional tool, it is not clear the existence of an ESA permits loans to broadly meet the "moderately liquid investment" definition, as proposed.

[10] When a loan is sold and settled as a participation, the buyer or "participant" receives economic exposure to the loan but does not become a lender of record. The trade counterparties typically execute a trade confirmation and then enter into a participation agreement which governs the relationship between the buyer/participant and the seller or "grantor." That participation agreement provides for the transfer of 100% beneficial ownership interest in the loan to the participant and the grantor retains bare legal title. The grantor continues to be the "lender of record" (i.e., a "lender" as defined in the credit agreement), so the participant has a direct relationship with the grantor and no direct relationship to the borrower. A participation generally is then elevated to an assignment as rapidly as is feasible.

meet redemptions.[11] In developing the ESA, the LSTA and its members focused on several key considerations: 1) leverage the informal expedited settlement practices that have proven effective for open-end loan funds, 2) eliminate the variables that would delay settlement, and 3) seek to minimize the potential operational risks of outstanding participations. The main elements of the ESA are described below:

ESA Pre-conditions:

- An **ESA Agreement** is executed by the dealer and an investment adviser on behalf of its open-end funds. The ESA Agreement sets forth the contractual relationship between the dealer and each fund and the obligations of each party to ensure expedited settlement. The LSTA has developed a form of ESA Agreement that can offer market consistency and bring efficiency to the negotiation process.

- An **Expedited Settlement Master Participation Agreement** is executed by the dealer and the adviser on behalf of its open-end loan funds. The use of a pre-negotiated Master Participation Agreement can ease and standardize the expedited settlement process because it allows ESA trades to settle by participation without negotiation and, by design, by simply completing a schedule on which the relevant trade details are set forth. The LSTA has developed a form of Expedited Settlement Master Participation Agreement based on its existing form of Participation Agreement which is used widely in the loan market.

- Dealer completes Know Your Customer and any other relevant internal approvals on the funds identified in the ESA Agreement.

The ESA Timeline:

- The open-end fund offers to sell one or more loans to a dealer. At the time of trade, the fund explicitly elects "expedited settlement" and if the dealer agrees to buy the loan(s) there is a binding trade in which expedited settlement is a material term included in the trade confirmation documenting the trade.

- Per the terms of the ESA Agreement and the trade itself, the parties will attempt to settle by assignment on or before T+3. However, if the parties are unable to settle by assignment in that timeframe, the trade will settle by participation. In either case, the selling fund receives the cash from the trade by T+3.

Mitigation of Operations Risk:

- The loans eligible to be traded pursuant to an ESA are fully funded, performing U.S.-dollar term loans. These are characteristics of the vast majority of U.S. institutional term loans and sales of these loans are the easiest to settle.

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[11] In implementing an ESA the relevant adviser and dealer may choose to customize certain elements of the ESA, but the availability of an industry standard base template is anticipated to significantly streamline the negotiation process and promote consistency.

- For similar reasons, the governing credit agreement of a loan eligible for an ESA trade cannot require any consent or notice for a loan transfer settling by participation.

- An ESA trade must be settled on an electronic settlement platform. The LSTA is working with electronic settlement platforms to build the schedule (based on the LSTA's form) which would be used for each ESA trade settling by participation. This would allow the loan trade to settle as an assignment or participation on the platform.

- The use of participations in expedited settlement arrangements is best viewed as an interim step on the way to ultimately settling the loan trade as an assignment – a step which permits the fund to receive the cash from its loan sale very quickly. However, participations require administration by the selling fund, e.g., passing on notices and interest payments to the buyer. The ESA includes provisions that are intended to limit the amount of time that a participation is outstanding before it is "elevated" to an assignment, i.e., the agent consents to the trade, accepts the assignment agreement and updates the loan register to reflect that the buyer is a lender of record.

<u>Cost of the ESA:</u>

- To compensate the dealer for both the quick conversion of the loan sale into cash and the possibility that the loan sale may settle as a participation which could increase the operational burden on the dealer, it is anticipated that trades settled under an ESA would be subject to a fee. The fee will be negotiated by the parties, but the fee structure set forth in the LSTA's ESA Agreement is an agreed-upon number of basis points on the principal amount of the loan being traded. Our understanding is that where expedited settlements have been used on an informal basis and a fee has been paid, 12.5 basis points has been the reported cost.

III. Conclusion

Importantly, open-end loan funds have consistently demonstrated their ability to meet redemptions in a wide range of economic and market environments, including stressed conditions, without dilutive effects due to existing tools. The LSTA, nevertheless, supports additional tailored measures to address liquidity risk and to enhance LRM programs to increase the resiliency of open-end loan funds in stressed market conditions and further ensure that investor redemptions are met. This is why we support the Proposed Rule's requirement of a 10% HLIM for open-end loan funds. In addition, we work continually with our members to develop additional anti-dilution tools to equip fund advisers with options to address various liquidity scenarios; the standardization of ESAs is such an example. We believe that these tailored enhancements, in addition to all the ways that open-end funds currently manage liquidity risk, provide many benefits and none of the harms that would result in eliminating open-end loan funds. We strongly recommend that the Commission consider this approach by maintaining the less liquid investment category.

The LSTA appreciates this opportunity to provide further comment and stands willing to provide additional information in person or in writing. Please feel free to contact me at (212) 880-3006 (tvirmani@lsta.org).

Sincerely,

Tess Virmani
Deputy General Counsel – Co-Head Policy