LSTA
THE LOAN SYNDICATIONS AND TRADING ASSOCIATION®

December 23, 2010

Via Electronic Mail (rule-comments@sec.gov)

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: File Number S7-32-10 - Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps

Dear Ms. Murphy:

The Loan Syndications and Trading Association ("LSTA") appreciates the opportunity provided by the Securities and Exchange Commission ("SEC" or "Commission") to comment on proposed Rule 9j-1 ("Proposed Rule"), promulgated under the Securities Exchange Act of 1934 ("Exchange Act").[1/] The Proposed Rule is intended to prohibit fraud, manipulation and deception in connection with the offer, purchase or sale of, and the exercise of any right or performance of any obligation under, a security-based swap. We hope our views assist the Commission as it considers public comments and completes the rulemaking process.

I. Overview

The LSTA is a not-for-profit trade association with a broad and diverse membership[2/] involved in the origination, syndication, and trading of commercial loans, as well as in the purchase and sale of protection against the default risk of borrowers through loan credit default swaps ("LCDS") and the replication of cash flows and various deliveries involved in holding a loan through loan total return swaps ("LTRS").[3/] 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

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1/ *See* Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, Exchange Act Release No. 63,236, 75 Fed. Reg. 68,560 (Nov. 3, 2010) ("Proposing Release").

2/ The 320 members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers, and other institutional lenders, as well as service providers and vendors.

3/ Because Section 761(a)(5) of the Dodd-Frank Wall Street Reform and Consumer Protection Act defines "security-based swap" to include a swap based on "a single security or loan, including any interest therein or on the value thereof," the Proposed Rule would apply to LCDS and LTRS.

transactions in loans and loan-based instruments. Since 1995, the LSTA has developed standardized practices, procedures, and documentation to enhance market efficiency, transparency, and certainty.

The LSTA strongly supports the principles underlying new Section 9(j) of the Exchange Act, as added by Section 763(g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Section 9(j) makes it unlawful for any person "to effect any transaction in, or to induce or attempt to induce the *purchase or sale* of, any security-based swap in connection with which such person engages in any fraudulent, deceptive, or manipulative act or practice, makes any fictitious quotation, or engages in any transaction, practice or course of business which operates as a fraud or deceit upon any person."[4/] Such misconduct is unacceptable in all of our capital markets and should be prohibited.

Designed to apply specifically to security-based swaps, the Proposed Rule incorporates antifraud and anti-manipulation language from Exchange Act Section 10(b) and Rule 10b-5 thereunder and Section 17(a) of the Securities Act of 1933 ("Securities Act").[5/] Notably, however, the Proposed Rule expands that language to encompass all rights and obligations during the life of a security-based swap and thereby imposes liability on a significantly broader set of activities than those traditionally viewed as occurring in connection with the purchase or sale of a security. Therefore, while Dodd-Frank calls for regulation of the "purchase or sale" of security-based swaps (and broadens the definitions of both "purchase" and "sale" with respect to security-based swaps),[6/] the Proposed Rule goes much further and explicitly reaches activity in connection with the "exercise of any right or performance of any obligation under" a security-based swap, which the Commission states would include conduct involving the "reference underlying" of the security-based swap.[7/]

While we appreciate the Commission's determination to develop an antifraud rule tailored to security-based swaps, we have significant concerns about the breadth and ambiguity of the Proposed Rule and the detrimental effects that it would have not only with respect to the market

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4/ Pub. L. No. 111-203, 124 Stat. 1376 (2010) (emphasis added).

5/ We note that because Dodd-Frank amends the definition of "security" in the federal securities laws to include security-based swaps, security-based swaps will be subject to all of the general antifraud and anti-manipulation provisions of the federal securities laws, including Section 10(b) of the Exchange Act, which prohibits direct and indirect manipulative and deceptive practices in connection with the purchase or sale of securities, and Section 17(a) of the Securities Act, which prohibits direct and indirect fraudulent, deceitful, and misleading practices in connection with the offer or sale of securities. *See* Proposing Release at 68561, 68561 n.4.

6/ *See* Dodd-Frank §§ 761(a)(3) and (4) (amending the definitions of "purchase" and "sale").

7/ In the Proposing Release, the Commission expresses its view that extending the scope of the Proposed Rule to these activities is necessary because payments and deliveries are made between parties after the purchase of the security-based swap. We note, however, that traditional securities may also involve call features, dividend payments, interest payments, and other rights and obligations that may be exercised or performed after the purchase of the security. Yet the antifraud laws and Commission rules applicable to securities do not attempt to regulate these activities.

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for security-based swaps, including LCDS[8/] and LTRS, but generally on syndicated lending. In particular, we are concerned that the Proposed Rule will interfere with legitimate activity in the LCDS and LTRS markets and with prudent lending and banking practices regarding syndicated loans, and might ultimately discourage bank and non-bank lenders from participating in these activities or reduce the extent of their participation.[9/]

We urge the Commission to consider and address these concerns prior to taking any final action with respect to the Proposed Rule. To this end, we agree with the joint letter submitted by the Securities Industry and Financial Markets Association ("SIFMA") and the International Swaps and Derivatives Association, Inc. ("ISDA") and their request that the Commission give further consideration to the differences between the security-based swaps market and the traditional securities market and to the complexities of the security-based swaps market, before adopting an anti-manipulation and antifraud rule regarding security-based swaps. Such additional consideration will better position the Commission to construct a rule that avoids triggering significant adverse effects on the market for security-based swaps and on the ability of banks and other lenders to make and maintain syndicated loans. Most importantly, we urge the Commission to craft any final rule to permit lenders to exercise their rights and remedies and to modify, forebear and waive provisions under credit agreements without regard to the effect that those actions may have on existing LCDS, LTRS or CDS position(s). Banks and lenders generally must be permitted to manage their lending and credit risk management activities without worrying that decisions or actions taken with respect to loans and lending facilities will be second-guessed because of their potential effects on related security-based swaps.[10/] The

8/ While the derivatives work of the LSTA focuses primarily on LCDS rather than credit default swaps ("CDS") generally, we note that many of the concerns we raise in this letter apply not only to LCDS, but also to CDS. CDS and LCDS resemble each other in most respects, with the primary difference being that under a CDS contract, the buyer of credit protection may deliver both bonds and loans (in either case, usually for payment at par) to the seller of credit protection upon a credit event (e.g., bankruptcy, failure to pay principal or interest, etc.) with respect to the underlying reference entity. Under LCDS, the buyer of credit protection may only deliver loans. Under both types of contracts, a failure to pay under either a bond or a loan may result in a credit event and subsequent settlement of the contract.

9/ Syndicated loans are a dependable way of providing large amounts of financing to businesses. For more than 50 years, syndicated lending has been integral to the support of thousands of companies and their projects and employees in the U.S. By definition, syndicated loans -- which provide $2.5 trillion of financing (in loans and commitments) -- are loans made to corporate borrowers in amounts of $20 million or more by an initial group of at least three lenders. *See* Joint Release, "Credit Quality of the Shared National Credit Portfolio Improved in 2010," (Sep. 28, 2010), available at: http://www.federalreserve.gov/newsevents/press/bcreg/20100928a.htm.

10/ In this regard, we further urge the Commission to make clear that the Rule, when finally promulgated, does not create a private right of action. The existence of a private right of action is a matter of congressional intent and, here, the plain language of Section 763(g) of Dodd-Frank shows no intent to create such a right for a violation of Section 9(j) or any rules promulgated thereunder. Moreover, Section 9(e) of the Exchange Act expressly permits a private right of action for violations of certain subsections of Section 9, but Dodd-Frank does not amend Section 9(e) to include a private right of action for violations of subsection (j). In the absence of clear congressional intent, courts will not infer a private right of action from a statute. *See Thompson v. Thompson*, 484 U.S. 174, 179 (1988) ("[U]nless congressional intent to allow a private right of action 'can be inferred from the language of the statute, the statutory structure, or some other source, the essential predicate for implication of a private remedy simply does not exist.'" (quoting *Northwest Airlines, Inc. v. Transport Workers*, 451 U.S. 77, 94 (1981))).

alternative could result in a gross distortion of business behavior in the loan markets, deprive lenders of the customary protections provided to them in credit agreements, and jeopardize safe and sound lending and banking practices. It could also discourage lenders from entering into forbearance and workout arrangements that prevent borrower bankruptcies and could make credit more difficult and expensive for corporate borrowers to obtain.

II. By introducing considerable uncertainty into the markets for security-based swaps and the reference underlying, the Proposed Rule would deter market participants from legitimate market and business activity and lead to a reduction in syndicated loans that are critical to corporate borrowers.

While the Commission concludes that a broad rule against misconduct relating to the exercise of rights or the performance of obligations is necessary to avoid undermining investor confidence in the integrity of the security-based swaps market, the Proposed Rule would itself create uncertainty that undermines investors' willingness to enter that market. In addition, apprehension about triggering allegations of fraud or manipulation under this broad rule through routine business decisions in areas unrelated to the trading of security-based swaps or to actions that may occur during the life of a security-based swap is likely to distort both rational behavior in the market for security-based swaps and the markets for the reference underlying.

The Proposed Rule would be particularly onerous on banks and other lenders who provide syndicated loans and are parties to, or make markets in, security-based swaps. As we discuss below, the Proposed Rule creates additional complexity and risk to lender groups because credit agreements are heavily negotiated to provide lenders with rights and remedies to protect their exposure to borrowers. Lenders' ability to exercise and enforce those rights and remedies is critical to the credit analysis of making and maintaining the facility and/or loan. At the same time, a robust LCDS and LTRS market is important to lenders' ability to hedge and finance these syndicated loans. The difficulty of implementing the Proposed Rule in the LCDS and LTRS market and the threat of liability could lead to less effective hedging and risk management activity and alter the manner in which lenders and borrowers have traditionally worked together to avoid costly bankruptcies and liquidations. A lender's uncertainty regarding its ability to exercise its rights and remedies under credit agreements without triggering significant exposure under the Proposed Rule could also lead to the unintended consequence of dissuading the potential lender from entering into a syndicated credit facility.

A. The ability of lenders to exercise their rights or remedies under credit agreements will be constrained by the uncertainty that routine business decisions could be recharacterized as manipulative of related security-based swaps.

Lenders will be reluctant to enter into security-based swaps because routine business decisions with respect to the underlying loan facilities may be construed as misconduct. The Commission notes that in bringing enforcement actions under Rule 9j-1, it will consider "the extent to which the effect of the misconduct on one or more security-based swaps is foreseeable to the party engaging in the misconduct or the purpose or the interest of that party."[11/] Because a security-based swap is by definition a swap based on "a single security or loan, including any interest therein or on the value thereof" or "the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer,"[12/] activity involving the reference underlying may frequently affect the value of the security-based swap and hence the exercise of a right or performance of an obligation under the security-based swap.

Lenders will be worried that if they enter into an LCDS or LTRS (or indeed a CDS) relating to the borrower, their ability to exercise their rights under a credit agreement or to waive any such right might be impaired throughout the term of the security-based swap. Because security-based swaps involve ongoing payments or deliveries, any decision a lender may make or action that it may take that, for example, allows a borrower to avoid a bankruptcy filing or payment default could be construed as manipulation in connection with the subsequent exercise of a right or performance of an obligation (whether such action is volitional or non-volitional).

This concern is acute when the reference underlying is a syndicated loan because syndicated loans have historically provided banks and lenders with extensive rights and remedies, including the ability to amend the terms of the credit agreement. Lending facilities, including syndicated credit facilities, are deliberately structured to provide lenders with protection and flexibility to call defaults in advance of a bankruptcy of the borrower, to waive events of default, or to require or permit a borrower to restructure the loan. These terms also benefit borrowers who look to their lender relationships for the ability and flexibility to renegotiate the terms of their loans, restructure their debt, and work through troubled situations.

If the Proposed Rule were adopted, a lender, when making a decision with respect to its rights or remedies under the credit agreement or considering a request from the borrower for consent, waiver or amendment, would have to assess whether and how its decision could affect the exercise of a right or performance of an obligation under an existing LCDS or LTRS, including the avoidance of such exercise or performance. Accordingly, a lender that has purchased protection under an LCDS would not be able to call an event of default or decline to amend the credit agreement or renew a line of credit without assuming the risk that its decision could be deemed – or alleged to be – manipulative. Similarly, if a lender has sold protection under an LCDS, the lender would not be able to grant any request from a borrower to waive an event of default and/or amend the credit agreement without taking the risk that consenting to such a request could be deemed – or alleged to be – manipulative. In order to avoid actions that could be second-guessed, some lenders may make decisions regarding the loan that it would not have made in the ordinary course of business; others may resort to less effective hedging mechanisms in order to avoid taking positions in related security-based swaps. This is not a theoretical concern in the loan market; Standard & Poor's LCD tracked more than 540 amendments for leveraged companies between January 2009 and November 2010. It would be highly disruptive

[11/] *See* Proposing Release at 68,564.

[12/] See Dodd-Frank § 761(a)(5) (defining "security-based swap").

to the loan market if lenders were required to undertake an extensive analysis on the impact of each amendment on any possible LCDS or LTRS position (or CDS position) that a lender may have.

Where a lender who also acts as a security-based swap dealer maintains offsetting positions in security-based swaps referencing the same loan, the Proposed Rule would expose the lender to liability regardless of how it exercises its rights with respect to the loan. For example, a security-based swap dealer may, via LCDS, sell credit protection to one customer and buy credit protection from another customer as part of its expected role as a dealer. In those circumstances, any action that the lender takes in connection with the underlying loan (or avoids taking), may be favorable to the interests of one customer but unfavorable to the other.

Reluctance to enter into security-based swaps where a lender has a position in the loan may undermine routine hedging strategies and prudent risk management activities and discourage lenders from participating in the LCDS or LTRS markets. The Proposed Rule may also have the effect of depriving the markets of dealers in these swaps. The reduced ability of lenders to hedge their exposure with swaps could reduce the availability, or increase the cost, of credit to borrowers. Moreover, the failure to take constructive action with respect to a borrower may subject an individual lender to claims of lender misconduct from either the borrower or its co-lenders.

We therefore reiterate our request that any rule that the Commission adopts pursuant to Section 9(j) should permit lenders to exercise their rights and remedies, and to modify, forebear and waive provisions, under credit agreements without regard to the effect that those actions may have on the existing LCDS or LTRS.

B. In order to avoid allegations of misconduct or fraud by omission, counterparties may have to disclose proprietary information about their investment and trading activities and other confidential information to each other.

Under the Proposed Rule, a party to a security-based swap could be liable for "obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." Because this negligence-based liability would apply to any payment received or made throughout the life of a security-based swap and since security-based swaps are entered into at various points in time, swap counterparties and dealers will have to consider whether they must continuously disclose proprietary information about their investment and trading activities and intentions to counterparties and in turn, be prepared to receive such information from their counterparties.

Determining what information must be disclosed on a real-time basis will be daunting because it is unclear what information would be "material" to the cash flows, payments, deliveries and other obligations or rights under a security-based swap. For example, if an entity has a substantial position in a distressed asset at the time that it enters into a security-based swap, it would have to consider whether it needs to disclose that position to its counterparty. If after having entered into the security-based swap, the entity is asked to participate in a creditor's committee, it would have to consider whether such participation and voting intentions must be disclosed to its swap counterparty. Similarly, if after having entered into the security-based swap, the entity decides to sell the distressed assets to another creditor, it would have to consider whether such disposal would be material. If the entity concludes that any such information is material, it would have to determine whether and under what circumstances it is permitted to disclose the information to its counterparty. To the extent that the entity's ability to disclose such information is restricted by fiduciary duty, Regulation FD or other law or obligation, the entity may have to insist that the counterparty sign a confidentiality agreement. However, the receipt of potentially material nonpublic information subject to a confidentiality agreement will likely require the counterparty to restrict certain trading and investment activities, and the counterparty may therefore refuse. A refusal by the counterparty to sign the confidentiality agreement and/or to accept such information will put the entity in an untenable position where any action with respect to the security-based swap agreement (such as the performance of an obligation or the receipt of a payment) will expose it to liability under the Proposed Rule.

This process will be further complicated in the context of lenders because credit agreements require borrowers to provide lenders and prospective lenders with certain nonpublic financial information pursuant to a confidentiality agreement. Syndicated loans are negotiated, structured, administered and, as the situation arises, amended on the basis of the borrower providing its lenders with nonpublic information about the borrower's business ("Bank Syndicate Information"). Although lenders generally have access to Bank Syndicate Information, some employees and representatives within lenders ("public side lenders") choose not to receive Bank Syndicate Information because receipt of such information typically triggers restrictions on trading the securities of the borrower.

The Proposed Rule would effectively prevent public and private side lenders from engaging in LCDS or LTRS with each other. Even if the public side lender were to acknowledge that it knowingly declined to receive Bank Syndicate Information, private side lenders would be exposing themselves to the risk that the Commission may charge them with misconduct or fraud by omission for not disclosing the Bank Syndicate Information to the public side lender during the course of the LCDS or LTRS. If public side lenders are no longer able to participate in the LCDS or LTRS market, the diminished ability of public and private side lenders to hedge their loan exposures would invariably lead to a reduction in the number of lenders in the market and an increased likelihood that certain corporate borrowers would find credit to be more difficult and expensive to obtain.

While we request that the Commission reconsider the practicality of applying this information-sharing provision throughout the life of a security-based swap, we specifically request that the Commission craft any final rule to permit parties to an LCDS or LTRS to abide by the negotiated terms of their agreement, including terms relating to the provision or receipt of Bank Syndicate Information, without incurring exposure under the rule.

C. The Proposed Rule may expose lenders to charges of misconduct when they make collateral calls.

Lenders who also provide LTRS typically require counterparties to provide collateral as initial margin and may require counterparties to provide additional collateral at various points during the term of the LTRS. Parties to LTRS agreements often negotiate dispute resolution rights that apply to disagreements regarding the lenders' calculations for collateral, which are based on the value of the loan, market and borrower-specific factors and other risk metrics.

In volatile markets, trading prices of some less liquid syndicated loans may not be as objectively discernable as they are for equity or fixed income securities. In turn, lenders will worry that margin calls on LTRS's based on what they consider to be a reasonable determination of a loan's value may be judged with hindsight as manipulative. Since LTRS providers often maintain a corresponding long position in the syndicated loans for which they provide LTRS, the Proposed Rule may make lenders susceptible to charges of manipulation when they make margin calls, as well as when they otherwise provide marks on such loans. The Proposed Rule could transform routine commercial disputes about valuation into regulatory violations.

As noted above, we ask that any final rule adopted by the Commission permit parties to an LTRS to abide by the negotiated terms of their agreement, including the circumstances and manner in which collateral calls and valuations will be determined. In particular, where the parties have negotiated dispute rights regarding collateral calls and valuations, such disputes should not expose parties to allegations of fraud or manipulation.

D. To ensure compliance with the Proposed Rule, large investors and lenders will have to implement complex and burdensome information gathering and monitoring systems within their organizations.

Because the Proposed Rule could apply to any activity that potentially affects the stream of payments, deliveries or other ongoing obligations or rights between parties to a security-based swap, each party will have to implement controls and mechanisms to track decisions it may take that could affect each such payment, delivery, obligation or right as well as to track changes in its positions in the security-based swap and reference underlying. Even a good faith failure to track such information and analyze it promptly and effectively could be deemed to be actionable misconduct because the Proposed Rule includes a sweeping negligence-based provision prohibiting "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."

Unless reliance upon information barriers is permitted, large investors and lenders that engage in trading or investment activity in various parts of their organization will have to consider the cost and effort required to identify all security-based swaps and related reference underlying held by the organization and to track and coordinate all activity that could affect the purchase, sale, payments, deliveries and other ongoing obligations or rights with respect to security-based swaps and reference underlying. For example, due to existing information barriers and organizational structures, individuals at a lender who are responding to a request for a loan amendment currently may have no interaction with those individuals at the lender who are responsible for executing or managing the lender's LCDS or LTRS transactions. Nonetheless, as noted previously, under the Proposed Rule, the very existence of such LCDS or LTRS positions could severely impact the decision of the individuals at the lender who are responding to the loan amendment request. Accordingly, a lender would have to first determine whether any part of its organization had an exposure to LCDS/LTRS of the borrower, and then its decision with respect to the amendment would have to be colored by all such positions. Not only would the effort to impose such coordination be enormous, but it could also undermine the efficacy of information barriers that many large investors and lenders have established to comply with various regulatory requirements. At the same time, the consequences of uncoordinated activity could be disastrous. In some cases, the lender may be barred from exercising a contractual right with respect to a large exposure in a syndicated loan or even selling the syndicated loan because of the potential impact that the exercise or sale may have on an insignificant position in swaps that another part of the lender has acquired.

At a minimum, any rule adopted by the Commission should recognize the use of information barriers. We also request that the Commission consider excluding certain risk management activities, such as macro-hedging and dynamic hedging from the scope of any final rule.

III. Scope of the Proposed Rule

Section 9(j) provides that it "shall be unlawful for any person . . . to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security-based swap." Through Dodd-Frank, Congress also amended the definitions of "purchase" and "sale" for security-based swaps to include the execution, termination, assignment, exchange, similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap.[13/] Despite the lack of evidence in either Section 9(j) or the amended definitions that Congress intended to give the Commission authority to broadly regulate the status of or issues relating to the "exercise of any right or performance of any obligation under" a security-based swap, the Proposed Rule reaches well beyond purchases or sales to conduct related to such exercise or performance under a swap agreement, including conduct involving the reference underlying.

While we recognize that the authority under Section 9(j) to prescribe rules "reasonably designed to prevent" fraudulent activity gives the Commission latitude to adopt prophylactic rules that encompass more than the core activity prohibited, even this broader rulemaking authority must be rationally and closely tied to the statute and its purposes. It is not clear to us that the Proposed Rule meets this requirement because Section 9(j) is not intended to reach fraud, as traditionally defined, in areas so far beyond the "purchase" or "sale," as those definitions are amended, of security-based swaps. As discussed above, we are concerned about the broad reach of the Proposed Rule over the performance of obligations under swap agreements and activities involving commercial loans, especially syndicated lending.

[13/] *See* Dodd-Frank §§ 761(a)(3) and (4) (amending the definitions of "purchase" and "sale").

IV. Conclusion

We appreciate the opportunity to share our views on the Proposed Rule. While we support the Commission's ongoing effort to combat fraud, manipulation, and deception in connection with the purchase and sale of security-based swaps, we strongly believe that an approach as broad as that taken by the Proposed Rule would result in significant adverse impact on the markets for security-based swaps and reference underlying. In particular, we believe the Proposed Rule should be carefully drafted to avoid undermining prudent and sound lending and banking practices.

We would be pleased to discuss our views further with you and to provide you with any additional information you believe would be helpful in your consideration of this matter. Please feel free to direct any questions you have in this regard to the undersigned.

Sincerely,

R Bram Smith

R. Bram Smith
Executive Director
The Loan Syndications & Trading Association

cc: Mary L. Schapiro, Chairman
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