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Further Definition of "Swap", "Security-Based Swap", and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping[1] - Treatment of Loan Index Swaps

Dear Mr. Stawick and Ms. Murphy:

Allen & Overy LLP respectfully submits these comments in response to the above-referenced joint release (the **Product Rules**) by the Securities and Exchange Commission (the **SEC**) and the Commodity Futures Trading Commission (the **CFTC**, and together with the SEC, the **Commissions**). The Product Rules further define, and provide interpretive guidance around, key definitions in the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] (the **Dodd-Frank Act**). In particular, the Product Rules provide additional guidance with respect to the swap and security-based swap definitions and include various criteria to be used in determining whether an index is a "narrow-based security index"[3], one of the concepts used in the Dodd-Frank Act to distinguish between swaps and security-based swaps.

We appreciate the Commissions' attempt to provide additional guidance regarding the scope of these key definitions. The Product Rules, however, do not, in our view, sufficiently address a number of areas of continuing ambiguity. In particular, this letter focuses on the treatment of Title VII instruments that reference or otherwise track portfolios or indices composed of loans (such instruments, **loan index swaps**). We believe that additional guidance is merited to provide market certainty and ensure that loan index swaps are subject to clear, but not duplicative, regulation by the appropriate Commission. Without further clarity from the Commissions,

[1] 76 Fed. Reg. 29,818 (May 23, 2011).
[2] Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[3] See generally Product Rules at Section III.G. ("The Term 'Narrow-Based Security Index' in the Security-Based Swap Definition").

this issue will compound the confusion that the Dodd-Frank Act's bifurcation of the credit derivatives market has brought to the U.S. financial markets.

1. STATUTORY DEFINITIONS OF "SECURITY-BASED SWAP" AND "NARROW-BASED SECURITY INDEX"

As the Commissions note in the Product Rules, the Dodd-Frank Act defines the term security-based swap to include a swap that is based on a "single security or ***loan***"[4] or "an index that is a narrow-based ***security*** index"[5] (emphasis added). The third prong of the definition of security-based swap also includes event-based swaps that are contingent on events that occur with respect to "the issuers of securities in a narrow-based ***security*** index"[6] (emphasis added).

The Dodd-Frank Act does not amend the definition of the term "narrow-based security index" to include loans. Therefore, while the Dodd-Frank Act expressly references swaps based on a single loan in its definition of security-based swap, it does not on its face address the characterization of a Title VII instrument based on more than one loan or expressly categorize a Title VII instrument that is contingent on events that occur with respect to more than one loan borrower, at least not to the extent such borrowers are not also "issuers of securities". Thus, under a strict statutory reading, a credit default swap (or a total return swap) that references *one* loan would be treated as a SEC-regulated security-based swap, while a similar Title VII instrument that references *two* loans would be treated as a CFTC-regulated swap. Furthermore, a similar Title VII instrument that references two *securities* would be treated as a SEC-regulated security-based swap. This would result in functionally and potentially economically similar products being treated in an arbitrarily different way, contrary to the spirit of the Dodd-Frank Act.[7]

The Commissions note that the Product Rules have been issued to set forth "new narrow-based security index criteria with respect to indexes composed of securities, ***loans***, or issuers of securities referenced by an index CDS"[8] (emphasis added). In the Product Rules, the Commissions have proposed modifying the criteria applicable to indices composed of debt securities to determine whether a credit default swap is based on a narrow-based security index.[9] Nowhere in the Product Rules, however, do the Commissions address the question of whether an index composed exclusively of loans should be treated as a "narrow-based security index" for purposes of the Dodd-Frank Act's key definitions. Given that the Commissions possess the authority to issue joint definitional rules with respect to both swaps and security-based swaps, we would encourage the Commissions to clarify the treatment of loan index swaps.

2. APPLICATION OF EXISTING "NARROW-BASED SECURITY INDEX" CRITERIA TO LOAN INDEX SWAPS

As the Commissions note, the original statutory definition of "narrow-based security index" was intended to apply to equity securities; the subsequent tests developed for volatility indices and debt securities include refinements specific to those products.[10] Because the Product Rules make no mention of the fact that the statutory definition of "narrow-based security index" does not refer to loans (and there is no basis for inferring

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[4] See Dodd-Frank Act at Section 761(a)(6) (amending Section 3(a) of the Securities and Exchange Act of 1934 by adding new paragraph 3(a)(68)(A)(ii)(II)).
[5] Id. (amending Section 3(a) of the Exchange Act by adding new paragraph 3(a)(68)(A)(ii)(I)).
[6] Id. (amending Section 3(a) of the Exchange Act by adding new paragraph 3(a)(68)(A)(ii)(III)).
[7] See, e.g., Section 712(a)(7) of the Dodd-Frank Act ("Treatment of Similar Products and Entities").
[8] Product Rules at 29,873.
[9] See Product Rules at n. 216 and accompanying text; proposed SEC rule at Part 240.3a68.-1b ("Meaning of 'narrow-based security index' as used in section 3(a)(68)(A)(ii)(I) of the Act").
[10] See Product Rules at nn. 198-99 and accompanying text.

that a loan should be treated as a "security" for such purposes), the Commissions should clearly identify what criteria the Commissions will use to determine whether a loan index is a narrow-based security index.

We query whether it is possible for the Commissions to extend the "narrow-based security index" criteria proposed in the Product Rules to loan indices without additional refinement to that definition for purposes of loan index swaps. In particular, the proposed criteria stipulate that an index is deemed a "narrow-based security index" if publicly available information concerning the constituent issuers of the referenced securities in the index is limited.[11] The Commissions should provide guidance as to whether a loan index composed of loans, or borrowers thereunder, in respect of which there is limited "publicly available information" will qualify as a "narrow-based security index". We note that many loan indices that are the subject of loan index swaps include borrowers who are not registered with the SEC; moreover, constituent loans may themselves be subject to confidentiality restrictions.

We appreciate the opportunity to comment on the Commissions' rulemakings related to the Dodd-Frank Act. We would be pleased to discuss any of the comments or recommendations contained in this letter.

Yours sincerely,

David G Lucking

David Lucking
Partner

[11] See proposed SEC rule at Part 240.3a68-1b(a)(1)(iv).