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Global Contacts

North America

Claire Murphy
140 Broadway, 24th Floor
New York, NY 10005
Tel: +1.212.510.2955

Europe:

Rob Helszajn
Munro House, Portsmouth Road
Cobham, Surrey KT11 1TF
Tel: +44.1932.586.331

Asia:

Celia Choh
83 Clemenceau Avenue
UE Square #11-01/02/03/04
Singapore 239920
Tel: +65.6393.8422

Latin America:

Buenos Aires

Judith Garbi
Leandro N. Alem 928 - Piso 1°
C1001AAR - Buenos Aires
Argentina
Tel: +54.11.4131.7282

São Paulo

Roberto D'Avila
Av. Morumbi 8234 - 1° Andar
Brooklin
São Paulo, Brazil
Tel: +55.11.5099.3989

info@lacrosseglobal.com

Bank Debt: Operational Challenges in a Profitable Market

The standardization of the secondary loan trading market, lower market volatility and increasing volumes continue to attract new investors to the market.

With the inclusion of higher margins, LIBOR floors and increased fees in new loan issues, investors in U.S. loan funds saw one of their best months ever in July and reported returns for the 12 months prior of 40.96%- all in the middle of a difficult period for the overall U.S. economy. The standardization of the secondary loan trading market, lower market volatility and increasing volumes continue to attract new investors to this market each year. While recent news has highlighted the opportunities in this market, loan transactions can be difficult for some new participants because of operational issues related to settling and maintaining these loans. The following is a detailed look at five of the biggest operational issues that are unique to this market.

Par vs. Distressed: Understanding the differences in timing and settlement

When trading syndicated loans in the secondary market, those trading at or near par are normally traded on much more standard documents and have shorter settlement times. Under Loan Market Association ("LMA") and Loan Syndication and Trading Association ("LSTA") standard terms and conditions, if a transaction is settling on Par/Near Par documents, standard settlement is expected on T+7 (counting from trade date and not including any non-business days). This timing may be extended if the loan has not been issued at the time of the trade. Although T+7 is the standard, as delays often occur, provisions are made for extended settlement times. *(continued on page two)*

LaCrosse announces completion of SAS 70 Type I certification

Type I certification completed in June; Type II certification expected by year-end

LaCrosse Global Fund Services has announced the completion of SAS 70 type I certification. The new certification is an international reporting standard that recognizes firms that successfully conduct an in-depth, third-party review of processes and controls. A "Big Four" public accounting firm conducted the audit, which was completed in June 2009.

"LaCrosse Global Fund Services' high standards in areas such as technology, services and operations are key components of our corporate infrastructure. The Type I SAS 70 is an independent validation of the value we bring to our clients and our continued focus on excellence in all important areas," said Stuart Feffer, co-chief executive officer. "We expect to receive Type II certification later in 2009 as well."

In recent months, LaCrosse Global Fund Services has announced additions to its client roster including: Cavenagh Capital Pte Ltd, Flowering Tree Investment Management Pte. Ltd., Noctua Asset Management, Numen Capital LLP, and Tahan Capital Management Pte Ltd. *(continued on page three)*

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As of the T+7 date, both parties are put in the position as if the trade had settled on that date. At this time, the seller will pay to the buyer the all-in rate on the loan being traded (taken from the Credit Agreement), and the buyer will pay to the seller the applicable LIBOR rate as compensation for the delayed settlement ("delayed compensation"; per market standards, delayed compensation is included unless specifically excluded from the transaction in the confirmation). In practice, as the all-in rate on the loan is often based on a LIBOR plus spread calculation, the LIBORs are netted out, and the spread is passed through to the buyer on settlement date. +

Loans trading on Distressed documents tend to be less standard and have lengthier settlement times. In LMA and LSTA markets, the standard for settlements on Distressed documents is T+20. This longer standard settlement period recognizes the lengthier legal negotiations that might be related to the distressed or non-performing asset, and additionally allows for the upstream review to take place. In distressed trading, review of all the purchase and sale documents preceding the current purchase must be carefully reviewed as each new purchase agreement relies on the representations of the previous agreement. Complete legal review is necessary to ensure proper protections are in place. Due to the often non-performing nature of these transactions, the delayed compensation calculations are also slightly different. In the case of distressed assets, the buyer must compensate the seller for cost of carry (and the seller must pay through any interest received) as of the T+20 date, provided the transaction has not settled. Per standard LSTA and LMA practice, the cost of carry is calculated as the average 1-month LIBOR (or EURIBOR for assets traded in Euros). As with Par settlements, these amounts are accrued until settlement, and all cash changes hands on the actual settlement date. +

While the difference between Par/Near Par and Distressed trading used to be easy to determine based on the price agreed for the asset at the time of trade, changes in the market and less available cash have made this more difficult to determine. The decision to use Par/Near Par versus Distressed documents is now often agreed at the time of trade based on whether the loan is performing or non-performing or on future expectations of the loan's performance. +

Standard Documentation

While there has been a strong movement toward standardization as volumes increase in the secondary loan trading markets in the US, Europe and emerging markets, one of the major documents dealt with and reviewed in these transactions has not been standardized. Credit Agreement review continues to be the most onerous of the document review requirements as each agent (and often each credit) may use a different format with items necessary for accurate settlement and maintenance located in different areas from previously reviewed Credit Agreements. While there have been murmurs in the markets about standardization, progress has yet to be made.

Unlike the lengthy Credit Agreement, development and expansion of associations within each distinct loan market (such as the LSTA, LMA, APLMA, JSLA and CLSTA) has increased the availability and use of standard purchase and sale documents for loan settlements. For most transactions, the standard documentation would include a confirmation laying out the economics of the trade, a purchase and sale agreement or participation agreement including many of the standard representations and warranties for the transaction and a purchase price letter or pricing schedule including all the settlement cash flows.

Participations vs. Assignments

During the early stages of document negotiation, it should be determined whether the transaction will settle as a participation or assignment. In a participation, the seller remains the legal holder of the asset, but the buyer becomes the beneficial owner. All notices from the agent will still be forwarded to the seller and may be passed to the buyer depending on agreed information rights included in the purchase and sale or participation documents. The seller may also pass on voting rights to the buyer with or without limitations depending on the seller's other holdings of the asset. The seller may choose to limit voting rights in participations or deny them altogether. The buyer and/or seller may include the right to elevate to a full assignment in the documents, and this should be noted by all parties. A buyer may not wish to be forced to elevate due to inability to hold the asset (due to limitations in the Credit Agreement or legal limitations) or due to unfavorable tax treatment. A seller may also include participation fees in the participation agreement that must be paid by the buyer to compensate the seller for administration expenses.

Unlike a participation, settling with a full assignment gives the buyer all the legal and beneficial rights to the portion of the loan they have purchased. The buyer becomes the holder of record and may communicate with the agent directly regarding payments and restructures on the loan. As noted above, this may expose the buyer to withholding taxes depending on the country of issue of the loan, and the ability of the buyer to hold the loan must be determined. Most Credit Agreements also include provisions for assignment fees, which are most commonly paid by the buyer or split between the buyer and seller at settlement. If preference for participation or assignment cannot be determined at the time the confirmation is generated, the box for 'Assignment' may be checked. If a participation is later determined to be the preferred method of settlement, the assignment may default to a participation.

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Pricing Schedules: What is Included?

- + A pricing schedule included in a Purchase Price Letter or as a schedule to the purchase and sale documents will include all the accruals and cash items to be included in the determination of the settlement amounts to be paid by the buyer to the seller. This may include but is not limited to: interest paid on the loan between trade and settle date; any delayed compensation (negative if paid to buyer; positive if paid to seller); the calculation of the traded portion of the loan multiplied by the price (the negotiated purchase price); any permanent reductions that occurred between trade and settlement date; transfer or assignment fees; and any legal fees if buyer and/or seller have agreed to cover each other's costs for negotiation and review of the transaction or representation of the loan in any court proceedings. Any other negotiated fees or charges may also be included in this calculation and should be detailed in the schedule.
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Settlement Delays: Sources and Issues

- + As settlement delays are provided for in standard documentation for these settlements, it can be assumed that there are many sources for these delays. Delays in obtaining agent consent or borrower consent to assignments tend to be common as agents may encounter large backlogs in assignments on heavily traded credits. Legal negotiation of documents between buyer and seller or delays in the buyer obtaining all documentation necessary to complete a full review may also delay settlement on less liquid or more distressed loans. On a more limited basis, ability of the buyer to obtain the necessary currency to settle a trade may result in short settlement delays.

While these types of transactions are not without challenges, the seniority of these types of loans in the capital structure and the ability of investors to alter the yields of these products to reflect market conditions currently makes them attractive investments for investors with ready cash. In today's secondary loans trading market, investors should be prepared for lengthy settlements and more contentious negotiations (including higher tabs with outside law firms) before deciding to participate in this market.

...SAS 70 (continued from page 1)

Why is SAS 70 Certification important?

A SAS 70 report provides valuable information about the administrator's internal controls and effectiveness of those controls. SAS 70 reports are provided for the benefit of clients and their auditors as they evaluate and place reliance on the control framework of the administrator. Clients can evaluate the quality of services provided and manage their operational risks more effectively. Auditors can leverage the information as an integrated component of the annual audit process.

SAS 70 compliance is also becoming increasingly important to clients' investors. Given the variety of scandals that have occurred recently and the current market environment, investors are more conscious of the internal controls of the investment managers and their key service providers. SAS 70 compliance is an industry standard that indicates an administrator's stated control objectives are effectively being met.

For more information, visit www.lacrosseglobal.com.

LaCrosse in the News

A roundup of news stories and press coverage on LaCrosse Global Fund Services. Click on the links below to open the articles in your web browser.

- + Aug. 10, 2009 **The Hedge Fund Journal** LaCrosse Global Fund Services Completes SAS 70 Type I Certification. +
- + July 14, 2009 **FINalternatives** LaCrosse Global Fund Services to Provide Fund Administration Services to Noctua Asset Management's Alto Global Fund, Ltd. +
- + July 2, 2009 **Press Release** LaCrosse Global Fund Services to Provide Fund Administration Services to Tahan Capital Management Pte Ltd. (pdf) +
- + June 24, 2009 **Hedgeweek** LaCrosse Global Fund Services to Provide Fund Administration Services to Flowering Tree Investment Management. +
- + June 12, 2009 **Reuters** LaCrosse and Ocwen Financial Announce Partnership to offer fund administration and industry-leading real estate expertise in loan servicing and valuation. +
- + June 10, 2009 **Opalesque** Opalesque Exclusive: Part One - Has third party administration become a necessity?
- + April 15, 2009 **Opalesque** LaCrosse Global Fund Services to Provide Fund Administration Services to Numen Capital LLP.
- + April 15, 2009 **The Hedge Fund Journal** LaCrosse Global Fund Services to Provide Fund Administration and Operations Services to Cavenagh Capital.
- + Feb. 23, 2009 **Global Custodian** LaCrosse Global Fund Services to Provide Operations Services to Primergy Capital Partners.

About LaCrosse Global Fund Services

LaCrosse Global Fund Services is an independently managed subsidiary of Cargill, one of the largest privately held companies serving customers worldwide. With 10 global offices, LaCrosse can work closely with a fund's prime brokers and custodians to meet all of its operational and administrative needs. LaCrosse provides support for a wide range of strategies run by global portfolio managers, covering fixed income, distressed debt, structured credit, equities, currencies, commodities and a full range of related derivatives.

LaCrosse began as a spinout of the middle- and back-office operations that had supported Black River Asset Management and, prior to that, Cargill Global Capital Markets. Today it is an independently managed subsidiary of Cargill providing services to the alternative investment industry. For more information, visit www.lacrosseglobal.com.

To see a complete list of asset classes supported by LaCrosse Global Fund Services, please click [here](#).