

**MEMORANDUM**

**TO:** File No. S7-14-11

**FROM:** Arthur Sandel  
Special Counsel  
Office of Structured Finance  
Division of Corporation Finance  
U.S. Securities and Exchange Commission

**RE:** Meeting with representatives of the Loan Syndications and Trading Association

**DATE:** January 15, 2014

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On January 14, 2014, Katherine Hsu, Arthur Sandel, David Beaning and Lulu Cheng of the Division of Corporation Finance and Sean Wilkoff and Igor Kozhanov of the Division of Economic and Risk Analysis participated in a meeting with the following representatives of the Loan Syndications and Trading Association (“LSTA”): Meredith Coffey and Elliot Ganz of the LSTA; Wynne Comer of Bank of America Merrill Lynch; Goran Puljic of Oak Hill Advisors, L.P.; Matthew Miller of Crescent Capital Group LP; Brandon Cahill of BlueMountain Capital Management LLC; Cynthia Williams of Dechert LLP; and Richard Klingler of Sidley Austin LLP

The participants discussed topics related to the Commission’s August 28, 2013 joint proposed rules regarding credit risk retention. A handout is attached to this memo.

Attachment

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# **Risk Retention and CLOs: Qualified CLOs**

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# A New Approach: The Qualified CLO

- A Qualified Open Market CLO that Meets Strict Criteria Would Require the Manager to Retain 5% of the Equity of the CLO
  
- A QCLO...
  - Requires a very significant funded cash investment by the manager
  - Tightens and codifies “best practices” for the CLO market
  - Encourages high quality underwriting
  - Creates a series of six overlapping protections for investors and restrictions for managers
  - Allows the CLO market to continue to function through a consensual arrangement
  - Avoids a major disruption to the credit markets
  - Does not require the agencies to grant an outright exemption or contest the definition of credit risk

# Qualified Open Market CLO: Six overlapping protections

- ❑ **Asset Quality Protections** – asset limitations ensure investment in high quality non-investment grade loans
- ❑ **Asset Portfolio Protections** – diversification requirements ensure that a portfolio is even more robust than the individual assets
- ❑ **CLO Structural Protections** – leverage limitations and interest coverage and overcollateralization tests provide additional protections for debt investors beyond the portfolio itself
- ❑ **Alignment of Managers' and CLO Investors' Interests** – retention requirements, subordination of majority of fees, ability of equity investors to remove manager ensure managers' alignment
- ❑ **Manager Regulatory Oversight** – CLO manager must be a registered investment advisor, which includes significant regulatory oversight and responsibilities
- ❑ **CLO Transparency and Disclosure** – monthly reports provide extensive information on assets and portfolio performance

# Qualified Open Market CLO: Asset Quality Protections

- **To ensure high quality non-investment grade loans, the CLO would be required to:**
  - ❑ have at least 90 percent of its assets comprised of senior secured loans and cash equivalents
  - ❑ have 100 percent of its loan assets issued by companies
  - ❑ have no assets that are ABS interests (including CDO of ABS, CDO squared, or synthetic ABS) or derivatives; loan participations and hedging permitted
  - ❑ not purchase assets in default, margin stock, or equity convertible securities
  - ❑ acquire only loans held or acquired by three or more investors or lenders unaffiliated with the CLO manager
  - ❑ hold only loans to borrowers whose accounts are subject to an annual audit from an independent, accredited accounting firm
  - ❑ have no more than 60 percent of its assets comprised of defined “covenant lite” loans
  - ❑ at the time of purchase of any asset, comply with the senior secured loan and covenant lite requirement, or, if not in compliance with any such requirement, maintain or improve the level of compliance after giving effect to such purchase

# Qualified Open Market CLO: Asset Portfolio Protection Requirements

- **To ensure a strong, familiar and diversified portfolio, the CLO would be required to have:**
  - No more than 3.5 percent of the CLO's assets to any single borrower
  - No more than 15 percent of the CLO's assets to any single industry
  - No more than 20 percent of the CLO's assets to non-U.S. borrowers (and no more than 10 percent may relate to borrowers outside the U.S. and Canada)
  - Each loan asset held by the CLO shall be denominated in U.S. dollars

# Qualified Open Market CLO: Structural Protections

- **To ensure a robust CLO structure:**
  - The CLO's equity would have to be at least eight percent of the value of the CLO's assets
  - The CLO would have to have overcollateralization and interest coverage tests, and if any such test falls below the required level specified for the transaction, available interest collections (and if necessary, available principal collections) must be applied to repay the CLO's debt in order of seniority until compliance with the applicable test is restored.

# Qualified Open Market CLO: Alignment of Managers' and CLO Investors' Interests

- **In order to align the interest of the manager and investor:**
  - The CLO must be an Open Market CLO rather than a balance sheet CLO.
  - The holders of the CLO's equity (excluding Manager Risk Retention Equity) must have the right to remove by vote the CLO manager for cause.
  - A majority of the CLO manager's fees, including any incentive fee, must be subordinated to payments then due in relation to the CLO's rated notes.
  - The CLO manager's discretionary sales of assets are limited each year to 30 percent of the principal amount of the CLO's assets (other than sales of defaulted or credit-deteriorated, credit-risk, or credit-improved loans).
  - The CLO manager (and/or affiliates and/or employees) must buy and, during the holding period, hold (and not hedge) five percent of the CLO's equity (the "Manager Risk Retention Equity").
  - For each of the first two years, distributions related to the Manager Risk Retention Equity cannot exceed an amount equal to the sum of (i) 30 percent of the purchase price of such equity and (ii) the amount of taxes that are reasonably expected to be required to be paid with respect to the Manager Risk Retention Equity for the related period (entitlements in excess of such distribution limit may be retained in an account solely for the benefit of the holders of the Manager Risk Retention Equity).
  - All holders of CLO securities that are U.S. persons within the meaning of Regulation S under the Securities Act of 1933, as amended, must be Qualified Investors.

# Qualified Open Market CLO: Regulatory Oversight

- **To ensure sufficient regulation of the manager:**
  - The CLO manager must be a registered investment adviser.
  - All purchases and sales of the CLO's assets must be conducted on an arm's-length basis and in compliance with the Investment Advisers Act.

# Qualified Open Market CLO: Transparency & Disclosure – Monthly reporting to investors

- **To ensure sufficient transparency and disclosure, manager must provide a monthly report that includes:**
  - A list of CLO assets, including with respect to each asset: obligor name; CUSIP (or security identifier) if applicable; interest rate; maturity date; the type of asset; and market price for each asset where available
  - With respect to the portfolio of assets: the aggregate principal balance and aggregate adjusted collateral principal amount thereof (adjusted as required by the CLO transaction documents) and the percentage of such aggregate adjusted collateral principal represented by each asset
  - Each applicable overcollateralization test and interest coverage test (and the level of compliance in relation to each test)
  - Purchases, repayments, and sales
  - The identity of each defaulted asset

# The QCLO Proposal should work jointly with the QCL and third party equity option

- There are managers that will not be able to satisfy the QCLO proposal
  - For instance, retention of 5% of the equity is still extraordinarily burdensome for smaller managers
  
- Therefore, the Qualified Commercial Loan and Third Party Retainer Option should remain acceptable alternatives
  - **QCL** - Agencies should expand the definition of loans that do not attract risk retention to include high quality leveraged loans that have a very low expected loss
  - **Third Party Retention** - Third party equity investors that commit to purchase and not sell or hedge a significant portion of the equity of a CLO and are involved in developing the asset selection criteria for the CLO should be permitted to retain the risk