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By Electronic Submission

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Washington, D.C. 20219
Docket ID OCC-2020-0002
RIN 1557-AE67

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RIN 3064-AF17

Mr. Christopher Kirkpatrick
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Washington, D.C. 20581
RIN 3038-AE93

Ms. Ann E. Misback
Secretary
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Docket No. R-1694 and RIN 7100-AF70

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090
File Number S7-02-20 and RIN 3235-AM70

RE: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds

Ladies and Gentlemen:

The Loan Syndications and Trading Association ("LSTA")[1] appreciates the opportunity to provide comments to the Agencies[2] on the notice of proposed rulemaking, "Proposed Revisions

[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 trading of commercial loans. The over 500 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. 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.

[2] "Agencies" refers to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. LSTA has previously submitted comment letters regarding

to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds," that would further amend the regulations implementing section 13 of the Bank Holding Company Act (the "Volcker Rule") that were finalized in December 2013 ("2013 Final Rule") and amended in November 2019.[3]

We appreciate the Agencies' consideration and proposal of additional changes to the covered fund provisions of the 2013 Final Rule. As discussed below, we support the Agencies' proposal to permit loan securitizations to hold a small amount of non-loan assets. We also support the Agencies' proposal to create a safe harbor for senior loans and senior debt interests to ensure that such debt interests are not ownership interests in covered funds. Although we very much appreciate the Agencies' proposal to allow loan securitizations to hold up to five percent of non-loan assets, we ask the Agencies to consider increasing this limit to ten percent to allow for additional flexibility. While we support the Agencies' modification of the "ownership interest" definition to clarify that creditors' rights include the right to participate in the removal or replacement of a manager, we urge the Agencies to revise their proposal to recognize that these rights may be available and exercised independently of the occurrence of an event of default or an acceleration event. We believe all of these changes will improve and streamline these provisions, provide more clarity with respect to the requirements of the Volcker Rule, and better align these provisions with the Volcker Rule's statutory rule of construction.

Background

When the Volcker Rule was adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Congress recognized the critical role of lending and securitization activities and included a statutory rule of construction to expressly prohibit the Agencies from implementing the Volcker Rule to limit or restrict the ability of a banking entity to sell or securitize loans if otherwise permitted by law.[4]

The LSTA membership is comprised of banking entities and others who are involved with syndicated corporate loans and loan securitizations. Syndicated corporate loans in the United States provide about $4.3 trillion of financing to U.S. companies; of this, approximately $1.2 trillion are leveraged loans that support "non-investment grade" companies, such as Burger King, United Airlines, Avis Rent a Car, and Equinox Fitness as well as other major employers in industrial and service sectors throughout the economy. These companies use the proceeds of syndicated leveraged loans to expand operations, create jobs, improve their goods and services, and otherwise propel economic growth. The size of syndicated leveraged loans generally ranges from $20 million to $2 billion and beyond.

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the "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds" to some or all of the Agencies on December 24, 2013; December 31, 2013; January 10, 2014; September 31, 2017; and October 16, 2018.

[3] Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. 12120 (Feb. 28, 2020) ("Proposed Rulemaking").

[4] Section 13(g)(2) of the Bank Holding Company Act provides: "SALE OR SECURITIZATION OF LOANS.— Nothing in this section shall be construed to limit or restrict the ability of a banking entity . . . to sell or securitize loans in a manner otherwise permitted by law."

Because loans of this size are typically too large to be held by one single lender, they are syndicated among a lender group, which may include loan securitization vehicles, also known as collateralized loan obligations ("CLOs"). CLOs provide more than $600 billion of capital to the syndicated leveraged loan market, or nearly half of all funded loans. Without the participation of CLOs, the syndicated loan market would be far smaller, and access to capital would be far more difficult for U.S. companies.

CLOs are created by securitizing pools of syndicated loans and selling notes with varying degrees of credit risk to investors with a broad range of risk appetites and investment objectives – including investors who would not directly purchase syndicated loans or lend to companies that typically receive them. Banking entities of all sizes provide a substantial portion of the capital to this sector, traditionally by purchasing and holding a large amount of the highest rated tranche of a CLO's debt securities. Banking entities have traditionally viewed the senior-most tranche of a CLO's debt securities, which is typically rated "triple A," as a safe-and-sound investment.[5] Today U.S. banks hold approximately $100 billion worth of triple A CLO notes; they also purchase and hold other investment-grade classes of CLO notes that are rated lower than triple A.

LSTA's Response to Proposed Amendments and Questions

We appreciate the Agencies' recognition that the definition of "covered fund" in the 2013 Final Rule is very expansive and that additional refinements and clarifications are necessary to comport more closely with the Volcker Rule, including the statutory rule of construction. Specifically, we endorse the Agencies' proposals (1) to permit loan securitizations to hold a small amount of non-loan assets and (2) to create a safe harbor from the definition of ownership interest for senior loans and senior debt interests. However, while we appreciate the Agencies' proposal to permit loan securitizations to hold up to five percent of assets in non-loan assets, we request that the Agencies consider modifying this amendment to permit loan securitizations to hold up to ten percent of assets in non-loan assets to allow for greater flexibility. We also appreciate the Agencies' proposal to clarify the types of creditors' rights that would not constitute ownership interests, but we urge the Agencies to further clarify that such creditors' rights include the ability to participate in the removal or replacement of a manager regardless of whether an event of default or acceleration has occurred.

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[5] It is also noteworthy that CLOs performed well during the financial crisis and have continued to perform well since. *See e.g.*, "S&P: CLOs show strong historic performance with few defaults," *LeveragedLoan.com* (Jan. 31, 2014), *available at* www.leveragedloan.com/sp-report-clos-show-strong-historic-performance-with-few-defaults. ("Looking at the default statistics, of the over 6,100 ratings issued by S&P on over 1,100 U.S. CLO transactions, only 25 tranches have defaulted and had their rating lowered to D as a result. Based on this, S&P calculated a 0.41% default rate, or just over four tranches for every 1,000 it has rated."); *see also* "Twenty Years Strong: A Look Back at U.S. CLO Ratings Performance from 1994 Through 2013," Standard & Poor's, January 31, 2014.

I. The proposed modification of the loan securitization exclusion to permit loan securitization vehicles to hold small amounts of non-loan assets is consistent with Congressional intent as reflected in the statutory rule of construction.

The Agencies have proposed to amend the loan securitization exclusion to allow loan securitization vehicles to hold up to five percent of assets in non-loan assets, and the Proposed Rulemaking seeks comments regarding this proposal.[6] We strongly support the proposal to allow loan securitization vehicles to hold a small amount of non-loan assets and believe it is consistent with Congressional intent and industry practice at the time of, and prior to, the implementation of the Volcker Rule. We also agree with the Agencies that this modification will give loan securitizations more flexibility to respond to market demand and reduce compliance costs without materially changing the nature and risk profile of the securitization. However, we request that the Agencies consider modifying the loan securitization amendment to allow up to 10% of a loan securitization vehicle's assets to be held in non-loan assets. As we discussed in our October 2018 comment letter to the Agencies, permitting these securitizations to have up to 10% of their holdings in non-loan assets would reduce the compliance burden associated with the 2013 Final Rule's exclusion and align the rule with the intent of the statute to protect economically beneficial loan securitization activity.[7]

With the Agencies' proposed modification allowing loan securitization vehicles to hold a small amount of non-loan assets, the loan securitization exclusion will conform more closely with the Volcker Rule's statutory rule of construction because loan securitizations at the time of the rule's adoption frequently held small amounts of non-loan assets. The statutory rule of construction states that "[n]othing in this section shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner otherwise permitted by law." This rule of construction was meant to achieve the lawmakers' goal of preserving the loan securitization opportunities (including CLO structures) commonly available to, and used by, U.S. businesses at the time of its enactment.[8] However, as implemented by the 2013 Final Rule, the exclusion for loan securitizations included only those securitizations comprised *solely* of loans and certain related servicing and hedging interests.[9] This category excluded a significant portion of CLOs that were in existence because CLOs at that time generally

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[6] 85 Fed. Reg. at 12129 (Question 14).

[7] *See* LSTA, Comment Letter on "Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds" (Oct. 16, 2018),https://www.federalreserve.gov/SECRS/2018/November/20181119/R-1608/R-1608 _101618_132702_439951659906_1.pdf.

[8] *See e.g.,* remarks by Sen. Dodd, "The purpose of the Volcker Rule is to eliminate excessive risk-taking activities by banks and their affiliates while at the same time preserving safe, sound investment activities that serve the public interest." 156 Cong. Rec. S5904 (daily ed. July 15, 2010).

[9] Under the 2013 Final Rule, aside from loans, loan securitizations are only able to hold:

> Rights or other assets designed to assure the servicing or timely distribution of proceeds to holders of such securities and rights or other assets that are related or incidental to purchasing or otherwise acquiring and holding the loans…; (C) Interest rate or foreign exchange derivatives that ['directly relate to the loans, the asset-backed securities, or the contractual rights of other assets' §__.10(c)(8)(iv)]; and (D) Special units of beneficial interest and collateral certificates …. §__.10(c)(8)(i)(B).

allowed for a small amount of bonds and other non-loan assets consistent with limits prescribed by their governing documents.

The proposed modification will give CLOs more flexibility to increase diversification in response to changing market conditions and allow banking entities to provide investors and markets with the types of loan securitizations that they desire. The Agencies appropriately recognize in the Proposed Rulemaking that "loan securitizations provide an important avenue for banking entities to fund lending programs, and allowing loan securitizations to hold a small amount of non-loan assets in response to customer and market demand may increase a banking entity's capacity to provide financing and lending."[10]

The Proposed Rulemaking seeks comment on whether the Agencies should limit the type of permissible non-loan assets to certain asset classes or structures.[11] We believe it is unnecessary to limit the non-loan assets to specific asset classes or structures because the modest limit (10%) proposed for these non-loan assets would not significantly change the nature and risk profile of the loan securitization, and non-loan assets would be subject to the same trading restrictions, the same eligibility criteria, the same "discounting" provisions for purposes of applying overcollateralization tests, the same coverage tests, and the same collateral-quality tests as any other asset. We do request that the Agencies clarify that the non-loan assets permitted by this proposal are not subject to the conditions set forth in the 2013 Final Rule for derivatives and special units of beneficial interest and collateral certificates that loan securitizations are currently permitted to hold.[12] While a 10% limit would provide loan securitizations with greater flexibility to respond to market conditions and investor preferences, the ability to include non-loan assets in a CLO would not permit additional or excessive risk-taking or evasion of the Volcker Rule.

As discussed above, CLOs are a vital part of the loan securitization market as they have for many years been the single largest source of capital that supports syndicated corporate loans to non-investment grade U.S. companies. Permitting loan securitizations to have up to 10% of their holdings in non-loan assets would better align the Agencies' regulation implementing the Volcker Rule with the goal of the statutory rule of construction to protect economically beneficial loan securitization activity. The importance of this activity to the U.S. economy was highlighted in the Financial Stability Oversight Council study's discussion of the rule of construction:

> [T]his inviolable rule of construction ensures that the economically essential activity of loan creation is not infringed upon by the Volcker Rule. The creation and securitization of loans is a basic and critical mechanism for capital formation and distribution of risk in the banking system. While these activities involve the assumption of principal risk, the broader benefits to the economy reflect the intent of federal borrowing subsidies and protections. Accordingly, the legislators determined that none of the restrictions of the Volcker Rule,

[10] 85 Fed. Reg. at 12129.

[11] 85 Fed. Reg. at 12129 (Question 14).

[12] 2013 Final Rule at §__.10(c)(8)(iv) and (v).

nor the backstop restrictions on permitted activities, will apply to the sale or securitization of loans.[13]

We believe it is notable that the Volcker Rule and its rule of construction did not define or in any way circumscribe, the terms "loans," "securitize," or "securitization." When a term is not defined in a statute, it must be interpreted consistently with what it meant at the time of the statute's enactment, i.e., it must be given its "ordinary, contemporary, common meaning."[14] In that regard, we believe that syndicated loans were clearly within the scope of loan activity that Congress wanted to encourage, and we urge the Agencies to acknowledge in the preamble to their final rulemaking that, as contemplated by the Volcker Rule and the statutory rule of construction, syndicated corporate loans are loans, notwithstanding the 2013 Final Rule's definition of "loan" which leaves open the possibility that certain loans could be securities.[15]

The Proposed Rulemaking also seeks comment on the appropriate method of calculating compliance with the proposed limit.[16] We agree with the Securities Industry and Financial Markets Association ("SIFMA") that calculating compliance with the limit on non-loan assets should be determined by reference to the par value of debt securities or assets on the day they are acquired by the loan securitization vehicle, and we support SIFMA's comments on this point.[17] We also agree with SIFMA in supporting the codification of the cash equivalents language in the Loan Securitization Servicing FAQ 4.[18]

II. We support the Agencies' proposed safe harbor that would exclude interests in senior loans and senior debt interests from the definition of ownership interest.

We endorse the Agencies' steps to clarify that a bona fide debt interest in a covered fund such as a loan securitization vehicle would not constitute an ownership interest under the Volcker Rule. The Proposed Rulemaking seeks comments regarding a proposed safe harbor from the definition of ownership interest for senior loans and senior debt interests that meet three specific

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[13] *See* Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds, at 17 (Jan. 18, 2011), at 47, *available at*: http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

[14] *Perrin v. United States*, 444 U.S. 37, 42 (1979) ("[U]nless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning" at the time the legislators enacted the statute). *See also FCC v. AT&T, Inc.* 131 S.Ct. 1177, 1182 (2011) ("When a statute does not define a term, we typically 'give the phrase its ordinary meaning.'" (quoting *Johnson v. United States*, 559 U.S. ----, ----, 130 S.Ct. 1265, 1267, 176 L.Ed.2d 1 (2010)).

[15] See 2013 Final Rule § __.2(t)). Indeed, if traditional loan instruments like syndicated loans were deemed to be securities, the rule of construction would be rendered meaningless.

[16] 85 Fed. Reg. at 12129 (Question 14).

[17] *See* SIFMA Comment Letter on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (March 11, 2020). To the extent that the non-loan assets include equity securities, we believe it would be appropriate to use the market value of the equity securities on the day they are acquired when calculating compliance with the limit on non-loan assets.

[18] *Id.*

conditions.[19] The Proposed Rulemaking also seeks comment on whether the safe harbor should be limited only to senior loan and debt interests.[20]

We believe the creation of a safe harbor for debt interests appropriately recognizes that like the typical capital structure of U.S. companies which are funded by both debt and equity securities, the capital structures of securitization vehicles and other covered funds have both debt and equity tranches. We support the proposed safe harbor and the proposed conditions, which are appropriately tailored to cover senior debt interests, while being rigorous enough to prevent banking entities from evading the prohibition on acquiring or retaining equity-like ownership interests. In that regard, we request that the Agencies confirm in the preamble to their final rulemaking that the reference to "senior" in the proposed safe harbor at least includes all exposures that would meet the definition of "investment grade" in the OCC's investment securities rule and implementing guidelines, as long as such exposures comply with the proposed conditions.[21] We agree with the Structured Finance Association (SFA) that such confirmation would provide clarity to market participants with respect to investment grade loans and debt interests that satisfy the proposed conditions but have one or more tranches of debt senior to them.[22]

In response to the Agencies' question regarding the reference to "fixed principal payments on or before a maturity date" under condition (1)(ii) of the proposed safe harbor, we believe the term "contractually determined principal payments" as suggested by the Agencies would be more accurate than the term "fixed principal payments."[23] Although the aggregate entitlement to principal associated with a senior debt interest is fixed by the governing contract, individual amounts of principal payment may vary from payment date to payment date and are not "fixed" themselves.[24]

[19] These conditions are: (1) the holders of such interest do not receive any profits of the covered fund but may only receive: (i) interest payments which are not dependent on the performance of the covered fund; and (ii) fixed principal payments on or before a maturity date; (2) the entitlement to payments on the interest is absolute and may not be reduced because of the losses arising from the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the principal and interest payable; and (3) the holders of the interest are not entitled to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).

[20] 85 Fed. Reg. at 12148 (Question 81).

[21] 77 Fed. Reg. 35,253 (June 13, 2012) (codified at 12 C.F.R. pt. 1); 77 Fed. Reg. 35,259 (June 13, 2012) (implementing guidance).

[22] *See* SFA, Comment Letter on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (April 2020).

[23] 85 Fed. Reg. at 12148 (Question 80).

[24] Similarly, we note that even though a senior debt interest holder has "entitlement to payments under the terms of the interest [that] are absolute," as stated in condition (2) of the proposed safe harbor, the actual amount that is paid (as opposed to owed) may be impacted by portfolio performance and other circumstances.

III. The Agencies should further modify the definition of "ownership interest" to recognize that the creditors' rights include certain rights to exercise remedies outside the context of an event of default or acceleration.

We appreciate the Agencies' proposal recognizing that creditors' remedies upon the event of default or an acceleration event may include the right to participate in the removal of an investment manager for cause or to nominate or vote on a nominated replacement manager upon an investment manager's resignation or removal. The ability of debt holders to respond to and remediate these threats or impacts is properly viewed as an essential creditor-protection right, rather than something that is indicative of an equity-like ownership interest prohibited by the Volcker Rule. However, it is critical that this proposed modification be expanded to cover such creditors' rights *outside* the context of an event of default or an acceleration event because in securitization vehicles such as CLOs, these types of rights are also provided to debt holders in circumstances independent of an event of default or acceleration (and regardless of whether such an event has occurred).[25]

The rights to participate in the removal and replacement of the CLO manager "for cause" or upon resignation are a critical part of the creditors' rights that CLOs provide holders of their debt securities to protect their debt interests. These rights are not structured to arise solely in the context of an event of default or an acceleration event under the CLO's governing indenture, and, in practice, they are usually triggered upon a manager's default under the CLO management agreement (as opposed to the CLO indenture) or the manager's resignation.

In most CLOs, events that allow for the removal of a CLO manager "for cause" typically include: (1) a willful breach by the manager of its obligations under the CLO management agreement or the CLO indenture, (2) an uncured material breach by the manager of its obligations under the CLO management agreement or the CLO indenture, (3) the dissolution or insolvency of the manager, (4) fraud or criminal activity by the manager in connection with its investment management business, (5) a default by the CLO in the payment of interest or principal that results from a breach by the CLO manager of its duties under the CLO management agreement or the CLO indenture, and (6) in some transactions, a deterioration in the performance of a CLO measured by an objective standard. All of these events pose a clear and direct threat to the interests of holders of the CLO's debt securities as creditors of the CLO, but do not necessarily give rise to an event of default or acceleration under the CLO indenture. Similarly, the resignation of the manager has a clear and direct impact on the interests of debt holders because it is tantamount to a change of control of the issuer — a circumstance under which traditional bank lenders often receive consent rights or the right to be repaid. Investors thus understandably view the ability to vote on a replacement manager as an important creditors' right, even if it is not associated with the occurrence of an event of default or acceleration.

[25] 85 Fed. Reg. at 12148 (Question 78).

In a standard CLO, these rights are provided to the so-called "controlling class" of debt holders designated by the CLO's governing indenture.[26] The controlling class is typically the holders of the most senior outstanding class of debt securities issued by the CLO. However, since CLO debt securities are repaid serially in descending order of their respective class seniority, any class of these debt securities can become the controlling class after the classes that are more senior to it have been repaid in full.

At the same time, these CLO debt holders are clearly creditors and do not have an equity-like "ownership interest," which is evidenced by the fact that they have only the right to specified principal and interest, but not any rights typically associated with equity-like ownership. For example, CLO debt holders do not: (1) have the right or ability to share in the CLO's profits or losses or to earn a return based on the CLO's performance, (2) have residual claim to the issuer's assets, (3) receive any of the "excess spread" between interest earned by the underlying assets and interest paid to the holders of other outstanding interests, (4) receive income on a pass-through basis or by reference to underlying performance, (5) have "synthetic rights" to any of these ownership characteristics, or (6) have the right to vote on establishing the issuer's objectives and policies, electing its board of directors, or controlling the decisions of the manager.

For these reasons, we urge the Agencies to modify their proposal to exclude from the definition of "ownership interest," a creditor's right to participate in the removal or replacement of a manager whether or not such rights are exercised as remedies upon the occurrence of an event of default or acceleration. In that regard, we believe the language in the Agencies' proposed amendment should be revised to read "excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event <u>and</u> a creditor's right to participate in the removal of an investment manager for cause or to nominate or vote on a nominated replacement manager upon an investment manager's resignation or removal, whether or not such rights are exercised as remedies in connection with an event of default or acceleration."

<u>Conclusion</u>

In conclusion, we applaud the Agencies' proposals which meaningfully reconsider aspects of the 2013 Final Rule to provide more clarity and alignment with the language and intent of the Volcker Rule and its statutory rule of construction. We fully endorse the Agencies' proposal to permit loan securitizations to hold a small amount of non-loan assets and to create a safe harbor from the definition of ownership interest for senior loans and senior debt interests. We request that the Agencies consider increasing the amount of non-loan assets that loan securitizations may hold from five to ten percent and consider a further modification of the "ownership interest" definition to recognize common creditors' rights.

[26] While these rights are typically also exercisable by the CLO's equity investors, the fact that creditor remedies are separately exercisable by equity investors should not result in equity treatment for debt securities that otherwise do not have equity-like characteristics.

We thank you for your consideration of our comments and concerns and stand ready to provide any additional information you believe might be useful. Please feel free to contact me at [redacted] if you have any questions regarding this letter.

Sincerely,

Elliot Ganz
General Counsel