

**MEMORANDUM**

TO: File No. S7-14-11

FROM: Giles T. Cohen  
Office of Commissioner Luis A. Aguilar

DATE: August 14, 2014

SUBJECT: Meeting with Representatives of The Loan Syndications and Trading Association  
("LSTA")

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On August 14, 2014, Commissioner Aguilar and Giles T. Cohen, Counsel to the Commissioner, met with the following individuals:

- Meredith Coffey, EVP, Research and Analysis, LSTA
- Elliot Ganz, EVP and General Counsel, LSTA
- Doug Kidd, Managing Director for Public Affairs, Invesco

The discussion included, among other things, the Commission's proposed rules for Credit Risk Retention.

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

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# A Middle Ground Approach: The Qualified CLO

- ❑ A Qualified CLO is structured to meet the policy objectives under Section 941 of the Dodd-Frank Act
- ❑ A Qualified CLO is, in principle, very similar to the “Qualifying Securitisation” concept proposed by the Bank of England and the European Central Bank in May 2014
- ❑ A Qualified Open Market CLO that meets strict criteria would require the manager to retain 5% of the equity of the CLO
- ❑ A Qualified CLO does not require the agencies to grant an outright exemption or open up the definition of “credit risk”

# Qualified Open Market CLO: Six overlapping restrictions and 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 adviser, which includes significant regulatory oversight and responsibilities
- ❑ **CLO Transparency and Disclosure** – monthly reports provide extensive information on assets and portfolio performance

# The Qualified CLO meets policy objectives of Section 941: Prudent asset selection and underwriting (1)

- The policy goal is advanced by the asset and portfolio quality requirements
  - Assets must overwhelmingly be senior secured loans to reputable audited companies, rather than riskier assets
  - Loans must be held by at least three lenders or investors unaffiliated with the manager, preventing the manager from entering into less liquid, bespoke transactions
  - Portfolio limitations on borrower and industry sector concentrations ensure that investors are protected through portfolio diversification
  - Managers are barred from selecting riskier asset classes such as ABS securities, derivatives, defaulted loans, margin loans or equity convertible securities

# The Qualified CLO meets policy objectives of Section 941: Prudent asset selection and underwriting (2)

- Incentives imposed on the CLO manager foster prudent asset selection and management
  - Buying and holding a substantial equity interest entails the manager losing its investment if the portfolio underperforms
  - Subordinated and deferred compensation structure means that fees are foregone
  - Managers must be registered advisers and are subject to removal by investors for cause
  
- Transparency and disclosure requirements provide important assurances of prudent asset selection and underwriting
  - Managers must report extensive information regarding the nature and ongoing performance of each asset in the portfolio thereby permitting investors to assess the manager's performance on an ongoing basis

# The Qualified CLO meets policy objectives of Section 941: Investor protection

- All asset selection and portfolio management criteria have as an underlying purpose the protection of investors
- The deferred and subordinated compensation structure aligns the managers' interest with the investors' interest
- The direct equity purchase and retention aligns the managers' interest with the investors' interest
- The requirement of minimum 8% equity provides subordination and protection for debt investors
- The CLO manager must be a registered investment adviser, subject to the corresponding responsibilities, including a fiduciary duty to its investors

# The Qualified CLO meets policy objectives of Section 941: Increased access to credit and competitive pricing

- By ensuring that Open Market CLOs remain a material component of credit markets, the proposed approach offers the continuity of borrowers' access to credit, competition in the provision of credit, and lower borrowing costs over the long term
- The existence of a robust CLO market also provides a stabilizing force to the credit markets
  - Open Market CLOs are not marked to market and provide a stable bid when other market participants are forced to sell during a dislocation
  - Because CLOs provide long-term funding to the loan market, there is no maturity transformation as can exist with other investors

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## Details on the six restrictions in the Qualified CLO

# 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

# In Conclusion: The Qualified CLO aligns with policy objectives and should be workable for industry

- The Qualified CLO is, in principle, very similar to the “Qualifying Securitisation” proposal released by the Bank of England and the European Central Bank
- The Qualified CLO is structured to meet the U.S. Agencies’ policy objectives
- The Qualified CLO should be workable for much of the CLO industry, though there will be managers unable to meet the criteria (such as purchasing and retaining 5% of the equity)