August 27, 2014

By Electronic Submission

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Regulations Division
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Re: **Credit Risk Retention; Joint Further Notice of Proposed Rulemaking**
SEC (File No. S7-14-11); FDIC (RIN 3064-AD74); OCC (Docket Number OCC-2013-0010); FRB (Docket Number R-1411); FHFA (RIN 2590-AA43); HUD (RIN 2501-AD53)

Ladies and Gentlemen:

The Loan Syndications and Trading Association ("LSTA")[1] is pleased to submit these comments in response to the joint Further Notice of Proposed Rulemaking, 78 Fed. Reg. 57928 ("FNPRM"),[2] concerning risk retention and the implementation of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").

[1] The LSTA, founded in 1995, is the trade association for the syndicated corporate loan market and is dedicated to advancing the interests of the market as a whole. The LSTA is active on a wide variety of activities intended to foster the development of policies and market practices designed to promote a liquid and transparent marketplace. More information about the LSTA is available at www.lsta.org.

[2] Credit Risk Retention, 78 Fed. Reg. 57928 (Sept. 20, 2013; originally released Aug. 28, 2013).

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At the suggestion of agency officials, the LSTA submits these comments to address questions raised with the LSTA regarding the proposed treatment of credit risk retention by Qualified CLOs submitted by the LSTA, SFIG, and SIFMA on January 10, 2014.

Under that proposed approach for "Qualified CLOs," an Open Market CLO meeting a series of requirements designed to ensure high quality underwriting and to protect investors would be treated as a "Qualified CLO." The manager of a Qualified CLO could satisfy the rules' risk retention requirements by retaining a five percent interest in the CLO's equity – in addition to retaining credit risk through a deeply subordinated and deferred compensation structure.[3] This approach would enable the continued viability of the CLO market and thereby avoid the most significant public interest harms that would arise from the loss of this important source of credit.[4]

In discussions with agency officials, the LSTA was asked to provide further clarification regarding aspects of the proposed approach for Qualified CLOs related to the status of the borrowers' auditors, the limitations on eligible investors, and the availability of trustee reports to SEC examiners.

(1) Audit Requirement. To be treated as a Qualified CLO, the CLO would have to satisfy, among other things, a series of requirements designed to protect the quality of the CLO's assets, including holding only loans to "borrowers whose accounts are subject to an annual audit from an independent, accredited accounting firm."[5] Although the CLO manager does not control the credit agreement that imposes limitations on which auditors the borrower may select and thus cannot oversee auditor selection, existing protections are robust. Those agreements nearly always require that the auditor be of "nationally recognized standing" or have similar stature. In addition, in light of the breadth of the registration requirement imposed by the Public Company Accounting Oversight Board (PCAOB)[6] and the resulting registration by even smaller and regional auditors,[7] we expect that any auditor employed by a borrower accessing this market would be subject to PCAOB oversight.

(2) Qualified Investor Requirement. To be treated as a Qualified CLO, the CLO would also have to meet a series of requirements designed to ensure alignment of the interests of CLO managers and CLO investors. One such requirement is that all holders of CLO securities that are U.S. persons within the meaning of Regulation S under the Securities Act of 1933 must be

[3] *See generally* LSTA, SFIG, & SIFMA Letter Comment (Jan. 10, 2014) at 6–15.

[4] *See id.* at 11–15 (citing previous LSTA letter comments).

[5] *See id.* at 7.

[6] *See* Public Company Accounting Oversight Board, Rule 2100, Registration Requirements for Public Accounting Firms, *available at* http://pcaobus.org/Rules/PCAOBRules/Pages/Section_2.aspx#rule2100.

[7] *See* Public Company Accounting Oversight Board, Registered Firms, *available at* http://pcaobus.org/Registration/Firms/Pages/RegisteredFirms.aspx.

Qualified Investors, as defined in detail in the LSTA, SFIG, and SIFMA letter.[8] These requirements are so extensive because CLOs are structured in a manner designed to permit CLOs to qualify for exemptions from the requirements of both the Investment Company Act of 1940 and the Securities Act of 1933. In the overwhelming majority of cases, this requires CLOs to limit sales of securities other than the CLO equity to "Qualified Institutional Buyers" under the Securities Act, and limit sales of CLO equity to (1) "institutional accredited investors" who are also "qualified purchasers," or (2) "accredited investors" who are either "qualified purchasers" or "knowledgeable employees." As you know, Qualified Institutional Buyers are an exceptionally restricted class of purchasers. The additional eligible purchasers for CLO equity are either institutional investors (a group that, typically, includes the collateral manager) or persons with a close working relationship with the CLO manager. As a result, the transfer limitations applicable to the equity issued in CLO transactions limits the investor base in a manner consistent with the requirements of the Securities Act of 1933 and the Investment Company Act of 1940, but permits purchases by precisely the persons who are being required to hold a stake in the CLO equity to align manager and general investor interests. Those are the persons who, under the policies of Section 941 of the Dodd-Frank Act and the agencies' proposed rules, are being required to have "skin in the game" in the form of retained credit risk. If eligible investors were limited to Qualified Institutional Buyers, that would limit the ability of CLO managers – who may not themselves be Qualified Institutional Buyers – to retain credit risk as contemplated by the agencies' rules and Section 941.

More broadly, these requirements impose a series of significant and appropriate investor protections. CLO securities are not a retail product, and the investor eligibility requirements ensure that will continue to be the case. The eligibility requirements are at least as extensive as those applicable to private placements, for which the risks to investors may be considerably greater. And, unlike eligibility restrictions for Rule 144A and other securities, the eligibility requirements applicable to CLO investors apply for the life of the security, extending their protections to any secondary purchasers.

(3) Trustee Reports. The proposed approach would further require Qualified CLOs to meet a series of requirements designed to increase transparency and disclosure, including provision of a detailed monthly report to noteholders.[9] That report would include information on the CLO assets, the portfolio, the level of compliance with each applicable overcollateralization and interest coverage test, purchases, repayments and sales, and the identity of any defaulted asset.[10] Because the standard confidentiality restrictions included in CLO agreements and applicable to the monthly trustee or similar reports prepared in CLO transactions do not restrict the CLO managers' ability to provide these reports to their regulators, and because CLO managers of Qualified CLOs must be registered investment advisers, we anticipate that there

[8] *See* LSTA, SFIG & SIFMA Letter Comment (Jan. 10, 2014) at 8–9 & n.23.

[9] *See id.* at 9–10.

[10] *Id.*

would be no limitation on provision of such reports to SEC examiners in their registered investment adviser examinations of such CLO managers. Even if that were not the case, CLO managers would be able to structure their transactions to comply with any future requirement that such reports be provided to SEC examiners who might review the operations and practices of CLO managers.

The LSTA appreciates the agencies' consideration of these comments and would be pleased to provide additional information that might assist the agencies' decision-making. Please contact Meredith Coffey at (212) 880-3019 or Elliot Ganz at (212) 880-3003 if you have questions regarding these comments or would like clarification on other aspects of the Qualified CLO proposal.

Sincerely,

R. Bram Smith

R. Bram Smith
Executive Director
Loan Syndications and Trading Association (LSTA)