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House Subcommittee on Capital Markets and Government Sponsored Entities Hearing on

The Dodd-Frank Act's Impact on Asset-Backed Securities

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Good afternoon Chairman Garrett, Ranking Member Maloney and members of the Committee. My name is Meredith Coffey, and I am the Executive Vice President in charge of research and analysis at the Loan Syndications and Trading Association, or LSTA.[1] The LSTA is an association that represents the interests of all participants in the $3 trillion corporate loan market. Importantly, the LSTA does not represent the securitization market or the market for Collateralized Loan Obligations (or "CLOs"). Instead, the LSTA represents the corporate loan market – and our concern is how certain regulation could severely diminish securitization (particularly CLOs) and how this could markedly reduce U.S. companies' access to the loans they need to expand, build factories, build cellular networks and engage in M&A as they grow and create jobs. We are grateful to be here today to testify on how important securitization is to lending and to U.S. companies, and how regulation – if it is poorly structured and implemented – could decimate this important market.

My testimony will begin with an introduction to the U.S. corporate loan market, will then describe CLOs and address how regulation could inadvertently – but very adversely – affect this very important source of financing for U.S. companies. Finally, I will offer relatively simple ways that the agencies can address the unintended problems that their rules create for CLOs.

The U.S. Corporate Loan Market

[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 engages in 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.

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According to the Shared National Credit Review, which is run jointly by the Office of the Comptroller of the Currency ("OCC"), Federal Reserve and Federal Deposit Insurance Corporation ("FDIC"), banks and non-bank lenders provide more than $3 trillion in loan and loan commitments to companies. As of mid-2013, U.S. and foreign banks provided $2.4 trillion, while non-banks (like CLOs, finance companies, mutual funds and others) provided nearly $600 billion in these loans and commitments.[2] The companies that borrow these loans include blue chip investment grade companies like IBM, UPS, Exxon Mobil, McDonalds, Wal-Mart, Microsoft and John Deere. But not every company can be Wal-Mart or Microsoft – and almost all companies need financing. Large non-investment grade companies that rely on the corporate loan market include Community Health, Sears, Aramark, SuperValu Stores, Rite Aid, Goodyear Tire, and Delta Airlines who, together, employ hundreds of thousands of Americans. The loan market also provides financing for smaller, innovative companies like web.com, 2nd Story Software, Rocket Technology, Websense, and Hyland Software. Indeed, nearly 5,000 non-investment grade companies receive significant financing from the corporate loan market[3] – it is a critical funding source for them.

Unfortunately, many companies may lose their access to capital in the years to come. As a result of a series of regulations over many years, banks have increasingly been discouraged from lending to smaller, non-investment grade companies. Meanwhile, major non-bank sources of financing – particularly CLOs – may be greatly diminished by regulations such as risk retention and the Volcker Rule. It is this threat to financing for U.S. companies that drives the LSTA to testify today.

CLOs and the Loan Market

U.S. CLOs provide approximately $300 billion in financing[4] to U.S. non-investment grade companies like healthcare companies Community Health and HCA, food companies Del Monte and Dunkin Donuts, technology companies big (like Dell Computer) and small (like NetSmart

[2] *Shared National Credits Program, 2013 Review, available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131010a1.pdf.
[3] Thomson Reuters LPC DealScan database.
[4] *Thomson Reuters LPC Leveraged Loan Monthly*, January 2014, at slide 39.

Technologies), and many more. According to Thomson Reuters, more than 1,000 companies receive financing from CLOs. In all, we estimate that companies that rely on CLOs employ more than five million people.

Unfortunately for these companies, the CLO industry is facing an existential threat. According to a study by Oliver Wyman, the risk retention rules alone threaten to reduce the CLO market by as much as 60 to 90%.[5] If the CLO market is reduced so dramatically, a substantial shortfall in financing for the companies that rely upon them would result. While it is possible that these companies may be able to seek other sources of financing, this other financing would likely be far more expensive. According to the Oliver Wyman study, if the CLO market were to shrink as anticipated, to the extent that supply of financing could be replaced, it would likely cost corporate borrowers $2.5-3.8 billion per year in additional interest costs to replace them.[6] So, the choice for U.S. companies would be to do without financing, or face markedly higher financing costs. Neither outcome bodes well for economic growth and job creation.

But what exactly are CLOs and why is regulation so troublesome for them? CLOs are straight-forward, long-only investment funds that invest in bank loans to U.S. companies. They are most akin to a mutual fund where an investment manager selects pieces of individual corporate loans to purchase and actively manages that portfolio of loans.[7] Critically, being long-only investments, CLOs are not complicated derivatives where some people have a stake in a portfolio's success while others have a stake in its failure. Nor are they originate-to-distribute structures that create loans for the sole purpose of selling and securitizing them. At bottom, a CLO is simply an actively-managed investment fund that uses securitization technology to provide its investors exactly the risk and return they are looking for.[8]

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[5] Oliver Wyman, *Risk Retention for CLOs: A Square Peg in a Round Hole* (Nov. 2013), at 14 ("Oliver Wyman Study"), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17298.
[6] *Id*. at 21.
[7] These corporate loans are usually very large – $20 million to more than $1 billion – and pieces of these loans are syndicated to many different investors, including CLOs. A CLO would typically purchase a $1-10 million piece of a loan.
[8] The terms "CLO" and "open market CLO" are used interchangeably in this testimony. Both terms include CLOs that are actively managed, as described above, but do not include synthetic CLOs or "balance sheet CLOs." A "balance sheet CLO" means a CLO whose assets consist predominantly of loans originated and transferred to the

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While CLOs are benign and proven investment products that have historically performed very well, they often are mistaken for collateralized debt obligations, or CDOs. In fact, they are quite different. Critically, the collateral is very different. CLOs invest in senior secured syndicated loans to U.S. companies, like Sears, HCA, SuperValu, Goodyear, Websense, among many others. The characteristics, credit risk and performance of each of these loans are very transparent. There is an active syndication and trading market for loans – in fact, more than $500 billion of U.S. syndicated loans traded in the secondary market in 2013.[9] Each loan is typically individually rated by a third party rating agency and there are two major pricing services that provide daily prices on these loans. Moreover, the typical CLO portfolio has only 100-150 companies in it; thus the manager can track these individual loans easily – and decide to sell a loan if it is underperforming. In addition, CLOs are diversified by industry, with no industry typically accounting for more than 15% of the portfolio. Finally, CLO investors receive a wealth of information regarding the CLO and the underlying assets on a regular basis. Every month, investors receive a trustee report that details the CLO's loan assets and, for each asset, reports its interest rate and maturity date. In addition, investors receive a report on the portfolio itself, how much each asset comprises of the portfolio and how the CLO is performing relative to its overcollateralization and interest coverage tests. Finally, the CLO investors receive a report on all purchases, repayments and sales during the month, as well as the identity of any defaulted loans.

Another critical difference between CLOs and CDOs is performance. In a report released in January 2014, Standard & Poor's wrote that it had rated over 6,100 CLO tranches in the 20 years between 1994 and 2013. In that time, just 25 CLO tranches defaulted, creating a 0.41% *cumulative* 20-year default rate.[10] Just eight investment grade CLO notes defaulted in that

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CLO by one or more of its affiliates other than in (i) open market transactions or (ii) from another open market CLO, and the assets and liabilities of such CLO are, immediately after issuance of its asset-backed securities in a securitization transaction, included under generally accepted accounting principles in the consolidated balance sheet of one or more of its affiliates.

[9] LSTA *Week in Review* (Jan. 24, 2014), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17433.

[10] Standard & Poor's, *Twenty Years Strong: A Look Back at U.S. CLO Ratings Performance from 1994 Through 2013* (Jan. 31, 2014), at 4-5, *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17549.

timeframe – a cumulative 20-year default rate of 0.15% - and *not one of the 3,997 notes rated AAA or AA defaulted*.[11] This compares extremely favorably to other assets.

Why did CLO notes perform so well? This performance was due to the unique characteristics described above (asset performance, diversification and disclosure) as well as structural protections in CLOs and an alignment of interest that already exists between the CLO manager and its investors.

But, unfortunately, regardless of the critical role that CLOs play in the provision of credit to U.S. companies and notwithstanding their stellar performance, CLOs are currently set to be swept up – and devastated – by regulation that was not intended to be targeted at them. The major regulatory threats to CLOs today are risk retention and the Volcker Rule.

The Volcker Rule

In the final Volcker Rule ("Final Rule") that was issued on December 10, 2013, CLOs that contain any securities (other than cash-equivalent securities) are "covered funds" and banks are not permitted to hold "ownership interests" in covered funds. Most CLOs issued before the publication of the Final Rule either hold small amounts or have the ability to purchase securities and thus are covered funds.[12] Moreover, based on a single provision contained in the Final Rule (which did not even appear in the proposed rule), banks that hold debt securities technically appear to have an ownership interest in these CLOs. There are seven "indicia of ownership" in the Volcker Rule that are intended to ensure that debt with certain equity-like features are treated as ownership interests. Unfortunately, one of the indicia of ownership – "the right to participate in the selection or removal" of an investment manager of a covered fund, "(excluding the right of

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[11] *Id.* at 6.

[12] Roughly 62% of outstanding U.S. CLOs actually hold some bonds, generally less than 3% of the portfolio, according to Thomson Reuters LPC. In addition, almost all outstanding U.S. CLO's have the ability to acquire securities under their transaction agreements. U.S. Banks, which hold approximately $70 billion of CLO notes, mostly in the AAA and AA rated tranches, do not have the ability to require the manager to sell bond holdings. Thus, simply "selling the bond holdings" is not a realistic solution to the ownership interest problem. Contrary to what the regulators have suggested, therefore, this is not a minor, easily resolved problem. *See, e.g.,* Gruenberg, Martin, testimony February 5, 2014, before the U.S. House, Committee on Financial Services.

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a creditor to exercise remedies upon the occurrence of an event of default or acceleration event)" – is a significant problem for CLOs.

CLOs provide the holders of their debt securities with a number of creditor rights designed to protect their debt interests. Most of these rights are vested in the "controlling class," typically the most senior class of debt securities then outstanding.[13] Most existing controlling class CLO debt security holders have the contingent right to participate in the removal and replacement of the CLO manager, but only "for cause," as such term is defined in the transaction documents. The definition of "cause" that would trigger the right of removal includes, for example:

- a willful breach by the manager of its obligations under the CLO transaction documents;
- the dissolution or insolvency of the manager;
- a material failure of a representation or warranty that is not timely cured; or
- fraud or criminal activity by the manager in connection with its investment management business.[14]

Most existing controlling class CLO debt security holders also have the right to participate in the replacement of a manager after the manager's resignation. The resignation of the manager 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.

These "for cause" and resignation events pose clear and direct threats to the interests of holders of debt securities as creditors of a CLO, and their ability to respond to and remediate these threats is properly viewed as an essential creditor's right, and not as an ownership interest.

[13] Since CLO debt securities are paid serially, any class of these debt securities can become the controlling class after the more senior classes have been paid in full.
[14] *See, e.g.*, *Offering Circular for the Finn Square CLO LTD. Transaction* (January 2013), at 128-130, which contains typical "for cause" manager removal and replacement provisions, *available at* http://www.centralbank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/14788/Prospectus%20-%20Standalone%20302052.PDF.

Oddly, the Final Rule carves out from the definition of ownership interest a security whose rights to remove or replace a manager stem from the occurrence of an event of default but do not carve out such rights when they are ***triggered by provisions that are meant to prevent an event of default****.*

In the absence of interpretive guidance from the agencies or action from Congress, this provision threatens to seriously disrupt the CLO market. The provision arbitrarily converts CLO debt securities into the equivalent of equity securities even though they have none of the indicia of ownership that markets expect from equity securities. And, since banks are not permitted to hold ownership interests in "covered funds,"[15] which, as defined in the Final Rule includes CLOs that hold any securities, that artificial conversion of debt into equity solely by virtue of these limited voting rights, in turn makes CLO debt securities ineligible for banks to hold.

We are heartened by the bipartisan recognition by lawmakers of this problem. As discussed below, we support the draft legislation that Representative Barr has prepared,[16] and believe its passage would certainly address the problem. In addition, we greatly appreciate the letter to the regulatory agencies that Representative Waters, Maloney and 15 other lawmakers sent to the regulators regarding the Volcker Rule's application to CLOs."[17]

As the letter notes, the Volcker Rule, as written, would indeed have a very disruptive effect on the CLO market. U.S. banks hold an estimated $70-80 billion of CLO notes, which would have to be divested before July 2015. Non-U.S. banks, which also may be subject to the Volcker ownership prohibitions, hold another estimated $60-80 billion of such notes. Even the threat of such a divestiture roiled the CLO market in December and January. Due primarily to uncertainty

[15] Covered funds are defined in a way that includes securitization vehicles, such as CLOs, that rely on the section 3c-1 or 3c-7 exemptions from the Investment Company Act of 1940.
[16] *See* Discussion Draft of H.R. _____, introduced by Mr. Barr, "To amend the Bank Holding Company Act of 1956 to exclude certain debt securities of collateralized loan obligations from the proprietary trading prohibitions known as the Volcker Rule."
[17] Letter from Rep. Waters et al. to Chair Yellen et al. (Feb. 12, 2014), *available at* http://democrats.financialservices.house.gov/press/PRArticle.aspx?NewsID=1629.

around the Volcker Rule, in January 2014, U.S. CLO issuance dropped nearly 90% - to less than $2 billion – from the year-earlier period.

Indeed, this result occurred nearly a year and a half before banks would have to dispose of CLO notes under the Final Rule and demonstrates that the amount of damage a forced sale could create is astonishing. If U.S. and foreign banks were forced to sell $70-150 billion of CLO notes, prices would undoubtedly fall and create significant problems for both the selling banks and for the market as a whole. While no one knows exactly how much prices would decline, a variety of scenarios illustrate how significant the problem could be. If CLO note prices dropped just 1% on a mass sale – a very conservative estimate – that would translate to a $1.5 billion loss of value on the estimated universe of bank-held CLO notes. Similarly, a 5% price drop could create a realized loss of $7.5 billion, while a 10% price decline translates to a $15 billion loss. Critically, these substantial losses would not in any way be related to the credit-worthiness of the underlying notes which continue to perform very well. Instead, the losses would be due to forced selling, driven entirely by the implementation of the Final Rule which arbitrarily converts CLO debt securities into ownership interest.

This threat has the potential of greatly reducing banks' interest in holding new CLO notes. It has been estimated that if the Volcker Rule were unchanged, demand among U.S. banks for CLO notes could drop by 80%, significantly reducing CLO formation – and markedly reducing credit availability (or increasing the cost of credit) for U.S. non-investment grade companies.[18]

Fortunately, there is an easy solution for this disruption. The draft legislation prepared by Congressman Barr would resolve a significant portion the problem, by removing the threat of a fire sale of $70-150 billion of CLO debt securities, and clarifying, prospectively, that the ability to participate in the removal or replacement of a CLO manager for cause does not constitute an ownership interest.[19] We also believe that the agencies could do much to stabilize the market by

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[18] *See* Thomson Reuters LPC "LoanConnector Content Teaser" (Feb. 10, 2014), *available at* http://share.thomsonreuters.com/loanpricing/lsta_teaser/lsta_teaser_20140214.html#4.*bern*.

[19] A number of our members have reported that certain of the agencies may be taking the position that two other subsections that define ownership interests, *i.e.*, §§ __.10(d)(6)(D) and (E), could apply to CLO debt securities and also render them ownership interests. We believe this interpretation is mistaken. A memorandum to the LSTA from

issuing simple regulatory guidance that would grandfather CLO notes issued prior to the publication of the Final Rule and clarify that CLO debt securities that contained the right to remove or replace a CLO manager for cause, or replace a manager upon its resignation, with no other indicia of ownership, will not be considered ownership interests[20]

We appreciate the work that members of the committee have done in providing a letter to the agencies recommending a solution, as well as Congressman Barr's bill that would address both grandfathering existing CLOs and resolving the ownership issue for new CLOs.

Risk Retention

As proposed to be implemented by the agencies, risk retention also poses an existential threat to CLOs and the financing that they provide for U.S. companies. To understand why, it is important to appreciate both the legislative goals and language of Section 941 of the Dodd-Frank Act, which addresses risk retention.

Section 941 of Dodd-Frank sought to use risk retention to align the incentives of "securitizers" with those of their investors. The very language of Section 941 suggests that it was intended to mitigate moral hazard in "originate-to-distribute" securitizations. The definition of a securitizer – that entity that "initiates or originates an ABS by ***selling or transferring assets***, directly or indirectly, to the Issuer" – must ***retain 5% of the credit risk of the assets***. The concept here is that a securitizer has a portfolio of assets on its balance sheet and, instead of selling 100% of the credit risk of the assets, it can only sell 95% - and must retain 5%.

While requiring the alignment of the interest of a "securitizer" in an originate-to-distribute securitization with its investors is reasonable, the application of risk retention to open market CLOs as proposed is extremely damaging. Actively-managed CLOs do not have a securitizer as

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the law firm of Clearly Gottlieb Steen and Hamilton addresses these issues in detail and strongly supports our view. Memorandum for Elliot Ganz, General Counsel, Loan Syndications and Trading Association (Feb. 3, 2014), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17547.

[20] The LSTA and other trade associations have submitted numerous letters to the regulatory agencies requesting this relief. They are available at http://www.lsta.org/WorkArea/showcontent.aspx?id=17404; http://www.lsta.org/WorkArea/showcontent.aspx?id=17355; and http://www.lsta.org/WorkArea/showcontent.aspx?id=17354.

defined in Dodd-Frank. There is no entity that initiates or originates a securitization by selling or transferring assets. Instead, a CLO acts as an investment fund; a CLO manager is hired to purchase assets from a number of individual banks or in the secondary market on an arm's length basis and actively manage the portfolio during a multi-year reinvestment period. Thus, the Dodd-Frank definition of securitizer simply does not correspond to open market CLOs. Ultimately, with no "securitizer" that matches the statute, the agencies decided to classify the CLO manager as the "sponsor" as it is the entity that ***selects assets for purchase***, and then manages the portfolio going forward. Because the agencies tagged the manager, the manager would need to purchase and hold 5% of the notional value – or $25 million of notes of any new $500 million CLO that is done.

There are two problems with the Agencies' proposed solution: First, as a matter of logic and statutory construction, it is contrary to the plain language definition of securitizer in Section 941 of Dodd-Frank to tag the *buyer* of assets as the securitizer, rather than the *originating seller*. Second, as a practical matter, it is economically unfeasible for nearly all open market CLOs to retain 5% of the notional amount of the CLOs they manage.[21]

Unlike banks, most CLO managers are thinly capitalized asset managers. They generally don't have the balance sheet or the funds to purchase $25 million of CLO notes for every new $500 million CLO they do. Consider a mid-sized CLO asset manager with 30 employees. If that CLO manager were planning to manage a new $500 million CLO, those 30 employees would need to come up with $25 million – quite possibly out of their own pockets. Most management firms simply do not have this capital. To illustrate the issue another way, CLO managers typically earn an annual 0.4%-0.5% management fee on the CLOs they manage. This means that a CLO

[21] A third problem has emerged for CLOs under the risk retention proposal as well: That the forms of retention are not equivalent. While the vertical, L-shape and horizontal retention options all require the same *dollar amount of retention* - $25 million for a $500 million CLO – they account for distinctly different amounts of *credit risk retention*. By definition, the vertical pro rata strip is 5% of the credit risk. However, because credit losses [eat up] the CLO capital stack from the bottom, the horizontal equity retention contains far more than 5% of the credit risk. A study by a Harvard economics professor indicated that nearly all of the credit risk would reside in holding equity equivalent to 5% of the CLO. *See* Letter from Professor Christine Ivashina to Directors, Commissioners, and Staff Members of Financial Regulator Agencies re: Notice of Proposed Rulemaking, Credit Risk Retention (Apr. 1, 2013), at Appendix A to LSTA Comment Letter on Risk Retention (Apr. 1, 2013) ("April Risk Retention Letter"), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=16434.

management firm would earn approximately $2-2.5 million per $500 million CLO per year.[22] This is less than one-tenth the amount of money that CLO managers would need to find simply in order to be allowed to run their business – a business that they have been running successfully with infinitesimal losses to note holders for over 20 years.

Because CLO managers generally do not have the funds to meet the risk retention requirements as structured by the agencies, there would be a severe impact on CLO formation. The impact can be measured in several ways. First, at the request of the agencies, in June 2013 the LSTA developed and distributed a survey to managers to determine whether they would be able to issue new CLOs if they were required to purchase and retain 5% of the face value of those CLO notes. Managers running 509 CLOs responded to the survey; they estimated that they would ultimately be able to maintain fewer than 60 CLOs – a decline of more than 80%. The survey asked managers to estimate the impact on the CLO market in general. Ultimately, 85% of respondents said that the CLO market would be reduced by 75% or more.[23]

Second, the Oliver Wyman Study, which reviewed what has occurred when CLO managers were required to purchase and retain CLO notes,[24] estimated that CLO activity would decline by 60-90%.

This would have a severe impact on companies that rely on CLOs for financing. Their access to credit would likely decline significantly. If the companies were able to find replacement funding, Oliver Wyman shows that it would likely come at a much higher cost. As discussed above, the study estimates that the cost of replacement financing could be an additional $2.5-3.8 billion per year.

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[22] This is maximum potential revenue, not profit; a very substantial proportion of the fee goes to paying expenses and would not be available for purchasing and retaining equity.

[23] *See, e.g.*, LSTA Comment Letter on Risk Retention (July 29, 2013) ("July Risk Retention Letter"), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=16881.

[24] The Oliver Wyman study observes that in "2009 and 2010, in the wake of the crisis, there was a major pullback in the appetite for higher-risk, higher-return investments in the credit markets. As a result, virtually all CLOs formed in this period involved the CLO managers contributing the entire equity portion of the CLO's liability structure. In 2009, when CLO managers had to provide all of the equity for their CLOs, the volume of newly formed CLOs dropped to approximately 2% of what had been formed in 2004, and were only about 1% of the 2012 volume. In the more stabilized market of 2010, CLO formation volumes were 14% of the 2004 volumes (and less than 8% of 2012 volumes)." Oliver Wyman Study, *infra* note 10, at 15.

CLOs played no role in the Financial Crisis and have an extraordinary 20-year track record. It is very unfortunate that a regulation targeted at an entirely different problem is likely to decimate CLOs. It is a problem that cries out for a solution.

Proposed Solution for Risk Retention and CLOs

In its comment letters, the LSTA has demonstrated that the plain language of the text of Section 941 does not apply to CLO managers[25]. Nevertheless, because the impact of the proposed rules would be so severe for the industry, the LSTA and other trade bodies have worked constructively with the agencies to forge a solution that the agencies find acceptable and that will not dramatically impair the CLO market.[26]

Most recently, based on work with our membership, the LSTA, SFIG and SIFMA submitted a comment letter[27] on January 10, 2014 advocating a form of risk retention that is designed to meet the objectives and concerns set forth in the proposed rules and in discussions with agencies' staff, while also avoiding the dramatic reduction in the scope and market role of open market CLOs. Under the proposed approach, open market CLOs that meet a series of criteria would qualify to satisfy the credit risk retention requirement through the CLO manager's purchase of five percent of the CLO's *equity* and through credit risk retained by the manager through the deeply subordinated compensation structure. The criteria are designed to protect investors and improve asset selection through loan asset and portfolio restrictions, leverage limitations, manager regulation, alignment of manager interests with investors, and transparency.

The proposed approach provides a range of protections for investors and ensures sound asset selection practices without requiring a different construction of Section 941 or a complete

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[25] *See* LSTA Comment Letter on Risk Retention (Aug. 1, 2011) ("August Risk Retention Letter"), at 7–14, *available at* http://www.sec.gov/comments/s7-14-11/s71411-223.pdf; April Risk Retention Letter, at 16–19; LSTA Comment Letter on Risk Retention (Oct. 30, 2013) ("October Risk Retention Letter), at 4–7, *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17146, (collectively, with the July Risk Retention Letter, the "LSTA Risk Retention Letters").

[26] *See* the LSTA Risk Retention Letters.

[27] LSTA, Structured Finance Industry Group, and Securities Industry and Financial Markets Association Comment Letter on Risk Retention (Jan. 10, 2014) ("January Risk Retention Letter"), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17403.

exemption for open market CLOs. At the same time, the approach provides a workable solution for most CLO managers while preserving the role of open market CLOs in ensuring credit price competition, broad access to credit markets, and varied product offerings to investors. Adoption of the proposal is well within the agencies' authority and can be implemented without seeking further comment on newly proposed rules.

Under the proposed approach, the rules would apply distinct risk retention requirements to a manager of an open market CLO that meets a series of requirements designed to ensure high quality underwriting and to protect investors. A CLO meeting the requirements would be treated as a "Qualified CLO." The manager of a Qualified CLO would be able to 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.

Essentially, the Qualified CLO creates six overlapping restrictions that meet a number of the agencies' objectives: It supports strong underwriting, it facilitates a continuity of credit, it ensures the alignment of interests of the managers and the investors, it limits the disruption in the market, and it protects investors. In effect, for a CLO to become a Qualified CLO, its governing documents would have to include requirements and restrictions around (1) asset quality; (2) portfolio composition; (3) structural features; (4) alignment of the interests of the CLO manager and investors in the CLO's securities; (5) transparency and disclosure; and (6) regulatory oversight.

To ensure appropriate asset quality, at least 90% of the Qualified CLO's assets must be cash and senior secured loans to companies; it cannot purchase ABS interests, derivatives, loans in default, margin stock, or equity convertible notes; loans must be held by three or more investors or lenders unaffiliated with the CLO manager; and no more than 60% can be loans that rely on incurrence covenants (as opposed to maintenance covenants). In effect, the asset quality tests require the CLO to purchase high quality non-investment grade loans that have a low expected loss.

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The next layer of protection comes from the composition of the portfolio. Not only must the CLO purchase higher quality non-investment grade loans, but it must do so in a diversified manner. To ensure this objective, no more than 3.5% of its assets can be invested in loans to any single company and no more than 15% can be invested in loans to any one industry. With robust diversification, the whole portfolio should be stronger than the sum of its assets.

The next layer of protection comes from the CLO structure itself. In order to differentiate Qualified CLOs from CDOs and to provide additional protection for the debt tranches, the Qualified CLO must have equity of at least 8% of the face value of the CLO assets. To add further creditor protections for the debt tranches, the Qualified CLO must be subject to interest coverage and overcollateralization tests that divert cash to pay down the notes if the portfolio underperforms.

Next, the Qualified CLO ensures the alignment of interests between the manager and its investors. First, it must be an open market CLO, not a balance sheet CLO.[28] Next, the equity investors must have the ability to remove the manager for cause. In addition, the majority of the managers' fees must be subordinated to the rated CLO notes. Moreover, the manager must purchase and retain 5% of the CLO equity. Finally, for each of the first two years, the manager cannot receive distributions on its retained equity of more than 30%. These protections – the ability to fire the manager, subordinating most of the income of the manager, requiring funded retention that is not paid out upon closing – align the interests of the manager and investor.

The next protection in the Qualified CLO – transparency and disclosure – ensures that the investor has enough information to make an informed judgment about the CLO. To be a Qualified CLO, the manager must provide a monthly report that provides significant information on the assets (obligor name, CUSIP, interest rate, maturity date, type of asset and market price where available) and on the portfolio (the aggregate balance, the adjusted collateral principal amount, and the percentage of adjusted collateral represented by each name). In addition, the

[28] *See infra* note 14.

report must detail each Overcollateralization and Interest Coverage test and their status, all purchases, repayments and sales, as well as the identity of each defaulted asset. With all this information, the QCLO is extraordinarily transparent, unlike some of the securitizations that played a material role in the financial crisis.

The final protection is built around regulation: The Qualified CLO manager must be a registered investment advisor, with all the regulations and responsibilities – not least the fiduciary responsibilities – that go along with this.

With these six overlapping protections, a Qualified CLO will have a sound structure, will invest in higher quality non-investment grade loans in a diversified manner, will ensure alignment of interests between the CLO manager and investor, will ensure that the investors are sophisticated and further ensure that these sophisticated investors receive all the information they need to make informed judgments. Furthermore, it will offer all these benefits while limiting the disruption that the current risk retention proposal would impose on the CLO and financing markets. Thus, the Qualified CLO approach would accomplish precisely the objectives of Section 941, related to ensuring prudent asset selection and underwriting, protecting investors, ensuring access to and competition in the provision of capital, and achieving related public interest benefits.

This proposal is eminently doable. The agencies have ample authority under each of three statutory sources to adopt rules implementing the approach outlined above. Section 941 of Dodd-Frank requires the agencies to shape its rules according to the public interest as well as provides additional, permissive exemption authority, each of which, properly construed, would encompass the proposed approach to CLO risk retention. In addition, the agencies have the authority to adopt rules implementing the proposed approach as a permissible interpretation of the term “credit risk” under Section 941. Apart from these specific sources of authority, more general statutory authorities empower the finance agencies,[29] and the Securities and Exchange Commission in particular,[30] to issue rules that would implement the proposed approach.

Conclusion

CLOs have been a benign and proven source of financing for U.S. companies for 20 years. CLOs survived the worst financial crisis since the Great Depression with extremely low default and loss rates. Moreover, they continue to provide nearly $300 billion in financing to U.S. companies. Unfortunately, inadequately structured and implemented regulation has the potential to shut down this market. In particular, both the Volcker Rule and risk retention pose existential threats to CLOs. Fortunately, there are ways to fix the implementation of the Volcker Rule and risk retention to allow them to work as their drafters intended, while still permitting CLOs to function and provide financing to the one thousand companies that currently rely upon them.

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[29] Section 23 of the Securities Exchange Act of 1934 ("Exchange Act") provides: The [Securities and Exchange] Commission, the Board of Governors of the Federal Reserve System, and the other agencies enumerated in section [3(a)(34)] of this title shall each have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter for which they are responsible or for the execution of the functions vested in them by this chapter, and may for such purposes classify persons, securities, transactions, statements, applications, reports, and other matters within their respective jurisdictions, and prescribe greater, lesser, or different requirements for different classes thereof."

[30] In addition to the exemption authority provided in Section 941, the Commission also has broad general exemption authority under the Exchange Act, which likewise readily encompasses adoption of the proposal described above. Under Section 36 of the Exchange Act, the Commission "by rule, regulation, or order, may conditionally or unconditionally exempt … any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." Among the provisions of "this chapter" is the credit risk retention provision. For the reasons explained above, the proposal is both "necessary" and "appropriate in the public interest" and is "consistent with the protection of investors."

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