May 26, 2017

Hon. Steven Mnuchin
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, D.C. 20220

Re: Ownership Interests in Connection with Certain CLO Debt Securities under the Volcker Rule

Dear Secretary Mnuchin,

In support of your efforts to identify counterproductive or overbroad financial regulations, as directed by President Trump in his order of Feb. 3, 2017 (“Executive Order”), 1 I write on behalf of the Loan Syndications and Trading Association (“LSTA”) to identify a significant financial regulation that is inconsistent with the Core Principles identified in the Executive Order and suggest that it be modified to advance the interests of U.S. corporate borrowers, investors, investment managers, banks, and the markets. The proposed regulatory relief is narrowly tailored and can be easily accomplished without legislation or rulemaking, through the issuance of a simple commonsense interpretation.

The modification we propose is limited to one component of the regulations adopted on December 10, 2013 to implement Section 619 of the Dodd-Frank Act (the “Volcker Rule”) by four agencies (the Securities and Exchange Commission (“SEC”), the Board of Governors of the Federal Reserve (“Federal Reserve”), the Federal Deposit Insurance Commission (“FDIC”), and the Office of the Comptroller of the Currency (“OCC”)2 and on January 31, 2014 by a fifth agency (the Commodity Futures Trading Commission) (“CFTC”)3 (together, the “Agencies” and the “Volcker Regulations”). The Volcker Regulations became effective on April 1, 2014.

We propose that the Agencies’ overly-broad definition of “ownership interest” in a “covered fund” be interpreted to make clear that the right of a debt security holder to participate in the removal or replacement of an investment manager for cause (“for-cause voting rights”)4 is not an ownership interest. Deeming debt securities with for-cause voting rights to be ownership interests effectively prohibits banks and their affiliates from owning the debt of collateralized loan obligations (“CLOs”) that are covered funds, even though the for-cause voting rights have

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4 Volcker Regulations Sec. 10(d)(6)(i)(A), codified at 12 CFR § 44.10(d)(i)(6)(A) (OCC); 12 CFR § 248.10(d)(i)(6)(A) (Federal Reserve); 12 CFR § 351.10(d)(i)(6)(A) (FDIC); 17 CFR 255.10(d)(6)(i)(A) (SEC); and 17 CFR 75.10(d)(6)(i)(A) (CFTC).
none of the characteristics of equity or partnership interests, do not further the purposes of the Volcker Rule, and provide no benefits to American corporate borrowers, investors, or the public. Instead this definition is inconsistent with the Core Principles outlined in the Executive Order and harmful to borrowers, investors, CLO managers, banks, and the capital markets. The interpretation we propose is narrowly tailored and can be easily accomplished without harmful consequences.

Background

Collateralized Loan Obligations

Syndicated leveraged loans in the United States comprise approximately $1.4 trillion of financing to American companies. The companies receiving these loans constitute more than 70 percent of U.S. companies and include a variety of well-known companies and major employers in industrial and service sectors throughout the economy. These companies are generally not eligible for investment grade loans. Issuers of CLOs have for many years been the single largest source of capital that supports these loans and the extensive range of American companies that depend on them to expand operations, create jobs, improve their goods and services, and otherwise increase competition and economic growth.

Issuers of CLOs perform this function by securitizing pools of syndicated bank 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 bank loans or lend to companies that receive them. According to S&P Global Market Intelligence, capital provided by CLO issuers has ranged from $50 billion to $125 billion annually as part of a syndicated loan market of approximately $130-550 billion annually. Banking entities of all sizes, which are covered by the Volcker Regulations, provide a substantial portion of the capital to this sector and traditionally have held a large amount of the highest tranche of CLO debt securities.

These CLO note holders have the right to specified principal and interest but do not have any of the rights typically associated with ownership. They do not have the right or ability, directly or indirectly, to share in the CLO’s profits or losses or to earn a return based on the CLO’s performance. They also have no residual claim to the issuer’s assets, do not receive any of the “excess spread” between interest earned by the underlying assets and interest paid to the holders of other outstanding interests, and do not receive income on a pass-through basis or by reference to underlying performance. Moreover, they do not share in the risk of their claims being reduced based on the allocation of losses, write-downs, or charge-offs on the underlying assets, and also do not have “synthetic rights” to any of these ownership characteristics.

In almost all CLOs, some percentage of the highest, or controlling, class of note holders (sometimes with other classes of note holders as well) have the contingent right to participate in the removal of the manager for cause and in the manager’s replacement after removal or

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5 For the avoidance of doubt, our request does not extend to the “equity” tranche of a CLO, even where denominated as debt, given that it does have indicia of ownership interests.
resignation. However, they do not have the types of voting or control rights that typically attach to equity securities, like the right to vote on establishing the issuer’s objectives and policies, electing its board of directors, or controlling the decisions of the manager. Since CLO debt securities are paid serially, any class of these debt securities can become the controlling class after the prior classes have been paid in full.

Events constituting cause for removal may involve, for example, a willful breach by the manager of its obligations under the CLO transaction documents, the dissolution or insolvency of the manager, or fraud or criminal activity by the manager in connection with its investment management business, as well as deterioration in the performance of a CLO measured by an objective standard. These types of events have a clear and direct threat to the interests of note holders as creditors of a CLO. The resignation of the manager also has a clear and direct impact on the interests of note holders because it is tantamount to a change of control of the issuer. The ability of note holders to respond to and remediate these threats or impacts is properly viewed as an essential creditor-protective right.

Applicability of the Volcker Regulations

“Loan securitizations” are not covered funds under the Volcker Regulations. However, the category of exempt loan securitizations includes only those securitizations comprised solely of loans and certain related servicing and hedging interests. This category is so narrow as to exclude virtually all CLOs that existed when the Volcker Regulations were adopted (“Legacy CLOs”). While Legacy CLOs were comprised primarily of loans, they necessarily also held cash and short-term highly liquid investments in order to be able to invest and reinvest in loans. They typically also held a small amount of corporate bonds, consistent with limits in their governing documents, giving their managers flexibility to adjust to market conditions.

Banking entities with an ownership interest in CLOs that do not conform to the narrow classification of loan securitizations are subject to the covered funds prohibition. The Volcker Regulation enumerates seven types of interests that, according to the Agencies, are “similar” to equity and partnership interests. Any one of these, standing alone, automatically constitutes an ownership interest. Of the seven types, the last six properly relate to economic control of the issuer and the potential for securities holders to receive an “upside” if the CLO performs well. These six types are generally not applicable to CLOs, but if they were, we would agree that they would be indicative of an ownership interest. The first type, however – for-cause voting rights – is not related in any way to the value or economic control of the issuer. This element of the Volcker Regulations irrationally provides that a senior CLO note holder with for-cause voting rights is deemed to have an ownership interest in the issuer. This goes far beyond the statutory prohibition against retaining an “equity, partnership, or other ownership interest” in a covered fund. For-cause voting rights have none of the characteristics of equity and partnership interests and thus simply cannot be considered ownership interests.

6 Volcker Regulations, Sec. 10(c)(8).
7 Volcker Regulations, Sec. 10(d)(6)(i)(A).
The Volcker Regulations contain a narrow exclusion from the for-cause voting rights ownership interest for “the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event.” However, a CLO note holder’s for-cause voting rights are not typically structured to occur in the context of an event of default or an acceleration event. Although it would be a simple, effective, and appropriately-tailored fix, the Agencies have declined to interpret the event of default or acceleration event exclusion to include for-cause voting rights.

Public Benefits of Regulatory Relief

Congress enacted the Volcker Rule to prevent banking entities from engaging in short-term proprietary trading in risky investments, help stabilize the largest financial institutions, and prevent “too big to fail” financial institutions. As part of this, the Volcker Rule prohibits a banking entity from acquiring or retaining an ownership interest in a hedge fund or private equity fund.

Prohibiting banking entities from acquiring or retaining CLO debt securities solely on the basis that they have for-cause voting rights does not accomplish or further any of these goals. Nor does it provide any other benefits to banking entities or to U.S. companies, investors, or the markets in general. On the contrary, it causes harm to each of these.

The Detrimental Effects Arising from Current Regulation

Banking entities have traditionally viewed the senior-most tranche of CLO debt securities as a prudent investment, and through such investment, have provided a significant amount of the capital necessary for banks to continue to make loans to U.S. companies. Indeed, CLOs performed well during the financial crisis and have continued to perform well. The expansive definition of “ownership interest,” however, has had and will continue to have a detrimental effect on all persons and entities that participate in or benefit from the CLO market.

Following the effective date of the Volcker Regulations, issuers of new CLOs have had to either eliminate for-cause voting rights for senior note holders or structure the new CLOs to conform to the conditions in the exclusion for “loan securitizations” so that the senior note holders can retain these limited but critically important rights.

Because of the misguided expansion of the ownership interest definition, CLOs that want banking entities to be able to invest in their debt securities are no longer permitted to hold even de minimis amounts of corporate securities. Traditionally, CLO managers held small amounts of corporate bonds in their portfolios which increased their diversification and also enabled them to respond flexibly to changing market conditions. The decrease in flexibility and diversification

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8See, e.g., 156 Cong. Rec. S5902-01 (Sen. Dodd) (“The purpose of the Volcker rule is to eliminate excessive risk taking activities by banks.”); 156 Cong. Rec. S4138-01 (May 24, 2010); (Sen. Dodd) (“We have also included the Volcker rule to help ensure that the biggest firms are as stable as possible.”); 156 Cong. Rec. S2682-02 (Apr. 27, 2010) (Sen. Merkley) (“[A] strong Volcker Rule is one of the most important provisions to prevent “too big to fail” financial institutions.”).
imposed by the Volcker Rule harms CLO market participants with no corresponding benefits to
the markets, market participants, or financial stability.

**Achieving Regulatory Reform**

The inclusion of for-cause voting rights of CLO note holders as an ownership interest represents
Federal regulation of the U.S. financial system in a manner inconsistent with the Core Principles.
It is thus ripe for elimination.

An ownership interest can be easily redefined to exclude for-cause voting rights from the list of
ownership interest triggers by issuing the following interpretation:

> The “rights of a creditor to exercise remedies upon the occurrence of an event of default
or an acceleration event” in Section 10(d)(6)(i)(A) of the Volcker Regulations includes
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.

Issuing this simple interpretation would effectively and more appropriately tailor the Volcker
Regulations to the statutory language and its purpose.

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We would be pleased to elaborate any of these points and would welcome the opportunity to
work with you and your colleagues to achieve regulatory reform that will benefit investors, U.S.
companies, investment managers, banks, and other market participants.

Respectfully,

R. Bram Smith
Executive Director