STRUCTURED FINANCE ASSOCIATION

Via Electronic Submission

Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090
(duplicate via email to rule-comments@sec.gov)

Re: File Number S7-03-22: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Feb. 9, 2022)

Dear Madam Secretary:

The Structured Finance Association ("SFA") appreciates this opportunity to provide preliminary feedback regarding the above-referenced proposed rule-making (the "Proposal"), which would significantly expand the regulatory requirements applicable to investment advisers to "private funds," a term that is defined in the Investment Advisers Act of 1940 (the "Advisers Act") by reference to reliance upon the Section 3(c)(1) or Section 3(c)(7) exclusions from "investment company" status. That expansion is proposed to be effected through the adoption of a number of new rules under the Advisers Act.

As an association representing participants across the full spectrum of the structured finance and securitization markets – including lenders, securities issuers, institutional investors, financial intermediaries, credit rating agencies, law firms, accounting firms, technology firms, servicers and trustees – SFA plays a vital role in the development of market-consensus solutions that support efficient and stable markets.[1] While our members often have conflicting views and interests, our governance structure requires consensus from all stakeholder groups before SFA takes an advocacy position on legislative or regulatory matters. As such, when we do provide feedback, we do so in a manner that reflects the views of the entire market ecosystem; and the relevant stakeholders for the Proposal include securities issuers, institutional debt investors and equity investors.

In line with the Commission's stated goals in the Proposal, it is important to SFA's members to ensure that the securitization market contains a strong disclosure regime, designed to provide investors with transparency and instill confidence in their ability to fully evaluate investment opportunities. This includes disclosing potential conflicts of interest, as such disclosure is essential to assuring that financial markets can efficiently allocate capital and create liquidity, thus allowing the country's households and businesses to grow and invest responsibly.

[1] SFA is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFA provides an inclusive network for securitization professionals to collaborate and, as industry leaders, to drive necessary changes, to be advocates for the securitization community, to share best practices and innovative ideas and to educate industry members through conferences and other programs. Further information can be found at www.structuredfinance.org.

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SFA and our members have been carefully assessing if, and how, each of the complex provisions in the Proposal might apply to collateralized loan obligation ("CLO") transactions that rely on the Section 3(c)(7) exclusion. This extensive regulatory analysis is further complicated by the fact that the observations, cases and application examples cited in the Proposal are focused almost exclusively on investment advisers that manage hedge funds, private equity funds or venture capital funds. The Proposal does not apply in a clear-cut and straightforward manner to CLOs, given that CLOs are structured as asset securitization transactions with the corresponding structural characteristics of asset-backed securities ("ABS") and extensive monthly reporting.

On March 1, SFA and 12 other trade associations brought to the Commission's attention the challenge presented by the proposed 30-day comment period and requested that the Commission extend the length of the comment period.[2] As highlighted in that letter, the 341-page Proposal would impose complex and sweeping regulatory changes that would impact a broad range of stakeholders, including participants in the CLO market.

Given the short comment period, SFA's mandate to represent the *entirety* of industry stakeholders, the breadth and complexity of the Proposal and the fact that the Proposal does not neatly apply in the CLO context, SFA and our members are still diligently working our way through the full Proposal.

Thus, in this letter we: (1) provide an overview of CLOs and compare them to hedge funds, private equity and venture capital funds; and (2) share our consensus recommendations *achieved to date* on the following components of the Proposal:

1. Absence of "Grandfathering" and Impracticality of Implementing Retroactively in the CLO Context

2. Proposed Rule 206(4)-10: Annual Financial Audit Requirement

3. Proposed Rule 211(h)(1)-2: Quarterly Statements Disclosing Performance, Fees and Expenses

We intend to supplement this preliminary submission, after we have completed our member assessment of the additional aspects of the Proposal, within 30 days.

We note at the outset our members' concern that certain aspects of the Proposal would have negative consequences for the CLO market that have not been appropriately considered, as the Proposal focuses primarily on traditional private funds reliant upon the Section 3(c)(7) exclusion.

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[2] Structured Finance Association, et al. (2022, March 1). Re: File Nos. S7-03-22, S7-01-22. Sec.Gov. https://www.sec.gov/comments/s7-01-22/s70122-20118198-271109.pdf

I. CLOs Explained

A. The Basics

As detailed in Appendix I, CLOs are fixed-income bonds structured to include debt and equity tranches and holding a diversified pool of senior secured corporate loans as the primary collateral for repayment of these tranches. The debt tranches are typically rated by at least one rating agency, with credit ratings from triple-A for the most senior tranche, through double-B or single-B for the most junior tranche. The senior debt tranches are sold exclusively to "qualified institutional buyers" ("QIBs"), as defined in Rule 144A under the Securities Act of 1933 (the "Securities Act"), and non-U.S. persons pursuant to Regulation S under the Securities Act.

B. Economic Benefits of the CLO Market

U.S. broadly syndicated and middle-market CLOs, with over $800 billion of securities outstanding, serve as a very important financing source for U.S. businesses, making credit more available and affordable to thousands of corporate borrowers with high levels of debt or that are rated below investment grade (BBB). CLOs provide approximately 60-70% of the funding for these companies and represent a significant portion of the market for sub-investment grade corporate loans. The obligors on these corporate loans use the proceeds to finance mergers and acquisitions, refinance existing debt, manage their capital structures and expand their businesses, as well as for general operating purposes. CLOs thus play a crucial role in maintaining credit availability to U.S. companies and supporting American economic growth and job creation. Many drivers of today's business and economic expansion succeed because funds for classic American risk-taking ingenuity are more available, at better rates, because the loans made to these businesses can be packaged into, and financed by, CLOs.

Like "asset-backed securities" ("ABS") that help families finance automobiles and homes, the CLO "securitization" process replenishes the funds needed to lend to thousands of non-Fortune 500 businesses. In addition to fueling America's corporate growth, CLOs help to expand the investor base for business loans, bringing more liquidity and stability to this important market. As the U.S. economy has grown, so have business lending and the loans packaged into CLOs to finance this expansion. Between 2019 and 2021, an average of $132.9 billion of U.S. broadly syndicated and middle-market CLOs backed by leveraged loans were issued annually. In 2018, the notional amount of leveraged loans outstanding cleared the $1 trillion mark for the first time in its history; and the outstanding amount of notes issued by U.S. CLOs was approximately $815 billion as of the end of Q1 2022.

II. The Differences Between CLOs and Other 3(c)(7) Vehicles

In its release relating to the Proposal, the Commission focused almost exclusively on investment advisers that manage hedge funds, private equity funds or venture capital funds. Very limited and indirect references were made to CLOs or their managers; the costs and benefits of the Proposal to the CLO market were not assessed to the degree that other 3(c)(7) vehicles were assessed. CLOs differ significantly, both structurally and operationally, from the hedge funds, private equity funds and venture capital funds on which the Commission has focused. Ignoring the fundamental and technical differences between CLOs and other 3(c)(7) private funds is both inappropriate and potentially perilous for capital formation.

Those differences include the following:

- CLOs predominantly issue debt, rather than equity securities, with roughly 90% of their capital structures attributable to debt.

- The debt, predominantly issued by CLOs as securities, are typically rated by at least one rating agency; and their structures and assets are thus carefully reviewed and surveilled on an ongoing basis by the applicable rating agencies and must meet stringent criteria to maintain these ratings.

- CLOs are structured with distinct tranches, each with their own risk profile and payment prioritization within the structure.

- Repayment of CLO bonds depends primarily on the cash flows from the CLO's collateral loan pool, rather than from an effort by the manager to capture increases in the market value of those loans.

- Because payments with respect to CLOs depend primarily upon the foregoing cash flows, CLOs are ABS, as defined in Section 3(a)(79) of the Securities Exchange Act of 1934 (the "Exchange Act"), subject to the Commission's rules ABS status entails, including, in certain cases, the need to file reports under Rule 15Ga-1 of the Exchange Act relating to asset repurchase requests and the credit risk requirements contained in Regulation RR under the Exchange Act.

- Because they predominantly issue debt securities, CLOs operate pursuant to the very strict requirements of bond indentures and have indenture trustees that hold the loans and other assets collateralizing CLO debt obligations.

- A CLO manager's authority is circumscribed not only by a collateral management agreement but also by the provisions of the indenture, which include rigid constraints on the manager's ability to acquire and dispose of assets.

III. Specific Recommendations Regarding the Proposal, As It Relates to CLO Managers

A. Necessity of "Grandfathering"

Because CLOs are structured securitizations, subject to the rigid provisions of their indentures – including onerous investor consent requirements for amendments – SFA believes that any material changes to the regulatory framework applicable to CLO managers could only be implemented prospectively. It likely would not be feasible for CLO managers to comply on any other basis, given the extreme difficulty of amending their governing documents and the impossibility of altering economics that already have been agreed upon by the parties. We note, as well, that CLO bonds have relatively short maturities, making any effort to retroactively implement significant changes both unnecessary and non-cost-effective.

For similar reasons, SFA believes that any transition period should provide affected managers with a realistic timeframe for compliance, which we believe for many of the proposed requirements and prohibitions should be 18 – 24 months.

B. Proposed Rule 206(4)-10: Annual Financial Audit Requirement; Issuer Financial Statements Have Limited Relevancy for CLO Investment Analysis

SFA members are concerned about the utility of mandating annual financial audits for CLOs, as audited financial statements are not material information for CLO investors. Neither the Commission nor the CLO investor community has deemed GAAP financial statements regarding ABS issuers, including CLO issuers, to be meaningful or necessary because the performance of ABS depends primarily upon the cash flows generated by the underlying assets, rather than upon the issuer's success as an operating company. We note, in this regard, that, in the contexts of Exchange Act reporting and Rule 144A, the Commission long ago crafted a specially-tailored disclosure regime for ABS, a regime that has never required audited financial statements relating to the issuer.[3] Regulation AB, which establishes an extensive Securities Act disclosure and Exchange Act reporting framework for SEC-registered ABS, continues this approach. Indeed, the Commission has specifically acknowledged that "… financial information regarding the issuing entity generally does not provide useful information to investors."[4]

Instead, CLOs, like other ABS, make extensive monthly and quarterly information regarding their assets, portfolio performance and cash flow distributions available to investors (and potential investors). Specifically for CLOs, the information furnished on a monthly and quarterly basis on the trustee's website includes:

1. in the case of each specific asset, principal balance, rating, industry, obligor name and certain rating agency data, such as recovery rates; and

2. in the case of the pool, compliance with overcollateralization and interest coverage tests, weighted average spread and weighted average life and other test compliance; and

3. information regarding cash flows from the underlying assets to the CLO distributions, capturing interest and principal payments and payments to service providers and other obligations.

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[3] *See, e.g.*, Resale of Restricted Securities, Rel. No. 33- 6862, reprinted in 55 Fed. Reg. 17933, 17939 (April 30, 1990) (creating a specially-tailored disclosure framework for ABS offered pursuant to Rule 144A; Kidder, Peabody Acceptance Corp. 1987 SEC No-Act LEXIS 2263 (July 24, 1987), approving a specially-created Exchange Act disclosure framework for SEC-registered ABS.)

[4] Asset-Backed Securities, Rel. No. 33-8518 (Dec. 22, 2004), reprinted in 70 Fed. Reg. 1506, 1511 (Jan. 7, 2005).

We note that, unlike the private fund managers upon which the Proposal is focused, CLO assets are held by indenture trustees; and CLO managers have no ability to access them, other than on a limited basis as permitted by the indenture. CLO managers accordingly are not subject to the annual audit provision of Advisers Act Rule 206(4)-2 with respect to which many private fund managers already are accustomed to relying on.

An annual financial audit requirement would thus represent a "sea change" in the CLO market and—along with the proposed quarterly statements rule discussed immediately below—reduce the cash flows available to CLO investors under the payment waterfall, thereby increasing the cost barriers to capital formation via CLO issuance, without affording any attendant regulatory benefits.

C. Proposed Rule 211(h)(1)-2: Quarterly Statements Disclosing Performance, Fees and Expenses Would Provide No Necessary Benefits

SFA members also are concerned that the need to provide CLO investors with quarterly investment statements containing, among other things, prescribed performance information would provide investors with no meaningful benefit, while unnecessarily increasing CLO operating costs.

It is market practice to equip CLO investors with monthly and quarterly reports containing cash flow and performance information germane to CLO investors. As described in the prior section, investors in a CLO receive both monthly and quarterly reports that include detailed cash flow information (including a calculation of amounts distributed to investors at each step of the payment waterfall) and detailed portfolio level information.

D. Further Comments

As noted at the outset, SFA expects to provide additional comments in a supplemental letter, addressing, among other things, the Commission's request for comment regarding issuers that rely upon exclusions other than Sections 3(c)(1) or 3(c)(7), the potential need for a "fairness opinion" in the context of "adviser-led secondaries" and the application of the proposed "preferential treatment" prohibitions and disclosure requirements to the CLO market. Given that the Proposal focuses almost solely on managers of private funds, such as hedge funds, private equity funds and venture capital funds, SFA believes that certain portions of the Proposal raise significant questions and concerns regarding the Proposal's applicability to CLO managers. Moreover, SFA believes that adoption of the Proposal, in its current form, could have significant unintended and adverse consequences in the CLO and corporate lending markets. We note, however, that SFA members may conclude that certain of the proposed rules could enhance transparency for CLO debt and equity investors.

SFA expects that it will submit that supplemental letter within the next 30 days. In the meantime, our membership stands ready to provide further input regarding this important topic, our comments in this letter and the status of the remaining portion of our analysis. If you have any questions about this matter, please contact Kristi Leo, SFA President, at [redacted] or [redacted].

Sincerely,

Kristi Leo
President, Structured Finance Association

APPENDIX

A CLO is a series of interest-bearing bonds, together with a small class of equity securities (each such class or series a "tranche"), backed by a diversified portfolio of assets comprised primarily of corporate leveraged loans. CLOs are created when financial institutions pool similar business loans to serve as collateral for bonds designed to be purchased by institutional investors, such as pension and retirement funds. Those investors purchase CLOs to earn interest income and achieve their portfolio investment objectives, while lending their support to growing American businesses. Indeed, the CLO securitization process replenishes funds to lend to thousands of non-Fortune 500 businesses, making credit more available and affordable for those enterprises.

The debt tranches are typically rated from triple-A for the most senior tranche, through double-B or single-B for the most junior tranche. CLO bonds are repaid through a payment prioritization referred to as a "waterfall," which is imposed in the CLO's indenture. The interest and principal payments received on the underlying corporate loans are collected and then distributed to CLO investors, with the senior most bonds being paid first, followed by the less senior bonds, then the most junior bonds and, lastly, the equity interest.

Investors in CLOs vary by equity and debt tranches, but are predominantly institutional investors, otherwise known as qualified institutional buyers, or "QIBs." The senior-most tranches are the least risky and are usually owned by insurance companies and banks. The riskiest tranche is the equity tranche, which appeals to investors seeking equity returns.

CLOs have a defined lifecycle. As an example, a CLO might have: (1) a warehousing stage of 3-6 months during which initial collateral is purchased; (2) a "ramp-up" period of 1-6 months during which additional collateral is acquired and ratings are confirmed; (3) a reinvestment period of 1-5 years during which the CLO manager actively manages the pool of leveraged loans seeking to improve the portfolio's credit quality; (4) a "non-call" period up to the first 2 years of the reinvestment period, after which the majority equity holder can choose to exercise certain redemption options established at the onset of the CLO and stated in its indenture; and (5) an amortization phase of 1-4 years during which the CLO tranches are paid according to the prescribed waterfall.

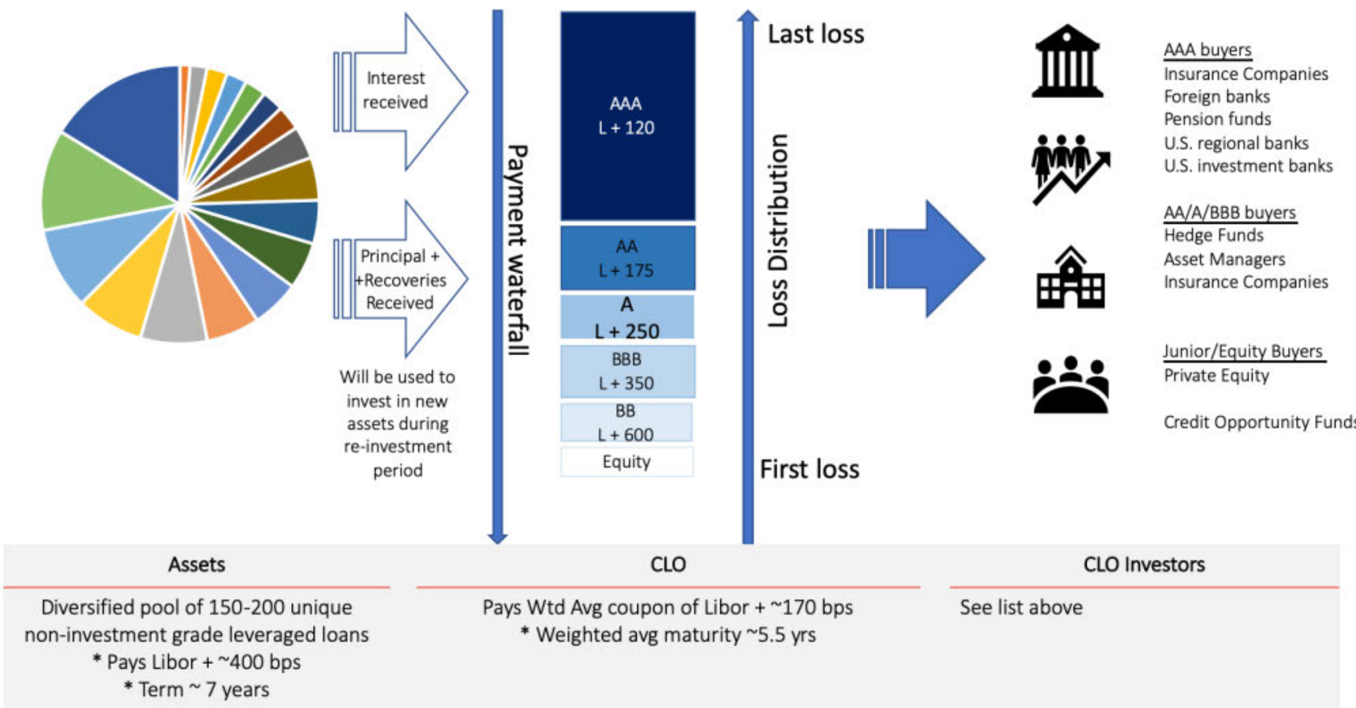
CLOs are structured with empirically-based levels of safeguards, including credit enhancement and portfolio-specific tests and mechanisms that are meant to protect CLO bond investors against some of the potential risks of the investment. By allowing credit risk to be matched with investor preferences in an efficient manner, those mechanisms make additional funding available for non-Fortune 500 companies, allowing those companies to finance themselves all-in at lower interest rates.

The maturities of a CLO’s liabilities are matched to underlying assets; and CLOs do not mark-to-market their assets, which protects the CLO market valuation even as the underlying market declines. As noted by Federal Reserve Chairman Powell: “while CLOs have facilitated the growth of leveraged loans, many have stable funding: Investors commit funds for lengthy periods, so they cannot, through withdrawals, force CLOs to sell assets at distressed prices.”[5]

A. The Collateral

The underlying assets are primarily leveraged loans that are term debt instruments, often with maturities of 5-7 years, issued by companies that have credit ratings below investment grade and higher debt service costs relative to earnings than do investment grade companies. Leveraged loans, which are arranged and distributed by large sell-side firms and are priced and traded in the secondary market, provide these corporate borrowers with important access to capital.

A schematic depicting the CLO structure is set forth below followed by additional explanation. Note that the most recent CLO transactions reference SOFR, rather than LIBOR.



Source: SFA, Fitch Ratings

As loans from creditors typically sit in the senior-most position in a company’s capital structure, in the event of a bankruptcy, leveraged loans are repaid before senior unsecured bonds, subordinated bonds and equity. This priority position has historically led to higher recovery for

[5] Powell, Jerome H. (2019, May 20). *Business Debt and Our Dynamic Financial System* [Video]. YouTube. https://youtu.be/XQEP8PPAQkM

leveraged loans than for subordinated debt instruments in most instances. In addition to offering higher yields to compensate for risk, leveraged loans commonly include contractual covenants designed to mitigate the risk of default, such as requirements that the borrower periodically furnish audited financial statements, maintain adequate insurance, maintain a specific leverage ratio and refrain from taking certain other actions that could result in the deterioration of the borrower's ability to repay existing debt. Historically, leveraged loans have included fairly stringent "maintenance" covenants which are tied to the borrower's financial performance and may, arguably, act as an early indication of the borrower's financial distress. These covenants establish a threshold and, if crossed, provide the lender with additional options it can choose to exercise. If breached, the lender typically can take several actions, such as demanding immediate repayment of the loan, increasing the interest rate on the loan, increasing the amount of collateral and/or waiving the covenant following some sort of loan renegotiation, often with more stringent loan terms.

B. Credit Enhancements & Risk Protections

Crucial to the CLO structure is the minimum required credit enhancement levels based largely upon the collateral quality and deal structure. Credit enhancement is found in the form of overcollateralization, "excess spread" and/or subordination. The senior bonds are the most protected from credit losses, as losses are absorbed first by the equity tranche, then by the junior-most bonds and, last, by the triple A-bonds. Pricing reflects the risk/reward position of the bonds with the safest, most senior triple-A tranche receiving the lowest return and the equity tranche receiving the highest return.

CLOs are also designed with covenants that require the manager to assess the portfolio's ability to cover bond payments. Dynamic coverage tests are used to detect and address collateral deterioration in order to protect the cash flows from the underlying assets used to repay the CLO bonds. When these coverage test thresholds are breached, cash flows are redirected to pay off the most senior bonds or purchase additional assets to restore overcollateralization, as outlined upfront in the CLO's offering documents. To cure a breach, CLO managers will seek to sell these lower-rated loans, often at some discount.

Examples of other risk protections built into CLOs include: (1) minimum requirements for the borrowers of the underlying leveraged loans, such as rating and capitalization; (2) requirements relating to the underlying loans, such as interest rate, place in capital structure and collateral; and (3) minimum diversification requirements for the pool's exposure to industries, countries, and borrowers, to avoid concentration risk.