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Canaras Capital Management LLC Comments on SEC Proposed Private Funds Rule

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Via email to rule-comments@sec.gov.
Subject: File Number S7-03-22

To the Commissioners and Staff of the US Securities and Exchange Commission.

Ladies and Gentlemen:

Canaras Capital Management, LLC ("Canaras"), based in New York, NY, is registered with the Securities and Exchange Commission ("SEC") as an investment adviser. Canaras and its affiliates served as an investment manager of Collateralized Loan Obligations ("CLOs")[1] since the commencement of business operations in 2006. Prior to creating Canaras, the founding partners had extensive experience in structuring and managing, CLOs, dating back to the first CLO transactions in the mid-1990s. With that history, we believe we can offer an informed perspective on the proposed private fund investor protection rules.

The SEC proposal seeks to increase transparency and enhance investor protection for private fund investors. This proposal was motivated, at least in part, by real or perceived conflicts of interest between general and limited partners and the need for greater transparency and investor protection. CLOs are structured differently from most private funds and do not have conflicts between general and limited partners. In addition, market standard CLOs already provide investor protections equal or superior to what the proposed rules would seek to achieve. We will give special attention to the SEC's proposal for annual Generally Accepted Accounting Principles ("GAAP") audits of CLOs. (See "CLOs, GAAP and IFRS" below). Such audits were standard practice in early CLOs but produced confusion and concern rather than transparency and protection for investors. As a result, the industry migrated to alternate practices that provide independent, duplicate, and complementary investor protections that are superior to protections expected from GAAP audits.

Background: CLO Structure Overview

CLOs are private corporations (or similar business entities) that purchase and hold a broadly diversified portfolio of syndicated corporate loans. Syndicated corporate loans are large loans made by a bank or other financial institution to corporate borrowers. After the loan is made, it is sold ("syndicated") in small tranches to a broad array of investors/buyers but primarily CLOs. The CLOs accumulate the loans and issue debt and equity securities that are collateralized by the loans. The syndicated corporate loan market at the end of 2021 was approximately $1.3 trillion in size and CLOs held approximately 63% of these broadly syndicated corporate loans.[2] Syndicated loans are highly liquid and traded through

[1] "Collateralized Loan Obligations" are technically the debt obligations issued by securitizations of bank loans. As this class of securities evolved since the mid-1990s, the term "Collateralized Loan Obligation" and its "CLO" acronym have become the common name of the securitization itself rather than the debt securities it issues. This comment will adopt that parlance.
[2] Source: S&P/LSTA Leveraged Loan Index constituents.

desks maintained by most major banks. Several pricing services provide independent, daily quotations for syndicated loans and CLO managers also regularly disclose their holdings to various information services. (See "Transparency" below.)

CLOs have a defined principal size and stated maturity. Typically, each CLO has a "reinvestment period" that allows the investment manager to replace loans that mature, prepay or are sold. This permits the investment manager to keep the portfolio fully invested for a defined period, typically 3 to 5 years. At the end of the reinvestment period, the portfolio may be sold in bulk, restructured with an extended reinvestment period and later stated maturity, or allowed to amortize.

The CLO's asset portfolio is funded with a combination of debt and equity. The debt typically provides approximately 85-90% of the total funding and is issued in tranches with public ratings ranging from triple A to single B. CLO debt is typically held by institutional investors, and major banks and investment banks maintain an active secondary trading market in CLO debt. CLO equity (often called "income notes" or "subordinated notes") is typically held by institutional investors or high net worth individuals and an active secondary market exists for CLO equity as well.

Governance and Compliance Advantages

A distinguishing feature of CLOs is their rigorous governance and compliance obligations. Unlike investment interests issued by a typical hedge fund or private equity fund, CLO debt and equity are issued under an indenture. The indenture is intensely reviewed and extensively negotiated by investors and rating agencies prior to the issuance of any CLO debt and equity to investors. The indenture is a lengthy document that sets out the rights of all debt and equity investors in granular detail, defines the investment guidelines for the CLO and investment manager, and enumerates permissible costs and expenses (including manager fees). The indenture also contains numerous restrictions and covenants that must be adhered to continuously. The indenture is strictly enforced by an independent trustee which is typically a major bank. The trustee also acts as the independent custodian of the CLO's assets. Because the trustee bears liability for deviating from the terms of the indenture, the trustee generally exercises no discretion in enforcing the indenture terms and requirements. Once the indenture is adopted, it can be changed only with the consent of the debt and equity investors.

Proceeds of CLO debt and equity issuance are paid into an escrow account maintained with the trustee, not with the CLO's investment manager. The CLO's investment manager has authority only with regard to asset selection, and that authority is limited by the indenture and the limitations are enforced by the trustee. When the investment manager selects a loan for purchase for the CLO, the trustee confirms that its addition to the CLO would not violate any terms of the indenture. If approved, the trustee settles the loan purchase and takes the loan into its custody. The trustee also collects all interest and principal payments on portfolio assets.

Distribution Oversight of Payments: "Waterfall"

At the end of a payment period (typically three months, as defined in the indenture), the trustee administers a preset, hierarchical "priority of payments" algorithm that is commonly referred to as the "waterfall." [3] In this process, the trustee distributes the CLO's payment period revenues (interest collected from loans) in a strictly defined priority order set forth in the indenture. The trustee's fee and a limited amount of operating expenses are paid at the highest priority and then interest is paid on the CLO debt in order of seniority (current interest due and any previously accrued amounts). The final step of the waterfall is the payment of residual amounts to the CLO equity investors.

The investment manager's fee is set at a percentage of CLO assets and is usually divided into "senior" and "subordinated" payments that are made at different seniority levels of the waterfall. Certain indentures may also include a performance fee. Performance fees are most commonly paid at liquidation of the CLO under closely defined criteria and subject to the oversight of the trustee. The investment manager cannot charge and the trustee will not pay any fee that is not explicitly set forth in the indenture. As such, the fees that motivated the SEC proposed rule (e.g. fees for unperformed services, fees associated with an examination or investigation of the adviser) do not arise in standard CLOs.

The formality of CLO structures and the rigidity of waterfalls makes it critically important that any new rules or regulations be applied prospectively and not to existing transactions. CLO Indentures do not contemplate changing compliance burdens and have no provisions for allocating the additional costs. Retroactive imposition of additional compliance requirements will cause significant dislocations and will likely engender multiple, costly lawsuits to determine who should bear the costs.

Tax Treatment Background and Implications

The great majority of CLOs are domiciled outside the United States, predominantly in the Cayman Islands, Jersey (Channel Islands), and Bermuda.[4] A primary reason for domiciling outside the US is to avoid withholding tax on payments to offshore equity investors.[5] The Cayman Islands, Jersey (Channel Islands) and Bermuda are favored because they do not impose taxes on the CLO's earnings, interest paid on the CLO debt, or dividend/residual payments to CLO equity. However, with the foreign domicile, CLOs with US equity investors fall under the Passive Foreign Investment Company ("PFIC") rules enacted in the Tax Reform Act of 1986.[6] PFIC rules are complex and more punitive than those that apply to domestic investments. A particular problem for CLOs is that any reserves taken for structuring costs or credit losses are treated as taxable income to US equity investors. Income that is subject to tax but not received in cash is commonly called "phantom income." To avoid the generation of phantom income, CLOs make sharp distinctions between principal and revenue flows.

[3] The waterfall is an important element in making CLOs "bankruptcy remote." All investors and creditors agree to the terms of the waterfall as set forth in the indenture at the initial launch of the CLO. If income in any payment period is insufficient to satisfy all CLO debt interest and expenses, the unpaid amount is accrued and carried over to the next period. Failure to pay amounts due at any point in the waterfall does not constitute an "event of default" and creditors cannot force the CLO into bankruptcy due to non-payment of claims.

[4] See Board of Governors, Federal Reserve System: https://www.federalreserve.gov/econres/notes/feds-notes/who-owns-us-clo-securities-20190719.htm

[5] If CLOs were domiciled in the US, non-US investors holding CLO equity could be deemed to be conducting a US trade or business and be subject to a 30% withholding tax on any investment dividends.

[6] See Internal Revenue Code Sections 1291-1296.

Funds contributed by CLO equity investors are credited to a principal account. Costs of establishing a CLO are charged against the principal account, and portfolio losses and other costs are also charged against the principal account. No reserves against income are taken to offset these charges or to restore the principal account balances. As a result, CLO equity holders typically recover only 50-75% of their original investment at the liquidation of the CLO, depending on the performance of the portfolio. The unrecovered principal is treated as a long- term loss for US taxpayers.

To offset this, CLOs generally pay out all residual earnings at the bottom of the waterfall to the CLO equity holders. These payments are treated as ordinary income for US taxpayers.

The result is that CLOs pay a stream of high equity dividends followed by a sizeable principal loss. Both the dividends and the liquidation payment are accorded the least favorable US tax treatment. Despite this, the internal rate of return on CLO equity investments is attractive and substantial amounts of on- and offshore capital has been allocated to this asset class.

CLOs, GAAP and IFRS

As described above, the tax treatment of CLOs disfavors accruals and reserves and prioritizes the generation of cash flow to service debt and to pay fees, expenses, and dividends to CLO equity. In contrast, US Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS") are grounded in the "matching principle." This requires reserves, accruals and adjustments to match reported revenue and the costs incurred in generating that revenue in any period.

Early CLOs operated as described above but also conducted GAAP audits. With the GAAP reserves, accruals and adjustments, the audited statements presented a financial profile that differed sharply from the results experienced by CLO investors. This undermined the purpose and value of the audited statements.

The treatment of launch costs provides a stark example of the problems in applying GAAP or IFRS methodology to CLOs. Legal, rating, underwriting and other issuance costs for a CLO approximate 1.5% of CLO assets, which is borne by the CLO equity. If the CLO is funded with 90% debt and 10% equity, the launch costs equate to 15% of the CLO equity. This immediately reduces the value of CLO equity to approximately 85% of the invested amount. Secondary market prices for CLO equity reflect this discount.

After closing, the cash flow and credit losses of the loan portfolio are the primary determinants of equity return and tax liability. The waterfall clearly and comprehensively communicates the cash flow and, with some adjustments, is indicative of US taxable income.

But GAAP and IFRS paint a far different picture. Under GAAP and IFRS, the launch costs are not written off at the initial launch of the CLO but rather are capitalized and amortized over the life of the CLO. Charges are made against income in each period to absorb the amortization. With this protocol, the financial results presented in GAAP/IFRS statements differ sharply what CLO investors experience and the reported income is only tenuously related to the taxable income for US

investors. Because of the matching principles, GAAP and IFRS materially overstate the value of equity and materially understate the amount of income paid to equity investors though the life of the CLO.

A similar problem may arise in the issuance of the CLO's debt. Some CLO debt classes may be issued at a discount from par. As with launch costs, the CLO will charge such discounts to the equity. Again, GAAP or IFRS will take a sharply different approach requiring the discount to be capitalized at the initial launch and amortized over the CLO's life. This compounds the discrepancy between the income received by CLO investors and that reported under GAAP or IFRS.

With the sharp differences between GAAP/IFRS financial reports and the reality experienced by CLO investors, audited financial reports created confusion and concern for CLO investors. The GAAP audit reports in the early CLOs reduced clarity and transparency and provided a misleading presentation of performance and condition, particularly for CLO equity investors. To address this, some CLO managers directed auditors to create reconciliations of the waterfall results with the GAAP/IFRS statements and the PFIC tax accounting. The reconciliations were so complex that they compounded rather than reduced investor confusion. CLO investment managers and investors soon recognized that GAAP/IFRS audits were both counterproductive and expensive and stopped conducting them.

The Audit Alternative

As described above, the creation of an indenture, the retention of an independent trustee/custodian, and the distribution of funds by a strictly governed waterfall process provide very substantial protection and transparency for CLO investors. Nevertheless, additional steps to assure that the trustee is accurately administering the indenture are warranted. But as described above, audits are not suited to this objective because they focus on financial statements that are incompatible with CLO structures, cash flows, and economics.

To provide additional financial oversight without the pitfalls of GAAP/IFRS audits, the industry evolved an alternative arrangement in which independent certified public accountants of recognized international reputation perform "agreed upon procedures" ("AUPs"). The accountants familiarize themselves with the indenture and then review and certify the CLO cash flows in each payment period to be sure that revenues and principal flows have been applied correctly and that the amounts to be allocated through the waterfall are accurate. The AUPs provide CLO investors a second level of protection because the work of the independent trustee is checked and confirmed by an independent public accountant. The AUP process is superior to an audit in several ways.

First, the trustee cannot execute the waterfall until the independent accountant reviews and confirms the calculations. This means that the AUP process provides a check and confirmation of the waterfall each period before funds are distributed. In contrast, an audit involves merely a sampling of transactions after the close of the CLO's fiscal year. While an audit can, at best, discover past errors or breaches of fiduciary duty, the AUP process prevents them.

Second, the AUP process applies independent accounting expertise in a way that better protects CLO investors. The focus of the AUP process is to assure that the indenture requirements are properly executed in real time. In contrast, an audit is retrospective, and its primary objective is to review GAAP statements that are prepared by the CLO but have no relevance to the CLO investors' risk and return.

Finally, the AUP is far more cost-efficient than an audit. AUP costs are typically $25,000-$30,000 per year while GAAP audits for CLOs cost investors $60,000 or, in some cases, much more, particularly if reconciliations with waterfall results are required.

Transparency

Another critically important feature of CLOs is the transparency of the asset portfolios and performance. As noted above, the loans held by CLOs are highly liquid and traded in deep markets. Market practices have evolved to require CLO investment managers to disclose portfolio composition and performance of their portfolios on a monthly basis. This information is readily available to existing CLO investors via posting the CLO's trustee website, while prospective investors and the general market participants can access these reports through services such as Bloomberg, Intex and many others. The reports provide both investors and potential investors detailed insight into CLO portfolios and performance. Similar disclosures and data access do not exist for other private fund categories where managers and general partners place a premium on the confidentiality of their investments and disclose as little as possible.

Summary and Recommendations

Canaras understands the need for investor protection and transparency. In pursuing these goals, we encourage the SEC to recognize the sharp differences between CLOs and private funds (in their various forms) and to avoid broad brush solutions that could cause more harm and confusion than good. The governance and compliance processes of CLOs are far more stringent than for hedge funds, venture funds and/or private equity funds and, in their current form, meet or exceed the objectives of the proposed rule.

In its evolution over almost 30 years, the CLO industry has adopted structures and procedures that protect investors and provide transparency. These elements are now industry-standard and include:

- The creation of very detailed indentures that are intensely negotiated between sponsors and investors prior to closing and specify investment criteria, covenants and fees;

- The appointment of an independent trustee and custodian to oversee and enforce the indenture and safekeep assets;

- Public debt ratings and ongoing monitoring of CLO performance by major rating agencies;

- Agreed upon procedures by independent public accountants that are performed each payment period in advance of distributions and catch errors before they occur; and

- The registration of most CLO investment managers as investment advisers (registration, typically, pursuant to the requirements of the Investment Advisers Act of 1940, as amended), which provides additional, material oversight of CLOs.

Together, these structural elements are particularly effective in protecting CLO investors and far exceed the protections available in hedge funds, venture capital and private equity fund structures. CLO structures continue to evolve as the market grows and investors demand additional protections as needs arise. Currently, the industry is focused on efforts to shorten settlement periods and digitize documentation; these efforts should further enhance CLO investor protections.

In developing its final rule, the SEC should differentiate among categories of private funds and give careful consideration to the protections that certain private funds already offer. A safe harbor should be created for funds that utilize indentures, ratings, trustees and qualified custodians, that have investment managers that are registered with the SEC as investment advisers, and that utilize AUPs as part of operational reviews. Imposition of new rules on existing CLOs and the imposition of GAAP audit requirements on all CLOs will create extraordinary dislocations and costs with no offsetting investor benefits.

We thank the SEC for consideration of this submission. We are available to discuss these or related matters to facilitate the SEC's development of a useful and efficient rule.

Sincerely,

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