Association for Financial Markets in Europe

Consultation Response

IOSCO Leveraged Loan/CLO Consultation – Good Practices for Consideration

15/12/2023

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **IOSCO Leveraged Loan/CLO Consultation – Good Practices for Consideration Consultation Report**. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

<u>Introduction</u>

Whilst AFME members welcome a statement of good practices and in principle support many of the objectives behind the recommendations in the consultation paper, their attribution and calibration does cause concern for the following reasons. In this document, please note that depending on the context, we use the word "investor" to refer to a lender in relation to leveraged loans and to refer to a CLO investor for CLOs.

Overall, it seems that the recommendations are focussed disproportionately on arrangers and underwriters as the parties with perceived control over the overall lending process. This, however, does not reflect the real power dynamics in negotiations in the current market. In reality, an arranger's or underwriter's ability to control the flow of information or the quality of data provided to syndicate lenders is often much more limited than the consultation paper seems to imply. Instead, the arrangers and underwriters are required to make their own sound and robust financial and risk decisions while addressing the interests of leveraged loan market participants generally. For example, arrangers and underwriters will have robust credit approval processes and committees that are distinct from the underlying deal teams; robust internal and external legal review; significant financial and legal due diligence; the creation of their own financial model that is stress tested by credit teams (based on the sponsor/borrower model) which are distinct from the underlying deal team.

It is also worth noting that the institutions investing in leveraged loans are themselves sophisticated professional institutions who shouldn't be relying on the arrangers' or underwriters' views on the suitability of a particular investment, or indeed primarily on the arrangers or underwriters to ensure that they receive a product tailored and appropriate to their specific demands and/or needs.

The leveraged loan market is a highly competitive market dominated by strong sponsors, borrowers and underwriters. Underwriting transactions in EMEA is a competitive process where, sponsors (typically) negotiate a commercial grid before negotiating commitment papers with underwriters on an individual ("treed") basis. The sponsor/borrower counsel holds the pen on documentation (including the term sheet and the facility agreement) and while these are subject to negotiation and market conditions, it is ultimately a risk decision for the underwriters as to whether they will agree to underwrite the transaction on the basis of the terms proposed by the sponsor/borrower. These risk decisions are already subject to a regulatory framework and are determined by the underwriters' own robust credit controls. All of this is happening as the share of leveraged lending undertaken by private credit / unregulated market players continues to expand. If these recommendations are strictly followed through in their proposed form, they could have the unintended effect of pushing lending into the private credit space, which carries the potential risk of encouraging investment into areas where there is less regulation and less control.

It should also be noted that unlike bonds, loans are neither securities nor regulated products and their arrangement and distribution should not be treated in a manner which is similar to the arrangement and distribution of securities and other public financial products. Members would like to caution against creating a *de facto* "shadow" regulatory framework which vests quasi-fiduciary duties in the context of unregulated products/activities in the arrangers and makes them the main party responsible for policing behaviours and best practices. Indeed, it would seem more impactful to look at the ways to encourage the "sell-side" (i.e., sponsors), being the party actually generating / being in possession of most of the information which may be lacking, to provide better quality information and data and to promote healthy lending practices.

Finally, it is important to remember that best practices are often used as a proxy for new regulation. From that perspective, and for the reasons outlined above, AFME would encourage IOSCO to clarify that these best practice recommendations are just that – best practice recommendations, as opposed to a model for mandatory and binding rules. Much of the suggested guidance goes well beyond the requirements for securities, and if implemented, would result in regulatory imbalance between very distinct products. As noted above, this would push (more) lending to the less regulated private credit market.

Keeping all of this in mind, here are our views on the proposals:

IOSCO proposed Measures

Measure 1: Debt repayment capacity test

We do not support the proposed measures. Leveraged loans are complex and bespoke products and it should be up for market participants to negotiate and agree their terms. The guidance ignores the fact that in the vast majority of situations it is the sponsor that dictates the terms and looks for arrangers and lenders capable and willing to accept any such terms. The sponsor also shares its own model with the arrangers and potential lenders (where permitted, i.e., loan only cap structures). Given that investors are sophisticated, they should be making their investment decisions on the information provided and should not rely on the arrangers/underwriters as the ultimate arbiter of the products' suitability for them. In addition, arrangers/underwriters should not be burdened with additional obligations/disclosures, as such misplaced obligations would likely have a negative effect on the parties' relationships and expectations, which would negatively affect the proper functioning of EU leveraged loan markets.

We are concerned that this measure may impose an incremental obligation on arrangers to ensure that the information proposed by this measure is being provided rather than focusing on whether they are already providing investors with all of the information that they need to make informed investment decisions. We suggest this would be an unhelpful shift of focus.

Being well aware of both the benefits of providing all material information to investors (as well as potential liability for failing to do so), arrangers work to ensure that all such information is provided to the relevant parties as part of their existing practices and procedures. Any unnecessary further prescriptive regulation in this area may have negative unintended consequences for arrangers and such parties, and may potentially interfere with other obligations under listing and other rules. It is also worth noting that bank lenders are already subject to robust regulations to ensure debt service compliance.

In addition, CLOs fall under the ABS disclosure rules and many CLOs are listed financial instruments, which means that they must comply with disclosure requirements under relevant listing rules. These rules require that material information must be disclosed to investors. This information will include permitted forward looking information and investors should be able to make their own relevant calculation regarding repayment tests, and each investor will have different requirements and methods for doing so. With regard to any objective of these proposals related to investor protection, an arranger's requirements and methods will likely be different from those employed by the investor and may therefore result in calculations and methods that the investor neither wants nor needs.

We also note that in many places the paper refers to "investors" rather than "lenders" which, while relevant for CLOs, does not reflect the parties' proper relationships in a loan context. We believe that this might indicate a general conflation between securities and loan markets and regulations, or application of securities related concepts to loans and loan analysis. It would be helpful for the proposals to take more note of the differences between the two markets and to make sure that any proposals are designed with those nuances and differences in mind.

Measure 2: Dividend recapitalisations

This proposed measure, if enacted, would also result in regulatory action relating to matters that our members consider to be commercial decisions. This is unnecessary, in our opinion, particularly since dividend capitalisations are voluntary and potential lenders can make their own independent decisions about whether to participate. Lenders are free to not participate if they are not comfortable. In the absence of reason to believe that extra "protection" is needed on this matter in a particular situation, we do not believe that these requirements should be imposed on the market.
In addition, a dividend recapitalisation is essentially an indication of the use of proceeds, rather than an issue of disclosure or lender/investor protection. We therefore do not believe that this area should be subject to regulatory or policy requirements or restrictions and find it strange that the proposed guidance goes even further than that required for securities.

Measure 3: EV calculations

AFME members do not support any measure that requires disclosure of EV calculations. It is not the role of the arrangers to disclose the EV of a company. Any such calculations by an arranger would come from a relatively subjective viewpoint, based on information provided by the borrower, and each firm would have different internal guidelines and calculation methods. As mentioned above, the institutions providing funds for leveraged loans are themselves sophisticated lending institutions who would not need to, and should not be relying on, the arrangers' calculations in this context. This would be an unnecessary and, in our opinion, misdirected additional disclosure requirement for arrangers that would potentially increase liability risks for arrangers with little discernible positive impact for participating lending institutions. For this measure, we welcome a comparison to the bond market, by pointing out that arrangers in that market would not be expected to provide this information to investors, if it were to be provided, it would come from the borrower.

Measure 4: EBITDA complexity and opacity

We note that the leveraged loan market is a generally unregulated market and fear that any prescriptive measure implemented as a result of these recommendations would lead to unhelpful and potentially harmful "regulatory creep" into this market that could be disruptive to existing market practices and expectations. We also caution against considering or applying standards to leveraged loans that aren't appropriate for that market.

We disagree with the proposed guidance. Such disclosures are not generally required for securities (other than a Reg S offering or with respect to non-GAAP measures, in which case such rules are followed even if not technically required by the GAAP rules). Further, it is unclear to us who should make such disclosures and if such obligation is to be on the arrangers/underwriters it would be disproportionate and inappropriate when considered in the context of, and in comparison to, other financial products. If such disclosures were to be imposed on the borrowers, we would question how this (and any other restrictions) could be enforced in practice.

EBITDA and associated definitions are complex given leveraged loans are a complex product bought by sophisticated lenders/investors. In practice, such parties will (typically) receive the Quality of Earnings, the lender presentation and/or Confidential Information Memorandum and participate in a Q&A process as part of the lender education in order for them to make their own informed decision and to derive their own EBITDA view.

In addition caps on costs savings and synergies are credit specific. A 'one size fits all' approach would not work.

Measure 5: Covenant Limitations and Loan Document Transparency

AFME members question whether the arranger should have the onus to provide this information, since the arranger is not typically "holding the pen" on these matters, which would be in the purview of the sponsor/borrower.

It should be clear exactly which party is subject to this recommended best practice. With respect to disclosure on such matters as "material covenant terms" in loan term sheets, we note that materiality is subjective and will likely differ for different lenders/investors. It would be more helpful for a lender/investor to tailor the relevant analysis to its own situation rather than expecting an arranger to provide a one-size-fits-all approach. We also note that implementation of prescriptive requirements relating to calculations such as incremental debt or other covenant capacity matters may lead to increased liability and more risk disclosure and analysis; this is because these matters are inherently subject to future, perhaps unknown, events and may not turn out as planned. Again, investors are provided with a breakdown of the balance sheet and EBITDA. Investors are sophisticated and should be able to make these calculations themselves (also taking into account their own investment requirements) rather than expecting that the information will come from the arranger.

Measure 6: Transparency and fairness during underwriting and syndication

In our view, this proposed measure looks at this issue from the wrong perspective. In the public bond market arrangers are intermediaries. They provide the borrower's information to investors, and investors make investment decisions themselves.

It is unclear why, in the leveraged loan context, it is important that the interests of the arrangers and investors should always be aligned. It is also unclear why investors would need such detailed information about arrangers' underwriting and syndication practices in every case and for each transaction. Providing feedback (even anonymised) on documentation points to all investors could expose arrangers to potential liabilities and anti-competition claims. We contrast that with some markets that include risk retention requirements and where it would therefore make more sense to require alignment in the interests between the parties, but also note that in the leveraged loan market, arrangers/underwriters do take the risk that they won't be able to sell a loan, and that this possibility provides sufficient positive incentives for them to package and offer loans in which they themselves see good value. We fear that this is another example of a proposed requirement that conflates the leveraged loan markets with securities based markets.

Imposing the suggested timelines is unlikely to be acceptable to borrowers in situations where clients need certainty of funds at very compressed timelines (e.g., public-to-private financing, rescue/pre-pack funding, etc.). In practice, the sponsor/borrower is also risking execution of a syndicated transaction where timing is compressed, as investors have the ultimate decision as to whether or not they will participate if they have not received enough time to review all documentation needed to make their investment decision. It is difficult to see how any suggested timelines could be enforced in practice.

Measure 7: Alignment of interest between underwriting entities and investors

While use of designated counsel is common in the leveraged finance markets, parties are free to appoint their own shadow counsel. We are confident that in most instances parties are still able to receive impartial and independent advice in leveraged loan transactions under the current framework – and it is our view that these parties are sophisticated wholesale institutions that are generally aware of the need to take their own independent advice (if required). While we agree that the designated counsel approach may be problematic and cause issues on certain transactions in practice, we do not believe that is should be within IOSCO's purview to take such a prescriptive approach to the work of legal advisors on these transactions. To the extent there are more systemic concerns around independence of legal advisors, this should be dealt with on a jurisdiction-by-jurisdiction basis in the rules applicable to the legal advisors (e.g., legal bodies, such as the SRA). This is another example of what we believe would be unnecessary and potentially harmful regulatory creep. Any prescriptive rules in this area should be considered by relevant bar associations rather than a market association. This could also likely result in market confusion, less clarity and uncertainty about their interaction with other existing rules in this area (which we believe are sufficient to address IOSCO's concerns). We therefore strongly suggest that this measure is not imposed and that parties are allowed to rely on existing regulation, rules and practices.

We disagree with IOSCO's views on alignment of interest. Underwriting lenders often take on substantial risk and must structure the financing with a view that they may have to hold the debt through to maturity. In addition, underwriters tend to hold material participation in revolving facilities which are more difficult to syndicate to non-bank lenders. However, regulators do not prescribe any risk retention through a minimum hold. Finally, please note the potential negative consequences of aligning interests between lenders from a competition law perspective.

Measure 8: Reducing restrictions on transferability of loans

In our view, this is another example of potential conflation of the loan and bond market. These proposals appear to be more relevant and applicable to bonds than to leveraged loans. Bonds are generally freely transferable and market expectations are higher for bonds than they would be for loans. While we would support measures intended to decrease limitations on the transferability of loans, aiming at making leveraged loans as liquid as HY bonds would significantly change the nature of the leveraged lending market.

Ability to restrict and control distribution is one of the features that differentiates loans from other public debt financing instruments so regulating this aspect may have an overall negative impact on the syndicated loan market.

Measure 9: Managing conflicts of interest where PE sponsors also act as lenders

With respect to IOSCO's description of the market in this measure, it appears that it is under the impression that disenfranchisement provisions are no longer widely used in loan markets. This is not the case in our experience as disenfranchisement mechanics are still very standard subject to carve outs.

If the intention is for this recommendation to become a binding or mandatory rule, it is unclear how it would be applied in practice form a regulatory perspective. Would it just be reminding parties that this tool is available? If so, we are not sure that it would be worth the effort. We are of the view that the loan documentation generally includes sufficient provisions to manage any such potential conflict of interest.

Finally, we question whether it is within the purview of IOSCO to recommend the imposition or prescriptive rules in this area, as conflicts of interest are, in our opinion, amply covered elsewhere, for example by the Solicitors Regulation Authority, and therefore we do not support any new rules in this area.

Measure 10: Managing conflicts of interest in management of CLOs

As a general observation, AFME would like to note that CLO managers are regulated entities both in Europe and in the US and through that, already subject to rules on best execution, contractual disclosures, cross trades and conflicts, to name but a few. These rules apply in the context of the services provided by CLO managers to their clients - CLO issuers. Furthermore, disclosure documents for CLOs (offering circulars/memoranda) already include market standard disclosure on the relevant issues, including on potential conflicts of interests, cross trades, and measures which are undertaken by CLO managers to manage these conflicts. It is not therefore clear what additional measures IOSCO may have in mind for this measure. If there are specific concerns which apply to specific situations or in specific markets, it would seem more appropriate that those are addressed in best practices for those markets, or through improvements to existing regulatory framework, rather than through potentially duplicative or overlapping sets of requirements.

Measure 11: Disclosure in CLOs

AFME would like to note that as securitisations, CLOs are already a highly regulated product in Europe. Transparency and disclosure requirements which apply to European securitisations (including CLOs) and which support the ability of investors to receive all material information on the CLO securities are already among the strictest of any regulatory framework applicable to fixed income products, including corporate and covered bonds. European securitisation requirements also include rules on risk retention and origination standards which support alignment of interest of originators and sponsors of CLO transactions with those of CLO investors. On top of this, in both Europe and the US, CLO issuers provide monthly reporting to investors on, among other things, the composition of the portfolio, trading activity, performance of the deal and compliance with various tests, such as concentration tests, collateral quality tests, overcollateralization tests and interest coverage tests. Investors can and do impose requirements when investing on specific things they want captured in the monthly reporting. On that basis, AFME members do not believe that any additional regulatory measures should be required in the context of this measure, and would indeed caution against creation of overlapping frameworks for the already tightly regulated product.

As shown above, there are many moving parts to disclosure under the Securitisation Regulation, and we note that CLOs are typically listed on non-regulated markets, and therefore are considered part of "private" market. Both EU and UK policy makers are engaged through consultations with an objective of adjusting the existing disclosure framework for securitisation, including CLOs to make it more proportionate. Any recommendations from this consultation should therefore take all the above into account to make sure that, while investors receive material information about the product, arrangers are not subject to prescriptive and unnecessary regulation that impacts flexibility and the ability of the parties to make and agree commercial decisions.

Measure 12: Disclosure on underlying loans

It is unclear how this Measure would be addressed since we are speaking in the context of an unregulated market. This is completely different from a securities transaction, as there are no binding rules requiring borrowers in leveraged loan transactions to disclose this information. Having said that, we would support the practices proposed by the Measure and would be very interested in more information regarding the tools that would be used to effect these proposals.

IOSCO appears to be concerned with the behaviour of CLO managers and suggests that they rely too much on credit rating agencies. We note that rating agencies are subject to a code of conduct and generally provide information that is very reliable. We also believe that this should a natural development after the increase in GRA regulation (including from IOSCO) and that it reflects the reality of the market rather than any bad behaviour or dereliction of duty on the part of any market stakeholder. Our view is therefore that this is not an area where additional rules or prescription is necessary.

AFME Contacts

Gary Simmons
Managing Director, High Yield and Equity Capital Markets
gary.simmons@afme.eu
+44 (0)20 3828 2723

Shaun Baddeley
Managing Director, Securitisation
shaun.baddeley@afme.eu
+44 (0)20 3828 2698

Maria Pefkidou
Associate Director, Securitisation
maria.pefkidou@afme.eu
+44 (0)20 3828 2707

Oscar Newman
Senior Associate, ECM & High Yield
oscar.newman@afme.eu
+44 (0) 203 828 2743

Nikray Izadi
Graduate, Equities, Capital Markets
nikray.izadi@afme.eu
+44 (0) 20 3828 2748