October 30, 2013

By Electronic Submission

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Re: **Credit Risk Retention; Joint Further Notice of Proposed Rulemaking**
SEC (File No. S7-14-11); FDIC (RIN 3064-AD74); OCC (Docket Number OCC-2013-0010); FRB (Docket Number R-1411); FHFA (RIN 2590-AA43); HUD (RIN 2501-AD53)

Ladies and Gentlemen:

The Loan Syndications and Trading Association ("LSTA")[1] is pleased to submit these comments in response to the joint Further Notice of Proposed Rulemaking, 78 Fed. Reg. 57928 ("FNPRM"),[2] concerning risk retention and the implementation of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").

[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 is active on 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.

[2] Credit Risk Retention, 78 Fed. Reg. 57928 (Sept. 20, 2013; originally released Aug. 28, 2013).

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LSTA
THE LOAN SYNDICATIONS AND TRADING ASSOCIATION®

I. Overview.

The LSTA appreciates the opportunity to continue to address the appropriate regulatory framework that should apply to CLOs and particularly to Open Market CLO managers. As you know, the LSTA (along with other commenters) has consistently set out why the plain language of Section 941 establishes that credit risk retention obligations do not apply to Open Market CLO managers and that Congress's purpose in enacting that provision, focused on correcting misaligned incentives arising from the originate-to-distribute loan model, does not support imposing those obligations upon Open Market CLOs or their managers.[3] The strong performance of CLOs during the recent financial crisis and the robust demand for CLO securities thereafter support these conclusions.[4] The LSTA also has explained why, even if the statute could be construed to apply to those managers, the agencies should exercise their exemption authority and relieve a defined class of Open Market CLO managers from the credit risk retention requirements.[5] That the agencies' proposed rules would dramatically decrease CLO formation and scale, and thereby harm important credit markets, is but one of many factors justifying the exemption.[6] In addition, the LSTA has shown that Open Market CLO managers already do bear a very significant degree of credit risk through the industry-standard, deferred compensation structure, where managers' compensation depends heavily upon returns to subordinated investors.[7] The LSTA has further proposed a set of requirements whereby managers would even more clearly bear sufficient credit risk through a combination of equity purchases and notes reflecting the deferred, contingent compensation structure that investors have demanded.[8]

The LSTA welcomes and appreciates the agencies' acknowledgement that the originally proposed rules pose significant risks to the continued participation of CLOs in important loan markets and appreciates the agencies' efforts to seek an alternative regulatory approach that would avoid those potential harms to CLOs, the loan markets, and the public interest.

Even so, the agencies' proposed alternative mechanism for retaining credit risk related to CLOs – having arranging banks retain risk in the course of generating CLO-eligible loan tranches – is an illusory alternative and unworkable. This is the unanimous conclusion that has emerged from extensive consultations with the leading banks that arrange the overwhelming majority of the relevant domestic loans that CLOs may acquire. Arrangers will not meaningfully

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[3] *See* LSTA Letter Comment (Aug. 1, 2011) at 7–14; LSTA Letter Comment (Apr. 1, 2013) at 16–19.

[4] *See* LSTA Letter Comment (Aug. 1, 2011) at 7; LSTA Letter Comment (Apr. 1, 2013) at 10–11.

[5] *See* LSTA Letter Comment (Aug. 1, 2011) at 14–19; LSTA Letter Comment (Apr. 1, 2013) at 22–23.

[6] *See* LSTA Letter Comment (Aug. 1, 2011) at 14–17; LSTA Letter Comment (Apr. 1, 2013) at 20–23.

[7] *See* LSTA Letter Comment (Apr. 1, 2013) at 3–5.

[8] *Id.* at 3–16.

pursue that alternative for a range of risk management, market operation, and financial considerations, and the agencies' proposal would in any event generate a series of adverse consequences in the form of increased systemic risk, diminished efficiency of the relevant credit markets, and decreased availability and increased cost of credit – all harming the public interest. *See infra* Part V.

Extensive discussions with lead arrangers and CLO managers have also generated other, more workable regulatory alternatives that would mitigate these harms to credit markets. *See infra* Part VI. While either approach would provide some relief, they would be more effective in combination:

- First, the alternative would establish criteria that define a set of high-quality loans that, when held by an Open Market CLO, would not attract obligations to retain credit risk. Those criteria reflect the experience of relevant loan market participants, provide appropriate flexibility to market participants in light of the varied range of leveraged and syndicated loans acquired by CLOs, and ensure that investors face considerably reduced risk when those loans are included among a CLO's assets. The varied protections for investors built into an Open Market CLO's structure and operation further support this limitation on the obligation to retain credit risk.

- Second, other entities with responsibility for shaping the CLO's asset selection criteria could, along with or instead of the Open Market CLO manager, meet the regulatory requirement by retaining credit risk related to the CLO. The ability of a third party to retain credit risk accords with the agencies' proposal that lead arrangers be able to retain risk (as well as with their rules addressing risk retention by multiple sponsors), and these third parties' role in determining the criteria for selection of the CLO's assets accords with the agencies' effort to have credit risk retention improve asset selection. The quantum of risk that must be retained by the CLO manager or an associated third party would be reduced below 5 percent on a *pro rata* basis to the extent the CLO's assets were comprised of higher quality loans meeting the criteria described above.

In any event, the agencies would need to modify their newly proposed cashflow limitation on sponsors that retain risk in the form of eligible horizontal residual interests if any workable credit risk retention arrangement is to be developed for CLOs. That limitation is incompatible with key features of CLOs that protect investors: for CLOs, unlike for other types of ABS, the manager reinvests proceeds (rather than repays principal) for a significant period, but payments of interest collection proceeds to securities holders – including equity holders – are not deferred during this period. To require otherwise would significantly and adversely impair the current economic model of CLOs. *See infra* Part IV.D.

This and other alternative regulatory approaches previously proposed by the LSTA would avoid the very considerable harms to the credit market that the agencies' proposed rules would produce. Evaluated in terms of the agencies' own statement of principles for assessing the costs and benefits of risk retention rules, the benefits of risk retention requirements in other contexts are simply not realized in relation to CLOs (because there is no investor/manager misalignment of incentives that requires regulation) and the costs are extremely large (because the proposed rules will dramatically contract CLOs' support for important credit markets that have no adequate alternative sources of capital, thus decreasing credit availability and competition and increasing borrowing costs). The effect of the rules would be to decrease the availability of credit, increase the price of credit for those companies still able to secure access, and decrease the liquidity of the secondary market, and as a result increase costs, and decrease employment and efficiency in industry sectors that secure credit through these markets. *See infra* Part IV.

The LSTA also welcomes the invitation to provide additional comment on its proposal that Open Market CLO managers may discharge their credit risk retention requirements by purchasing CLO equity securities and holding securities embodying the significant credit risk already arising in the manager's compensation structure demanded by investors. The comments indicate why, under the LSTA's proposal, CLO managers' interests would be aligned with investors' interests and why a reasonable construction of the statutory term "credit risk" must focus on retention of financial risk rather than the face value of ABS assets. The proposed approach also finds support in Commissioner Piwowar's suggestion that it is appropriate to focus on "subordinated performance fees that have components dependent on the performance of the overall pool or on junior tranches" because "[s]uch fees could potentially mitigate concerns about misaligned incentives between originators, securitizers, and investors."[9] *See infra* Part III.

All of these alternative approaches are relevant only if Section 941 applies to Open Market CLOs, but the agencies have yet to – and cannot – provide an explanation for why that is so. The comments address why the agencies' recent defense of their construction of Section 941's definition of "securitizer" is contrary to the plain language of the provision and why, even if Section 941's term "transfer … indirectly" could be viewed as ambiguous in this context, applying the provision to Open Market CLO managers is not a reasonable construction of that language or consistent with the objectives Congress sought to achieve. *See infra* Part II.

II. Section 941 Does Not Require Managers of Open Market CLOs to Retain Credit Risk.

The LSTA previously set forth why Section 941, which Congress intended to counteract the misalignment of incentives between loan originators and investors arising from the originate-to-distribute model of loan origination, does not apply to Open Market CLO managers.[10] The

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[9] Commissioner Michael S. Piwowar, Statement Regarding Joint Rule Reproposal Concerning Credit Risk Retention, Aug. 28, 2013, *available at* http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370539792894.

[10] The LSTA urges the agencies to define "Open Market CLO" as proposed in the LSTA's Letter Comment of March 9, 2012: a CLO "(i) whose assets consist predominantly of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in open market transactions or [from other non-balance sheet CLOs] and of temporary investments, (ii) that is managed by a manager, and (iii) that is not a balance sheet CLO." *See* LSTA Letter Comment (Mar. 9, 2012) at 4. The agencies' re-proposed rule, by contrast, defines Open Market CLO as a CLO "(1) Whose assets consist of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in open market transactions and of servicing assets, (2) That is managed by a CLO manager, and (3) That

LSTA analyzed the language and purpose of Section 941 and showed that Congress did not intend to impose risk retention requirements on Open Market CLO managers.[11] Other commenters have reached the same conclusion.[12] In short, Congress did not intend to do so precisely because Open Market CLOs present none of the problems Section 941 was designed to fix. Because Open Market CLO managers only facilitate the CLOs' purchase of assets, they do not directly or indirectly sell or transfer assets to the CLO – and are thus not within the scope of the statute's "sponsor" definition of "securitizer" as the agencies incorrectly assert.[13]

In particular, Open Market CLO managers operate CLOs independently of any person responsible for originating loans, and thus do not generate loans that they can either sell or transfer to a securitizing vehicle. They are, instead, agents of the CLOs and facilitate the CLOs' purchase of loans. They thus are not within Section 941's "sponsor" definition of "securitizer," which is limited to "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer."[14] The plain language of Section 941 thus forecloses its application to Open Market CLO managers.[15]

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holds less than 50 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates of the CLO." Credit Risk Retention, 78 Fed. Reg. 57928, 58033 (Re-Proposed Rule, §__.9(a)). Limiting "Open Market CLOs" to those whose assets include only senior, secured syndicated loans and servicing assets fails to account for the realities of the CLO market in which CLOs that acquire assets in open market transactions often include a mix of senior, secured loans, and non-senior secured loans. The LSTA's proposed definition accounts for this market reality while ensuring that the vast majority of CLO assets are of the highest quality. *See* LSTA Letter Comment (Mar. 9, 2012) at 7 (proposing a requirement that an Open Market CLO "hold not more than 10 percent of the aggregate outstanding principal amount of its assets in corporate credit obligations other than senior, secured syndicated loans and temporary investments").

[11] *See, e.g.*, LSTA Letter Comment (Aug. 1, 2011) at 7–14; LSTA Letter Comment (Apr. 1, 2013) at 17–19; LSTA Letter Comment (July 29, 2013) at 9–10.

[12] *See* American Bar Association Business Law Section Letter Comment (July 20, 2011) at 93–95; Securities Industry and Financial Markets Association ("SIFMA") Letter Comment (June 10, 2011) at 68–69; American Securitization Forum ("ASF") Letter Comment (June 10, 2011) at 135–136; JP Morgan Chase & Co. Letter Comment (July 14, 2011) at 53–60; The Financial Services Roundtable ("FSR") Letter Comment (Aug. 1, 2011) at 31–32; Morgan Stanley Letter Comment (July 27, 2011) at 21; Bank of America Letter Comment (Aug. 1, 2011) at 24–30; Wells Fargo Letter Comment (July 28, 2011) at 26–29; White & Case Letter Comment (June 10, 2011); Cong. Jim Himes and other Members of Congress Letter Comment (July 29, 2011).

[13] *Compare* Credit Risk Retention, 78 Fed. Reg. 57928, 57962.

[14] Dodd Frank Act, §941(b) (Exchange Act, §15G(a)(3)(B)).

[15] The LSTA acknowledges that a loan originator or fund using a CLO for balance sheet financing purposes is a securitizer and a sponsor because it organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the CLO issuer. Balance sheet financing CLOs are not "Open Market CLOs."

In the re-proposal order, the agencies assert for the first time that Section 941's language is ambiguous because the phrase "by selling or transferring assets, either directly or indirectly" can encompass the "purchase" of assets.[16] That is plainly incorrect. The term "sale" cannot be extended to include "purchase," and relying on "transfer" yields no different result. A party that effects a sale or transfer is the counterparty to the purchaser (or transferee), and there is no doubt that the Open Market CLO manager acts as the agent for the *purchasing* CLO. A party that undertakes a sale or a transfer must be the party that holds an asset (and is thus capable of effecting a sale or transfer), and there is equally no doubt that the Open Market CLO manager never has title to or possession of the asset – and thus is not a party capable of transferring or selling it. Congress clearly intended the phrase "transfer … indirectly" to ensure that a party that originated a loan could not avoid the statutory obligation by passing the loan to an ABS through an associated intermediary that "organize[d] and initiate[d]" the securitization and that did not formally "sell" the asset to the purchasing entity. For Open Market CLOs, however, the manager does not serve as such a conduit on the selling or transferring side of the transaction, and simply acts as the purchaser's agent. The term "transfer … indirectly," especially when evaluated in the context Congress sought to address, cannot bear the construction of "purchase" that the agencies suggest.

Even if Section 941's plain language did not foreclose the agencies' statutory construction, and the statute were ambiguous, the agencies' claim that the statute could be reasonably construed to encompass "purchasers" is also incorrect. The agencies first suggest that such a construction is reasonable because Congress sought generally to increase regulatory incentives to improve asset selection leading to asset backed securitizations.[17] That is wrong in two respects. As the legislative history repeatedly indicates, Congress focused on the underwriting deficiencies associated with the originate-to-distribute model,[18] and did not generally identify independently managed and structured securitizations as requiring additional regulatory incentives to improve asset selection. The agencies' order cites no legislative history to the contrary. In addition, the agencies' construction in this respect is unreasonable because it reads out of the statute the further limitation that such persons are subject to regulation only if they do so "by selling or transferring assets … to the issuer." By focusing instead on any party

[16] Credit Risk Retention, 78 Fed. Reg. 57928, 57962. The agencies less directly suggest that the Open Market CLO manager's role in "selling" assets in the course of managing the CLO supports the agencies' construction of the statute. The Open Market CLO manager does buy and sell assets once the CLO has issued securities, as part of the expertise the manager employs to enhance investors' returns. That post-formation role, however, has nothing to do with "organiz[ing] and initiat[ing] an asset-backed securities transaction," which is the only context where "selling or transferring assets" can render a party within the scope of Section 941. Because the Open Market CLO manager does not in any respect sell or transfer assets in the course of "organiz[ing] and initiat[ing] an asset-backed securities transaction," Section 941 does not apply. (Correspondingly, an arranging bank may sell loans to an Open Market CLO manager, but because the transaction is among independent parties and the arranger is not in that context "organiz[ing] and initiat[ing] an asset-backed securities transaction," the arranger is similarly not within Section 941's definition of "sponsor.")

[17] Credit Risk Retention, 78 Fed. Reg. 57928, 57962.

[18] S. REP. NO. 111-176, at 128–131 (2010).

that selects assets, the agencies would render this provision superfluous, which is fatal to a construction of a statute.

The agencies also argue that their construction is reasonable because the plain language reading of the provision would otherwise create opportunities for evasion.[19] But that concern has no application in this context. An entity that does originate loans and seeks to distribute them through a securitization it initiates *does* "indirectly transfer" them when it uses an associated intermediary to place them in the issuing entity. In addition, an agent can be deemed to act on behalf of its principal. Neither circumstance applies to Open Market CLO managers. To the extent the agencies can identify any particular circumstances where appointment of an agent could permit a loan originator to evade the statute's requirements, they can readily craft an anti-evasion provision to address that risk. But the risk of evasion, which is not present here, cannot justify the agencies' construction of "transfer … indirectly" to mean "purchase."

III. The Agencies Must Correctly Construe Section 941's Requirements Related to Retention of "Credit Risk."

In evaluating options for risk retention for Open Market CLOs, in the event the agencies conclude that Section 941 applies to such CLOs, the agencies must correctly construe Section 941's requirement that a securitizer retain "not less than 5 percent of the credit risk for any asset … that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer."[20] A proper reading of this provision shows that it is readily satisfied by the LSTA's April 2013 proposal for Open Market CLO managers to retain credit risk through a combination of holding subordinated securities and purchasing five percent of the CLO's equity.[21] The agencies, in the FNPRM, have requested additional comment on how this proposal meets the requirements and purposes of Section 941.

The LSTA previously set forth how, as a matter of industry practice and economic theory, "credit risk" is the exposure to financial loss arising from the borrower's non-performance.[22] As the LSTA has demonstrated, the quantum of the credit risk held by a CLO manager depends significantly on how deeply subordinated or contingent the interest retained by the manager is in light of the performance characteristics of the assets at issue.[23] Indeed, the

[19] Credit Risk Retention, 78 Fed. Reg. 57928, 57962.

[20] Dodd Frank Act, §941(b) (Exchange Act, §15G(c)(1)(b)(i)).

[21] *See* LSTA Letter Comment (Apr. 1, 2013) at 9–12.

[22] *See id.* at 8–9; *see also* Credit Risk Retention, 78 Fed. Reg. 57928, 58025 (Re-proposed Rule §__.2) (defining credit risk as, *inter alia*, "[t]he risk of loss that could result from the failure of the borrower in the case of a securitized asset, or the issuing entity in the case of an ABS interest in the issuing entity, to make required payments of principal or interest on the asset or ABS interest on a timely basis").

[23] *See* LSTA Letter Comment (Apr. 1, 2013) at 8–9.

agencies have acknowledged that a deeply subordinated position reflects the assumption of disproportionate credit risk.[24] "Credit risk" cannot reasonably be construed as equivalent to the face value of the assets held by an ABS, and to fail to assess risk in light of the degree of subordination would be to ignore the plain meaning of the statutory term and the economic and market understandings that inform it.

These basic principles underlay the LSTA's proposed alternative risk retention structure for CLOs. Open Market CLO managers would retain credit risk through a combination of (i) the CLO manager's retention of securities, based on CLO managers' current market-derived compensation structure, reflecting deeply subordinated and contingent positions whose value depends on the performance of the CLO's assets; and (ii) the CLO manager's purchase of five percent of the CLO's equity.[25] Through this two-part structure, the CLO manager's risk retention would exceed 10 percent of the credit risk of the CLO's assets, which clearly satisfies and indeed far surpasses the statutory standard.[26]

As noted, the LSTA's April 2013 proposal is based in part on CLO managers' compensation structure. The agencies have acknowledged that this compensation structure "incorporate[s] credit risk sensitivity and contribute[s] to aligning the interests of the CLO manager and investors with respect to the quality of the securitized loans."[27] Indeed, this is clearly the case because investors have negotiated and demanded that compensation structure because it protects them so directly. The agencies nonetheless have declined to consider managers' compensation in the calculation of risk retention.[28] The agencies would err if they were likewise to reject the LSTA's April 2013 proposal on this basis. The agencies' reasons for refusing to count CLO managers' compensation structure toward credit risk are flawed, because they fail to recognize the economic risk the managers bear and the very substantial alignment of interests between the Open Market CLO managers and CLO investors, including investors in the most subordinated securities. And even if the agencies' reasons for discounting the compensation structure itself were valid, the LSTA's proposal more than adequately addresses these concerns.

Initially, the agencies incorrectly fault the manager fee structure as insufficient for having the manager retain a "small expected value" of "less than 1 percent."[29] This reasoning reflects an erroneous construction of credit risk as based on the face value of the asset pool, without

[24] *See, e.g.*, Credit Risk Retention, 76 Fed. Reg. 24090, 24151 (Apr. 29, 2011).

[25] *See* LSTA Letter Comment (Apr. 1, 2013) at 8–9.

[26] *Id.* at 8–12.

[27] Credit Risk Retention, 78 Fed. Reg. 57928, 57963.

[28] *Id.*

[29] *Id.*

regard to the degree of subordination of the manager's position or the performance characteristics of the assets at issue. As noted above, Section 941 requires the retention of a portion of "the credit risk for any asset." In the context of CLO assets, construing this provision as using the face value of the asset pool is not reasonable as a matter of plain language, informed by industry practice and basic economic theory. These sources indicate that the credit risk retained through the fee structure is itself more than 5 percent of the total credit risk.[30]

The agencies also err in finding the current compensation structure to be inadequate on the ground that the manager contributed no cash initially that would otherwise "be available to absorb losses as expected."[31] This rationale does not accord with the intent or operation of Section 941's risk retention requirement. As the agencies elsewhere acknowledge, the principal objective of the risk retention requirement is to ensure that investor and manager incentives are aligned, leading to improved underwriting or asset selection.[32] That incentive alignment occurs whether or not the retained interest is funded by cash initially. Poor performance of the CLO assets directly and adversely affects the CLO manager's financial position. CLO managers' interests are thus directly aligned with investors' interests regardless of any initial cash contribution.[33] Indeed, the agencies' treatment of other risk retention alternatives confirms that the statute need not, and was not intended to, protect investors through the creation of a first-loss "buffer" of the manager's cash contribution. The vertical holding alternative does not provide this buffer, and the agencies acknowledge that it is not required in other contexts.[34] And even if the statute and risk retention obligation did place a premium on such a "buffer," faulting the proposal on this basis is not reasonable in light of the structural protections for investors built into CLOs: by construction, CLOs are overcapitalized, with managers committing to adhering to particular overcapitalization ratios, which are designed to provide just such a buffer against losses.

In dissenting from the re-proposed rule, Commissioner Michael Piwowar emphasized that the agencies "should have given further consideration to subordinated performance fees that have components dependent on the performance of the overall pool or on junior tranches."[35]

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[30] *See* LSTA Letter Comment (Apr. 1, 2013) at 3–5, 9; *id.*, App. A. at 5–6 (analysis by Harvard Business School Professor Victoria Ivashina concluding that notes based on CLO managers' compensation structure are exposed to more than five percent of the CLO's credit risk).

[31] Credit Risk Retention, 78 Fed. Reg. 57928, 57963.

[32] *E.g.*, *id.* at 57932.

[33] *See* SIFMA, FSR, American Bankers Association, and ABA Securities Association Letter Comment (Oct. 30, 2013) (hereinafter "SIFMA, *et al.* Letter Comment") at Part I.I ("Unfunded forms of risk retention by the sponsor provide all the same incentives for the sponsor to ensure that the securitized assets are of the highest quality.").

[34] *See* Credit Risk Retention, 78 Fed. Reg. 57928, 57963.

[35] Commissioner Michael S. Piwowar, Statement Regarding Joint Rule Reproposal Concerning Credit Risk Retention, Aug. 28, 2013, *available at* http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370539792894.

Commissioner Piwowar explained that "[s]uch fees could potentially mitigate concerns about misaligned incentives between originators, securitizers, and investors."[36] The LSTA similarly urges the agencies to give further consideration to performance fees and to recognize that such fees embody significant credit risk and create real interest alignment benefits.[37]

In any event, any remaining concerns the agencies may have about the adequacy of CLO managers' compensation structure alone to satisfy Section 941's requirements should be fully allayed by the LSTA's April 2013 proposal, which enhances Open Market CLO managers' exposure to credit risk in two significant respects. First, this enhancement occurs through the translation of the compensation structure into a securities position and the limitations on disposition (or hedging) of those securities. Second, investor and manager interests are further aligned through the additional equity position that Open Market CLO managers must purchase, beyond the securities holdings reflecting the market-based compensation structure. This equity purchase increases the face value of CLO securities (and credit risk) to be held by the manager, above that reflected in the typical compensation arrangement. And, it requires the manager to contribute cash that contributes to the "buffer" that would "absorb losses," should the agencies maintain their position that such a buffer is necessary.

The LSTA's April 2013 proposal ensures that a CLO manager retains far more than 5% of the CLO's "credit risk," properly construed, and enhances CLO managers' already significant exposure to credit risk through their subordinated and contingent fees.[38] The proposal thus fully meets the requirements and purpose of Section 941 and, as the LSTA has demonstrated,[39] would alleviate much of the harms to the CLO market and the public interest that the agencies

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[36] *Id.*

[37] *See also* American Bar Association Business Law Section Letter Comment (July 20, 2011) at 94 (noting that managers' fee structure aligns manager and investor interest and is "a powerful proxy for risk retention"); SIFMA Letter Comment (June 10, 2011) at 70 and n.90 ("Because [managers'] fee structure is so strongly tied to performance and so tightly aligned with the investors' interests, … there is no need to require additional risk retention in managed CLOs," and in any event such compensation "should count in full as part of the required risk retention."); ASF Letter Comment (June 10, 2011) at 137–138 (managers' fee structure addresses the policy concerns behind Section 941); JP Morgan Chase & Co. Letter Comment (July 14, 2011) at 53 (fees align interests and make risk retention unnecessary for CLOs); Morgan Stanley Letter Comment (July 27, 2011) at 20 ("[T]he full amount of [managers'] deferred compensation should be credited against any risk retention requirement."); Bank of America Letter Comment (Aug. 1, 2011) at 26 (CLOs should be exempt from the rule in part because managers' fee structure "closely align[s] the economic interests of the collateral manager with those of the CLO investors."); Wells Fargo Letter Comment (July 28, 2011) at 28 (discussing compensation structure among the reasons CLOs should be exempt from risk retention); Cong. Jim Himes and other Members of Congress Letter Comment (July 29, 2011) (same). *Compare* Credit Risk Retention, 78 Fed. Reg. 57928, 57961 (noting that "a commenter" proposed that CLO managers' fees be counted toward risk retention).

[38] *See* LSTA Letter Comment (Apr. 1, 2013) at 3–16; *id.*, App. A. at 6 (analysis by Harvard Business School Professor Victoria Ivashina concluding that under the LSTA's proposal, the CLO manager would retain "at least 10.1% of the CLO credit risk").

[39] *See* LSTA Letter Comment (Apr. 1, 2013) at 14–16.

acknowledge would be caused by subjecting CLOs to the standard risk retention envisioned in the proposed rule.

IV. The Agencies' Proposed Rule as Applied to Open Market CLOs Would Significantly Harm the Public Interest And Would Produce No Benefits.

The costs of the agencies' proposed CLO rules are significant and far exceed the rules' benefits, which the agencies have not – and cannot – identify. The SEC acknowledges that it must undertake an analysis of the relative costs and benefits of the proposed rules, and basic administrative law principles requiring a reasoned explanation of the proposed rule impose a like requirement on the other agencies.[40] Even so, neither the SEC nor the other agencies have fulfilled their obligation to ensure that the benefits of their proposed approach exceed the costs the rules impose on loan recipients, lenders, syndicate participants, CLO managers, investors, and the public interest generally. This obligation arises as part of the agencies' duty to reasonably construe the statute, to ensure that their rules are rational and non-arbitrary, and to satisfy the obligations inherent in the securities laws. A proper analysis of the costs and benefits of the proposed rules would show that the rules secure no public interest benefits and significantly harm market participants, investors, and the public at large. Under basic administrative law principles, the agencies cannot proceed with and must significantly modify their proposed rules.

A. <u>Agencies' cost-benefit analysis</u>.

The agencies' own macroeconomic cost-benefit considerations point to why the proposed rules addressing CLOs impose significant costs but secure no benefits. The agencies' macroeconomic analysis traces the benefits of the rules implementing Section 941 generally to reducing the misalignment of incentives created by the originate-to-distribute model of loan generation and securitization. In particular, the benefits arise from correcting "the misaligned incentives between the originators/sponsors of ABS and the ultimate investors" which caused "lax lending standards and relaxed credit enhancement standards during the period before the financial crisis."[41] The agencies' analysis also identifies "the significant potential costs" of imposing risk retention requirements.[42] "If the costs are deemed by sponsors to be onerous enough that they are no longer able to earn a sufficiently high expected return by sponsoring securitizations, this form of supplying capital to the underlying asset markets would decline" – and this "could reduce capital flows into the underlying asset markets, thereby reducing the amount of capital available for lending and possibly adversely impacting efficiency."[43] The

[40] *E.g.*, Credit Risk Retention, 78 Fed. Reg. 57928, 58004.

[41] *Id.* at 58006.

[42] *Id.*

[43] *Id.*

degree of this adverse effect would depend on "the cost and availability of alternative … funding sources."[44]

The agencies completely fail to apply these principles to the CLO market and to their rules addressing credit risk retention by CLO managers,[45] but those principles clearly show that the costs of the rules for the CLO market far exceed any benefit. As described below, the benefits of the agencies' rules do not apply in the CLO context, because Open Market CLO managers do not participate in an originate-to-distribute process of securitization and are already subject to incentives that closely align their interests with investors' interests. *See infra* pp. 12–14. In addition, "the significant potential costs" identified by the agencies are certain to materialize in the CLO market. If the agencies' rules are implemented in their current form, CLO formation will decrease dramatically; alternative sources of capital are limited and relatively expensive; and credit will thus become less available and more expensive in important markets dependent on funding from CLOs. *See infra* pp. 14–17.

B. The proposed rules would produce no benefits.

Because the interests of Open Market CLO managers are already aligned with CLO investors' interests, the credit risk retention rules do not produce public interest benefits by solving any "misalignment of interests" problem that exists for other ABSs. Several structural and market features of Open Market CLOs buttress and ensure this alignment of manager and investor interests.

First, the deferred, contingent nature of the principal components of CLO managers' compensation aligns investor and manager incentives, as well as ensures that managers bear substantial retained credit risk. As LSTA has described at length, Open Market CLO managers are compensated if and when equity holders receive returns – after holders of all other classes of CLO securities have received payments due to them.[46] In addition, a crucial component of Open Market CLO managers' compensation arises only once all investors have secured a very significant return on their *entire* investment. This creates a direct, financial incentive for the manager to select the best-performing assets and to manage the loan portfolio in investors' interest after the CLO is initiated. Indeed, Harvard Professor Ivashina has calculated that the economic interest represented by the managers' deferred compensation components is equivalent to more than 5 percent of the credit risk of the CLO loan portfolio.[47]

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[44] *Id.*

[45] The agencies have yet to apply their general macroeconomic principles to the CLO market, as they are obliged to do. *See id.* at 58003–58024. Their limited discussion of the impact on CLO markets does identify a related cost of the regulations (decreased competition) and fails to establish that the rules would, as applied to Open Market CLO managers, create any public interest benefits. *See id.* at 58015.

[46] LSTA Letter Comment (Aug. 1, 2011) at 6–7; LSTA Letter Comment (Apr. 1, 2013) at 4–5.

[47] LSTA Letter Comment (Apr. 1, 2013) at 3–5, 9; *id.*, App. A. at 5–6.

This alignment of interests should not be surprising in light of the market role investors play in Open Market CLO formation. Open Market CLO managers are independent of originators, and their ability to form CLOs and attract investment depends directly on whether the terms they offer are attractive to investors. The industry model has emerged as the result of the demands of investors. This is especially true of the managers' compensation structure. Investors have insisted on, and ratified the adequacy of, the deferred and contingent, performance-based compensation scheme. They have done so because that structure protects investors by providing Open Market CLO managers with strong incentives to undertake thorough evaluations of loan quality and to protect investors through the active management phase of the CLO's operation.

Second, the Open Market CLO model has similarly developed to incorporate a series of other features that protect investors. These structural features further establish that the credit risk retention rules generate no benefits in this context by filling some gap in existing investor protection.

Five structural features are especially important.[48] Investors have insisted on overcapitalization ratio tests that provide an additional buffer for CLO investors for their returns in the event of market downturns.[49] Likewise (and unlike for most other classes of ABSs), CLOs provide a period of active management of the loan portfolio, permitting the manager to respond to new information and changed circumstances by buying and selling portions of the loan portfolio in order to safeguard investors' interests. In addition, investors have insisted that CLO managers commit to limiting their purchase of commercial loans to those with very senior interests – typically, secured first lien loans. This ensures that even in the event of default of a portion of the loan portfolio, the CLO has a high likelihood of recovering a significant portion, and in many cases all, of the invested funds. This protection is in addition to the protection afforded to CLO investors by the far superior recovery rate for leveraged loans, compared to other ABS asset classes, in the relatively limited instances where there is a default. *See infra* p. 24 n.76. In addition, investors increasingly insist that CLO managers be registered investment advisors, and the overwhelming majority of CLOs are currently managed by registered investment advisors. LSTA has acknowledged that all CLO managers should become registered investment advisors, which carries with it a certification of a level of expertise and especially a

[48] All of these features, including especially the overcapitalization ratio tests and the senior secured first lien taken in portfolio loans, illustrate why the agencies' reference to the "riskiness" of leveraged loans, Credit Risk Retention, 78 Fed. Reg. 57928, 57963, provides no basis to impose additional risk retention requirements in relation to CLOs. The relevant "risk" is to CLO investors, not to the asset class as a whole, and the structural features of CLOs and the other systemic and market features identified in this section are designed to ensure that the risks assumed by CLO investors are far less than the risks posed by the asset class as a whole.

[49] At times, the agencies' structuring of risk retention requirements seeks to create a loss buffer held by the ABS manager in the form of retained credit risk. *See, e.g., id.* at 57938–57939 (describing the eligible horizontal residual interest option for risk retention). The CLO's overcapitalization serves just this function, acting as a buffer absorbing loss that must be exhausted before CLO investors' interests are adversely affected. Indeed, because CLO managers' compensation in large measure depends on CLO investors' first securing a benchmark overall return, the CLO manager is at risk for the losses experienced even by the overcapitalization buffer.

set of fiduciary obligations and related legal and regulatory incentives to act on behalf of investors.[50] Finally, CLO managers must attract clients over multiple transactions and by developing a strong performance record, which provides a further incentive to select assets in investors' interests.

Third, the nature of the commercial loan market, and the Open Market CLO manager's position in that market, provide additional protections for CLO investors. The loan syndication process ensures that multiple, highly sophisticated institutions review financial details associated with each syndicated commercial loan and perform their own due diligence related to the transaction. In addition, the Open Market CLO manager often benefits from the information and transactions associated with the secondary loan market, which is the source of much of the CLO loan portfolio. The Open Market CLO manager performs its own evaluation, including reviewing the loan characteristics and the creditworthiness of the borrower.

The investor protections arising from all of these features of Open Market CLOs and the commercial loan market are reflected in the strong performance of CLOs during the recent financial crisis and the resurgence of investor demand for CLOs in the aftermath of the crisis. The LSTA has outlined in considerable detail the strong performance of CLOs during the financial crisis, reflected especially in the very few actual losses suffered by CLO investors.[51] Other commenters have also established a strong record supporting this point.[52] That performance has led to a positive verdict from investors and the market broadly regarding the protections for investors and the alignment of manager and investor interests reflected in CLOs. Investors have shown very strong demand for CLOs in the years following the financial crisis, and they have required no additional regulatory protections before concluding that the current structure of CLOs adequately protects their interests. That performance and the various features of CLOs leading to it also readily justify an exemption from the credit risk retention requirements under relevant statutory criteria.[53]

C. The proposed rules would impose significant costs.

The proposed rules would impose significant, adverse costs through dramatically reduced

[50] *See* LSTA Letter Comment (Mar. 9, 2012) at 4.

[51] *See* LSTA Letter Comment (Aug. 1, 2011) at 7; LSTA Letter Comment (Apr. 1, 2013) at 19; LSTA Letter Comment (July 29, 2013) at 2, App. A.

[52] *See* American Bar Association Business Law Section Letter Comment (July 20, 2011) at 90–93; ASF Letter Comment (June 10, 2011) at 134–135; SIFMA Letter Comment (June 10, 2011) at 69; Morgan Stanley Letter Comment (July 27, 2011) at 18; Bank of America Letter Comment (Aug. 1, 2011) at 23; Wells Fargo Letter Comment (July 28, 2011) at 29; The Center for Capital Markets Competitiveness of the United States Chamber of Commerce Letter Comment (Aug. 1, 2011) at 4; Cong. Himes and other Members of Congress Letter Comment (July 29, 2011) at 2.

[53] *See* Dodd Frank Act, §941(b) (Exchange Act, §15G(c)(1)(G)) (power to "provide for a total ... exemption of any securitization, as may be appropriate in the public interest and for the protection of investors").

formation of CLOs and resulting impairment of the credit markets supported by CLO capital – leading to lessened availability of credit and more expensive credit for those borrowers still able to access those loan markets. This result is precisely the adverse consequence that the agencies themselves identified as a "significant potential risk" when they addressed the proposed rules' macroeconomic effects. *See supra* pp. 11–12. In addition, as the reason the agencies offered for proposing an alternative form of credit risk retention (an illusory and unworkable option, *see infra* pp. 17–20), the agencies specifically anticipated that their previously proposed rules could well reduce the number and scale of CLOs.[54]

The LSTA and other commenters have submitted extensive record evidence that the agencies' proposed rules would dramatically reduce the formation and presence of CLOs. We previously canvassed the survey of CLO managers that indicated that the decrease in CLO offerings is anticipated to be in the order of 75 percent.[55] A broad range of comments and record evidence separately established that the proposed rules would adversely affect the formation and continued operation of the CLO market.[56] This adverse result arises because many CLO managers are too small to secure or devote funds of that magnitude for positions that cannot be disposed or hedged. For other CLO managers that might have that financial capacity, holding such a position would require a restructuring of current business models and anticipated returns – making a once viable business much less profitable, requiring that managers instead devote those funds to other, more productive uses.

This anticipated reduction in CLO formation and scale that the proposed rules would produce will have significant, adverse effects on important commercial loan markets. At any particular time, CLOs hold commercial loan assets of approximately $275–300 billion. For leveraged and syndicated commercial loans not extended directly by banks, we understand that CLOs have in recent years provided more than 50 percent of the loan capital. In certain periods, CLOs provided up to 70 percent of the support for these loan markets. The loan markets relevant to CLOs provide in excess of $100–125 billion of credit annually, supporting companies in many of the most important sectors of the economy.

If capital made available to these commercial loan markets through CLOs were to significantly diminish, as we and others expect if the agencies proceed with their proposed rules, the potential substitute sources of capital would be considerably less extensive and more expensive. Arranging banks already seek alternative sources of funds to support the credit extended to commercial borrowers in these markets, and those alternative sources cannot provide

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[54] *See* Credit Risk Retention, 78 Fed. Reg. 57928, 57962.

[55] *See* LSTA Letter Comment (July 29, 2013) at 3–6.

[56] *See* LSTA Letter Comment (Aug. 1, 2011) at 14–17; LSTA Letter Comment (Apr. 1, 2013) at 14–16; LSTA Letter Comment (July 29, 2013) at 3–9; SIFMA Letter Comment (June 10, 2011) at 70; ASF Letter Comment (June 10, 2011) at 137; JP Morgan Chase & Co. Letter Comment (July 14, 2011) at 50; FSR Letter Comment (Aug. 1, 2011) at 32; Bank of America Letter Comment (Aug. 1, 2011) at 29–30; Wells Fargo Letter Comment (July 28, 2011) at 29; White & Case Letter Comment (June 10, 2011) at 2.

nearly the amount of capital or the liquidity provided through CLOs. This is largely because CLOs have evolved into a highly efficient and successful channel of capital from investors to commercial loan borrowers. This role has developed as a result of CLO managers' demonstrated track record of selecting high-quality loans, the alignment of investor and manager interests created by the compensation structure typical of CLOs, and the broad array of structural protections and safeguards that Open Market CLOs offer to investors. Alternative vehicles for directing investors' capital to these commercial loan markets are inferior in important respects for many investors and, as a result, simply do not and will not for the foreseeable future have nearly the capacity to support the loan markets as CLOs do.

For these reasons, if the agencies proceed with their proposed rules, less credit will be available in these commercial loan markets and the credit that is extended will be more expensive. This is so because there would be less capital directed to support these commercial loan markets and because much of the capital from remaining sources would be provided less efficiently. Increased credit costs and decreased availability can be traced to decreased competition in the provision of credit, to increased costs associated with its provision, and to the operation of simple principles of supply and demand where the supply of capital materially decreases even as there is continued demand for credit.

The practical result of these effects of the agencies' proposed rules on the commercial loan markets is clear. Fewer commercial borrowers will be able to secure credit. Limited credit will flow toward higher-credit borrowers, locking out of the market an array of companies that have successfully secured credit over the past years. Those companies will, in turn, be less able to add employees, fund innovation, and increase production to more efficient levels. That is, their cost structure and competitive capabilities will worsen, with harmful consequences for their owners, employees, customers, and the public at large. Competition will be impaired. And, for those companies still able to access these commercial loan markets, borrowing costs will increase. The adverse results for them are similar, if less stark, than for their peers that are excluded from the credit markets: their cost structure will increase, diminishing their ability to grow and produce efficiently. That will have similarly adverse effects for competition and for their employees, owners, and customers.

D. The newly proposed cashflow restriction would also harm the public interest.

A separate source of harm to the public interest arises from the newly proposed requirement that would restrict projected cash flows to sponsors that retain risk through holding an eligible horizontal residual interest in an ABS.[57] This requirement prohibits the holder of the horizontal residual interest from receiving cash at a faster rate than the rate at which principal is paid to investors in all ABS interests in the securitization.[58]

[57] *See* Credit Risk Retention, 78 Fed. Reg. 57928, 57938–57939.

[58] *Id.*

As applied to CLOs, this requirement would not benefit the public and would have significant adverse effects on the financial returns available to CLO managers that might otherwise be able to meet the credit risk retention requirement by holding an eligible horizontal residual interest. This adverse impact on CLOs arises from their unique feature of having the CLO manager protect investors by actively managing the loan portfolio during a significant portion of the CLO's life, even as the CLO makes distributions to securities holders. That is, CLOs are structured to provide equity holders (including managers holding an eligible horizontal residual interest) with distributions on an ongoing basis throughout the life of the CLO. They also have a reinvestment period, during which the CLO manager *reinvests* principal proceeds by purchasing additional loans. Thus, under the proposed cashflow restrictions, CLOs with managers that would retain horizontal risk would have to restructure to defer equity-related payments, materially reducing their effective returns.[59]

This adverse effect on CLOs is presumably unintended by the agencies and produces no public interest benefits. The requirement attaches to a reinvestment practice that is designed to protect investors, and it is inconsistent with a distribution mechanism that investors have demanded and find in their interests. At the same time, it produces no offsetting protections for CLO investors.

By further constraining the ability of CLO managers to satisfy the agencies' credit risk retention requirement, this new requirement will further curtail CLO formation – even more than the curtailment that the originally proposed rule would create. In response to a survey undertaken by the LSTA, a significant majority of CLO managers reported that under the originally proposed rule, they could not or would not issue any CLOs. *See supra* p. 15. Certain CLO managers who previously indicated that they would or could issue at least some CLOs under that rule have since indicated to LSTA that, if the cashflow restriction also goes into effect, they would issue considerably fewer CLOs (approximately a further 50% reduction overall). As a result, the new requirement in combination with the originally proposed rule would produce even greater negative effects on competition, cost of credit, liquidity, capital formation, and provision of services to investors.[60]

V. The Agencies' Proposed Alternative Approach, Whereby Lead Arrangers Could Retain Credit Risk, Is Illusory and Unworkable and Would Harm the Public Interest.

Acknowledging that their previously proposed rule threatened to impair CLO formation and harm the markets that CLOs support,[61] the agencies proposed an alternative mechanism for

[59] *See* SIFMA, *et al*. Letter Comment (Oct. 30, 2013) at Part I.A.

[60] To the extent CLO formation was facilitated by permitting third parties to retain the credit risk (as proposed below and by the agencies in the re-proposal order), this aspect of the agencies' rules would similarly make that shifting of risk retention uneconomical for the associated third party.

[61] Credit Risk Retention, 78 Fed. Reg. 57928, 57962.

credit risk retention related to CLOs. That alternative had no support in the record and had not been proposed by commenters. That is for good reason: the alternative, whereby the lead arrangers would hold and not hedge a portion of the syndicated loans to create a CLO-eligible tranche that would not incur risk retention obligations if purchased by a CLO,[62] is not a practical or viable alternative. While the effort to create a regulatory solution that does not dramatically reduce the formation and market role of CLOs is widely appreciated, the proposed alternative is illusory and would not be workable for loans suitable for CLOs.

To assess the feasibility and practical implications of the agencies' proposed alternative, the LSTA surveyed a wide range of business representatives covering all disciplines of the banks that have acted as lead arrangers in the overwhelming percentage of domestic syndications that produce loans purchased by CLOs. Those officials are responsible for the banks' origination units, underwriting and credit assessments, risk reporting and management, trading, regulatory compliance, and other functions. They represent banks that are members of the LSTA and include the top 10 syndicated loan arrangers by volume, together comprising a domestic market share exceeding 75 percent in 2012.[63]

The institutions surveyed by the LSTA indicated that they cannot envision a context in which their supervisory regulators and principles of prudent risk management would encourage them to arrange loans in a manner that would produce CLO-eligible loans. Put simply, the proposal does not work for the CLO market.

Officials of the consulted arranging banks uniformly reported multiple reasons why the proposed alternative is unworkable and would be harmful to the market. These include:

- Prudent risk management. Banks' prudent risk management practices require that they actively manage their risks and retain the flexibility to dispose of loan assets in response to market conditions. A requirement that the arranger not sell and not hedge its position would be directly contrary to these basic principles of prudent risk management.[64] Bank supervisors have emphasized that prudent risk management practices should include active, ongoing assessment and management of risks and that additional risks arise from the limited ability to flexibly adjust portfolios in response to changing risk environments. The supervisors' emphasis on flexibility is reflected in the OCC's Handbook on Leveraged Lending, the Interagency Guidance on Leveraged Lending, and the newly proposed Liquidity Coverage Ratio rule.[65]

[62] *Id.*

[63] *See* League Tables, Thompson Reuters GOLD SHEETS, Vol. XXVII, No. 1 (Jan. 7, 2013) at 5.

[64] *See* International Association of Credit Portfolio Managers Letter Comment (Oct. 30, 2013).

[65] *See* Comptroller of the Currency, Leveraged Lending, Controller's Handbook (Feb. 2008) at 5, 9 (identifying "liquidity risk" as one of the primary risks associated with leveraged lending), *available at* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/_pdf/leveragedlending.pdf; *id.* at 16–17 (ongoing loan review with management and disposition planning for troubled loans); Interagency Guidance on

- Reduced Credit Availability. Continuing to hold a portion of the loan, especially without the ability to hedge that position, would reduce the arranger's ability to extend credit to leveraged borrowers. Prudent lending practices require that lenders limit their credit risk exposure arising from individual borrowers. To the extent the lender is required to hold a portion of a term loan unhedged, that practice would reduce the additional credit that could be available to the borrower – and access to that credit may be particularly important to the borrower. Moreover, a lender required to hold a portion of the term loan tranche would have to dedicate additional capital and other regulatory charges and costs to reflect that loan position, leaving less capital available for other credit to that customer. Particularly important sources of credit that would be reduced are access to working capital revolvers and cash management services and liquidity, which only banks provide and which cannot be easily replicated by other capital markets participants, including through CLOs and the bond market.

- Increased Cost of Providing Credit. Holding a portion of the loan would increase the costs of arranging loans, thus restricting the availability of credit to borrowers. A lender required to hold a portion of the syndicated loan would also have to dedicate additional capital to reflect that loan position. The regulatory requirement thus ensures that less borrowing will occur. Credit will likely be unavailable to the most marginally profitable or credit-worthy borrowers, who will have been effectively crowded out by the new regulatory requirement.

- Implementation Complexity and Risk. The practical difficulties associated with creating CLO-eligible tranches are substantial and could present significant litigation or liability risks that banks should not be expected, and would not be willing, to assume. A system for confirming the initial qualification of a loan as CLO-eligible would be required, which presents considerable implementation uncertainties and may well require representations that surveyed banks indicated they would be unwilling to make – nor should they be required to do so.[66] These factors would therefore strongly deter the issuance of CLO-eligible loan tranches.

- Non-commercial voting rights requirement. The additional voting rights required by the proposed regulations for CLO-eligible loans would be administratively unworkable and commercially unacceptable to other parties to the broader loan transaction.

Leveraged Lending, 78 Fed. Reg. 17766, 17773–74 (Mar. 22, 2013) (encouraging development of sound hedging policies, active assessment and management of portfolios, and disposition path for problem credit); Federal Reserve, Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring; Proposed Rule (Oct. 24, 2013) (premium placed on liquidity for prudent bank and systemic risk management, and requiring minimum levels of liquid assets for internationally active banks), *available at* http://www.federalreserve.gov/FR_notice_lcr_20131024.pdf.

[66] Lenders in credit facilities are responsible for their own diligence and credit decisions. Arrangers and administrative agents do not make any representations to lenders in the facility and are not fiduciaries to the lenders. Market participants would be unwilling to overturn decades of market practice and the traditional allocation of risk.

For related reasons, the proposed alternative would not serve the agencies' goal of avoiding harm to the loan markets and the public interest even if it proved to be workable to some marginal degree. For example, having arrangers hold positions without the ability to sell or hedge, rather than pursue prudent risk management policies that rely on dynamic position management, would increase risk to the arranger and systematic risk. By increasing costs of extending credit, the alternative would make capital more expensive – with related adverse effects for borrowers, their employees, owners, and customers, and the public at large. A policy with the practical effect of crowding out borrowing would have similar adverse effects on all these parties when borrowers cannot access the credit markets or cannot obtain particular sources of additional credit (*e.g.*, working capital revolvers and cash management products).[67]

The proposed alternative also is likely to present broader threats to the loan markets and the public interest. The creation of both CLO-eligible loans and non-eligible loans with otherwise comparable characteristics would distort and restrict the initial syndication process and the secondary loan market. The secondary loan market would place a premium on CLO-eligible loans, and liquidity related to non-eligible loans would be reduced. Relative to a "normal" market, both types of loans would be less liquid because they would each reflect a smaller, divided market. Syndications would be similarly distorted: differential pricing and liquidity reductions would arise both because CLOs could participate significantly in the syndication support for only CLO-eligible loans, and syndicate participants would assess loans in terms of potential secondary market liquidity.

A final, separate type of harm to the loan markets and the public interest would arise as a result of the adverse effect of the proposed rules, including the newly proposed alternative, on the formation of new CLOs. The proposed alternative simply holds out no prospect of preventing the agencies' rules from dramatically impairing the number and scope of new CLOs – leading to the various, significant adverse effects on borrowers, the syndication process, CLO investors, and the customers and employees of borrowers that were set out above in Part IV. Even to the extent that CLO-eligible loans were produced, the transition difficulties associated with CLOs being able to accumulate sufficient assets would be immense, leading to a medium term dissolution of CLO formation even in the most optimistic scenarios.

VI. Other Risk Retention Alternatives Would Impose Fewer Costs Than the Approach Outlined by the Agencies.

Agency officials have encouraged the LSTA and its members to suggest alternative regulatory requirements that would satisfy the broad objectives of Section 941 in the event that the agencies' proposed alternative proved unworkable or unsatisfactory. The LSTA has already proposed several alternative approaches and appreciates that the agencies are soliciting comment on the most recent of those proposals. *See supra* p. 2 & Part III. In addition, the LSTA has

[67] *See* Dodd Frank Act, §941(b) (Exchange Act, §15G(d)(2)(C)) (in allocating risk retention, agencies must consider "the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms").

recently worked extensively with its members, including CLO managers and arranging banks, to explore and develop an additional alternative. The most promising approach is set out below and provides a workable alternative that would impose far fewer costs than the options advanced in the agencies' re-proposed rule.[68]

In developing a proposal that could work for the CLO market while addressing the agencies' concerns, the LSTA consulted the wide array of banking officials described above. *See supra* p. 18. These officials represent all disciplines of the lead arranging banks that comprise the vast majority of the domestic market. The LSTA also consulted a broad range of CLO managers.

A. The design and objectives of the proposed approach.

The proposal outlined below has been developed and should be assessed in light of other sources of incentives, arising from both the market and regulation, bearing on Open Market CLO managers. It would be applied and limited to a context where important sources of incentives and selection processes independently lead to careful asset selection by Open Market CLO managers and align managers' interests with investors' interests. The adequacy of additional regulatory requirements should be considered in light of these distinct incentives already affecting Open Market CLO managers.

A significant source of these incentives is CLO managers' deferred, contingent compensation structure, under which, as noted above, CLO managers already bear significant risk. CLO managers' compensation depends on the performance of the CLO assets and consequently places a premium on the careful selection and management of those assets. In this way, the compensation structure aligns the interests of CLO managers with those of investors, as the agencies have acknowledged.[69] Indeed, investors and the competitive process have shaped and ratified this compensation structure as protecting investors' interests. CLO managers already have significant "skin in the game."

In addition, Open Market CLO managers are independent of originators and exercise their own judgment in selecting among products originated by unaffiliated entities. As a result, they select and manage CLO assets free from the potential conflicts and disincentives related to the originate-to-distribute model that Section 941 was designed to eliminate. They attract investors based in large measure on this position of independence and the resulting quality of asset selection. Moreover, Open Market CLO managers are registered investment advisors, with associated fiduciary duties – and potential liabilities – to their investors. This status triggers a

[68] The LSTA offers this proposal without forgoing the legal and policy objections the LSTA has previously raised regarding the imposition of a credit risk requirement on Open Market CLO managers. *See* LSTA Letter Comment (Aug. 1, 2011); LSTA Letter Comment (Apr. 1, 2013); LSTA Letter Comment (July 29, 2013); *see also supra* pp. 4–17.

[69] *See* Credit Risk Retention, 78 Fed. Reg. 57928, 57963.

separate and quite effective regulatory and supervisory regime that also provides incentives for careful selection and management of assets. Indeed, as the American Bar Association has explained, CLOs are the only ABS managed by registered advisors, which results in a variety of protections for CLO investors and is thus another important factor ensuring the proper alignment of investor and manager interests.

The quality of CLO assets is further ensured through the multiple layers of underwriting decisions that inform CLO asset selection: the arrangers' decisions in underwriting the loans, the market's evaluation in pricing and arranging the loans, and the CLO manager's decisions in selecting the loans for the CLO to purchase. Often, the assessments reflected in secondary market pricing also contribute to the selection of high-quality assets. This multilayered decision-making approach contributes to ensuring the quality of the CLO's assets.

Moreover, CLO managers select (and CLO investors demand) loan features that protect investors through high effective returns that are not reflected in technical default rates. Prominently, CLO managers select senior secured loans. Together with other loan features that contribute to higher recovery rates for leveraged loans as an asset class as a whole,[70] this manager role often further ensures complete or very substantial recovery and loss protection even in the event of default, and was an important reason why CLOs protected investors so well during the recent financial crisis. Other features of CLOs, including the overcapitalization ratio and equity tranche, further protect investors' returns.

In addition to operating against the backdrop of these Open Market CLO features that already align manager and investor interests, the proposal draws on the principal rationales and objectives reflected in two important, related aspects of the agencies' rules implementing Section 941. First, because the regulations are designed to produce high underwriting and investment selection standards, they are needed less when the assets backing a securitization inherently reflect less risk and would categorically pass more stringent selection tests.[71] This rationale underlies Congress's and the agencies' treatment of both qualified residential mortgages and qualified commercial loans. As discussed below, the proposed alternative reflects this same principle with regard to high quality assets in the CLO context.

Second, the agencies have recognized that it is not necessary for the CLO manager to retain credit risk when another designated party instead holds that risk. The agencies' alternative proposal – under which the lead arranger's retention of credit risk would provide the basis for the creation of CLO-eligible loan tranches – reflected just this principle.[72] The agencies' proposed

[70] *See infra* p. 24 n.76.

[71] *E.g.*, Credit Risk Retention, 78 Fed. Reg. 57928, 57980 (underwriting standards for qualifying assets are intended "to be reflective of very high-quality loans because the loans would be completely exempt from risk retention"); *id.* at 57969 (Section 941 allows the agencies to issue exemptions that would help ensure high quality underwriting standards and promote the public interest).

[72] *See id.* at 57962.

rules further reflect this principle by allowing sponsors to share or to shift risk retention obligations.[73] As discussed below, the proposed alternative seeks to employ and build upon this same principle and rationale by allowing a third party to retain risk in relation to a CLO under certain conditions.

B. The proposed alternative approach.

The proposal has two related components. The first relates to the quantum of risk that the Open Market CLO[74] manager or coordinating party must retain, with the retention level reduced to the extent the CLO holds higher quality commercial loans that meet specific criteria, defined for this particular purpose in light of what constitutes high quality loans in this market sector. *See infra* pp. 23–27. The second relates to when the credit risk may be retained by a person other than the CLO manager, broadly consistent with principles underlying the alternative proposed by the agencies. *See infra* pp. 27–28. The components are designed to work in tandem for maximum benefit: the CLO's holding of eligible, high quality loans would reduce the extent of credit risk that would have to be retained, and one or more of the Open Market CLO manager or associated parties could discharge that retention obligation.

1. Reduced credit risk retention for qualifying assets.

The first component of the proposal provides that the face value of the credit risk that must be retained for an Open Market CLO would be reduced, on a *pro rata* basis, to the extent that the commercial loans backing the issued CLO securities qualify under the specific criteria described below.[75] That is, if an Open Market CLO's assets consist of 20 percent commercial loans that qualify under the proposed criteria and 80 percent loans that do not qualify, the required risk retention for that Open Market CLO would be 4 percent (rather than 5 percent) of the face value of the CLO's assets.

To ensure that commercial loans that qualify to reduce Open Market CLO risk retention are the product of high underwriting standards and reflect the practicalities of the loan syndication market, the proposal would be limited to senior secured first lien loans. This

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[73] *See id.* at 57966–57968 (securitizers can share risk with originators); *id.* at 58026 (when an ABS has multiple sponsors, credit risk need not be retained by every sponsor).

[74] As noted above, *see supra* n.10, "Open Market CLO" should be defined as a CLO "(i) whose assets consist predominantly of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in open market transactions or [from other open market CLOs] and of temporary investments, (ii) that is managed by a manager, and (iii) that is not a balance sheet CLO." *See* LSTA Letter Comment (Mar. 9 2012) at 4.

[75] As the agencies have acknowledged, Section 941 gives the agencies the authority to exempt assets that meet certain underwriting standards. *See* Credit Risk Retention, 78 Fed. Reg. 57928, 57979. The agencies also have the authority to adopt exemptions "in the public interest and for the protection of investors." Dodd Frank Act, §941(b) (Exchange Act, §15G(c)(1)(G)(i)).

requirement ensures enhanced loan quality and protection against losses.[76]

In addition, the loans would have to meet one of the following additional criteria, which are based on market experience in this sector and the criteria the agencies have developed to identify high-quality loans in other contexts. This flexible approach to identifying commercial loans that qualify to reduce Open Market CLO risk retention responds to the market reality that high quality loans arise in a variety of forms not susceptible to a single, standard set of criteria. At the same time, the criteria ensure that eligible loans are limited to higher quality loans.

A commercial loan would qualify to reduce Open Market CLO risk retention if it was a senior secured first lien loan and if either:

i. The loan has a ratio of first lien debt to total capitalization of less than or equal to 50%.[77] Such a ratio ensures that junior debt and/or shareholder equity have "skin in the game" to absorb any losses; <u>or</u>

ii. The loan has a total leverage ratio less than or equal to 4.5 times.

In addition, the credit risk retention requirement would be reduced to the extent the CLO held a small subset of loans requiring specialized treatment. First, retention would be reduced with regard to debtor-in-possession ("DIP") situations, where the arranger acts in order to roll-up pre-petition loans or participate in new DIP financings. Second, retention would be reduced for loans resulting from court-approved Chapter 11 exit financings.

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[76] By limiting the universe of loans that qualify to reduce CLO risk retention to senior secured first lien loans, the proposal recognizes the effect that seniority and security have on the quality of loans, as appropriately defined by loss experience. For example, the default rate for conduit CMBS, jumbo mortgages, and leveraged loans – for ABS assets of 2006 vintage – were broadly equivalent (8.5%, 9.1%, and 8.9%, respectively). The severity of loss (given a default) for leveraged loans was much less than for the other asset classes (49.4%, 46.5%, and 18.0%, respectively). Thus the actual loss rate for conduit CMBS and jumbo mortgages was many times higher than the rate for leveraged loans (4.18%, 4.24% and, for leveraged loans, 1.6%). (Sources: Moody's Investors Service and Bank of America Merrill Lynch research).

[77] For these purposes, the ratio of first lien debt to total capitalization means the ratio of first lien debt to the total of first lien debt, junior debt capital, and shareholder equity. "First lien debt," in turn, means funded first lien debt plus capital leases less unrestricted cash. "Junior debt capital" means funded second lien debt, unsecured bonds, holding company debt, mezzanine debt, and subordinated bonds. "Shareholder equity" means preferred securities plus common stock. For public companies with market capitalization of greater than $200MM, shareholder equity would be based on the 30-day average exchange traded share closing price prior to the announcement of the transaction, plus the acquisition price paid for the target. For public companies with market capitalization of less than $200MM and for non-financial sponsored private companies, shareholder equity would be based on average acquisition multiples of such businesses plus the acquisition price paid for the target. Finally, for financial sponsored backed transactions, shareholder equity would equal cash equity invested and retained plus the value of any rolled equity from prior owners or managers based on the purchase price paid for the company. In the event the proposed transaction involves a roll up of two or more sponsor backed companies, shareholder equity would be calculated based on the greater of (i) cash equity invested and retained in the businesses or (ii) a reasonable approximation of the value of such retained equity investment based on average acquisition multiples of such rolled up businesses.

Further, two important administrative and transitional provisions are also required. First, whether a loan qualifies to reduce CLO risk retention should be determined at origination. This reduces regulatory uncertainty, facilitates trading, and addresses the absence of adequate, current information regarding many loans. Second, a loan originated before the effective date of the Risk Retention Rule would not attract risk retention obligations. In this way, the proposal avoids the major disruption in the market that would otherwise result from the inability of CLOs to secure adequate assets in the period following the effective date of the new rules.[78]

A CLO that holds loans meeting the criteria set forth above should be allowed to reduce its credit risk retention requirement on a completely *pro rata* basis. For a CLO with qualifying loans comprising 80% of total assets, only 1% of the face value of the assets would have to be retained. In the context of other qualifying assets, such as qualifying commercial or auto loans, the agencies have proposed a minimum risk retention requirement for blended pools.[79] Under the agencies' proposal for other qualifying assets, the risk retention requirement is reduced *pro rata* for qualifying assets comprising up to 50% of the total ABS assets, and is likewise reduced *pro rata* for assets that comprise 100% of total assets, but there is no *pro rata* reduction for qualifying loans comprising more than 50% but less than 100% of the ABS assets. As a general matter, there is no supporting justification for permitting a full offset when an ABS holds 100% high-quality loans but only a 50% offset when, for example, an ABS holds 99% high quality loans. As the Securities Industry and Financial Markets Association ("SIFMA") and other trade associations have explained,[80] allowing a fully *pro rata* reduction in retention for all high quality assets while requiring 5% risk retention for non-qualifying assets ensures that sponsors "hold a meaningful exposure to all assets they securitize that are subject to the full risk retention requirement."[81] In any event, a fully *pro rata* approach is clearly warranted for assets that qualify for reducing CLO risk retention, given the multiple investor-protective characteristics of Open Market CLOs, including overcollateralization and the independence of the CLO manager.

Rules adopting this proposed approach also would have to alleviate and seek to avoid potential administrative and implementation uncertainties. For example, having the qualified loan designation serve as a permanent categorization established at the time of origination, rather than a status that must continue to be monitored and could be revoked based on the borrower's performance, would remove considerable administrative difficulties and market uncertainty. Similarly, the rules should ensure that the originating bank is not responsible for providing representations or warranties regarding or verifying whether a loan is appropriately categorized

[78] The LSTA agrees with the position expressed by SIFMA, FSR, the American Bankers Association, and the ABA Securities Association that applying the rules to such "legacy loans" would not serve the objectives of Section 941 because it would not be possible to retroactively affect the credit quality of such assets. *See* SIFMA, *et al*. Letter Comment (Oct. 30, 2013) at Part I.H.

[79] Credit Risk Retention, 78 Fed. Reg. 57928, 57986.

[80] *See* SIFMA, *et al*. Letter Comment (Oct. 30, 2013) at Part I.G.

[81] Credit Risk Retention, 78 Fed. Reg. 57928, 57986.

as a loan qualifying for reduced risk retention.[82] To the extent that the CLO manager needs to make representations to the regulators or to investors, the rules should provide that the CLO manager is entitled to rely on the financial information provided by the borrower.

Finally, the rules should establish a reasonable sunset period for CLO risk retention. Under the re-proposed rule, most ABSs that are subject to the risk retention requirement can take advantage of a sunset provision that limits the length of time that sponsors are prohibited from selling or hedging the retained interests.[83] Specifically, under the re-proposed rule, sponsors may sell or hedge those retained interests upon the latest of: (1) when the securitized assets have been amortized to less than 33% of their original principal amount; (2) when the outstanding principal balance of the underlying assets is less than 33% of its original amount; or (3) two years after the closing of the securitization.[84] The LSTA appreciates that the agencies have recognized that it is unnecessary to restrict the sale and prohibit the hedging of retained interests for the entire life of a securitization and that a shorter period of risk retention adequately serves the purposes of Section 941.[85] Unfortunately, however, as the agencies acknowledge, the proposed sunset provision provides no relief for Open Market CLOs, which are actively managed structures that reinvest the proceeds of principal repayments.[86] The LSTA believes that a two-year sunset period is appropriate for Open Market CLOs. Flaws in the structure of an Open Market CLO or in its asset selection criteria will virtually always come to light within the first two years. Accordingly, the agencies should modify the sunset provisions as they apply to Open Market CLOs.

As noted above, the criteria for loans that qualify for reduction of CLO risk retention under the LSTA proposal are drawn from the criteria the agencies have developed for identifying high quality loans in other contexts, while taking into account the unique needs of the CLO market and the overall high quality of CLO assets. Certain of the criteria the agencies have proposed for qualifying assets in other contexts are simply inapt for the CLO market. In particular, many of the agencies' proposed criteria for other contexts are designed to reduce the risks associated with static asset pools. By contrast, CLO assets are actively managed during the most relevant period of the CLO's operation. This important characteristic of CLOs distinguishes them from static asset pools and renders such additional restrictions unnecessary.

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[82] This includes any certifications such as those envisioned in the re-proposed rule's underwriting standards for qualifying commercial loans. *See id.* at 58039 (Re-Proposed Rule, §__.16(a)).

[83] *See id.* at 57977–78.

[84] *Id.* at 57978.

[85] *Id.* ("The agencies have concluded that the primary purpose of risk retention—sound underwriting—is less likely to be effectively promoted by risk retention requirements after a certain period of time has passed and a peak number of delinquencies for an asset class has occurred.").

[86] *See id.* at 58015.

Among the agencies' requirements for qualifying commercial loans that are not apt for the CLO context is the agencies' proposal to exclude any ABS with a reinvestment period from the qualifying commercial loan exemption.[87] This prohibition is entirely counterproductive in the CLO context because CLOs typically feature a reinvestment period, and this feature serves as an important mechanism to protect CLO investors.

Similarly, the agencies' requirements that qualifying commercial loans have a straight-line amortization payment and a maximum five year loan term do not fit the CLO context. These criteria, as applied in the syndicated loan market that generates assets employed by Open Market CLOs, have little or no bearing on loan quality. A very significant portion of the highest-quality and historically best-performing loans in this sector would fail these criteria. Moreover, to the extent that the five-year loan term limitation is designed to address duration risks related to unforeseen developments, the operation and structure of CLOs already addresses that risk: CLOs are actively managed, and CLO managers can continue to monitor asset quality, and respond appropriately through asset dispositions, through much of the life of the CLO. Furthermore, a five-year requirement makes these loans unattractive to borrowers and is a dramatically more stringent requirement than the criteria the agencies have recognized as adequate for qualified residential mortgages. Other aspects of the agencies' qualifying commercial loan definition are likewise inapplicable or ill-suited to CLOs.[88]

2. CLO credit risk retention by third party anchor equity holders.

The second component of the proposal provides that a third party, rather than the Open Market CLO manager, could retain some or all of the required quantum of credit risk in appropriate circumstances.[89] The agencies' proposed alternative of having an arranging bank hold the risk retention for a CLO – although unworkable for the reasons explained above – demonstrates as a general matter that a third party's retention of credit risk can satisfy Section 941's requirements in the CLO context.[90] Likewise, the third party retention proposal comports

[87] *See id.* at 58038 (Re-Proposed Rule §__.15(a)(3)).

[88] For example, the requirement that the qualifying asset ratio be determined as of the cut-off date (Credit Risk Retention, 78 Fed. Reg. 57928, 58039 (Re-Proposed Rule §__.15(b)(1))) is designed for static asset pools, not actively managed ones like those in CLOs. Likewise, the provision allowing a sponsor to repurchase a loan that is later found not to meet the qualifying criteria reflects an originate-to-distribute model in which the sponsor is an actual originator (Open Market CLOs, of course, do not use the originate-to-distribute model, and the entity the agencies have deemed the CLO "sponsor" does not originate the loans). Other criteria are similarly problematic for CLOs, such as the inability to mix loans with other assets, the prohibition on payments in kind, and the requirement that the loan be funded within six months of closing the securitization.

[89] The LSTA agrees with the view expressed by SIFMA, FSR, the American Bankers Association, and the ABA Securities Association that when there are multiple sponsors of an ABS, the sponsors should be able to allocate risk retention among themselves, rather than requiring one of the multiple sponsors to hold the entire risk retention amount. *See* SIFMA, *et al.* Letter Comment (Oct. 30, 2013) at Part I.K.

[90] *See* Credit Risk Retention, 78 Fed. Reg. 57928, 57963.

with the rule's provisions recognizing that when there are multiple sponsors of an ABS, it is not necessary for every sponsor to retain risk,[91] and the criteria outlined below ensure that the third party plays a role in enhancing asset quality. The proposal below is also consistent with the agencies' acceptance of third party risk retention in the CMBS context.[92]

To be eligible to retain credit risk related to the CLO, the third party would be required to have a role in setting the selection criteria for the assets held by a CLO and the power to veto any change to asset selection criteria. The agencies have indicated that an entity that selects the assets that go into a CLO meets the definition of "sponsor" and is an appropriate party to retain credit risk.[93] These criteria thus accord with the agencies' emphasis on asset selection as central to the definition of "sponsor" and with their related objective of imposing credit risk retention requirements to improve the quality of asset selection.

Specifically, for a third party to retain credit risk related to the CLO, the following criteria would have to be met:

i. Prior to the CLO's acquisition of the initial CLO assets, the third party must review and assent to the asset eligibility criteria, concentration limits, collateral quality tests, and reinvestment criteria of the CLO's asset pool; and

ii. Any material change to the above parameters would require prior written consent by the third party retaining the CLO credit risk.

In addition, to enable the third party retaining credit risk to evaluate before the CLO closes whether the CLO manager is able to meet the asset selection criteria, at least 50% of the initial asset pool would have to be acquired (or be under a commitment to be acquired) by the closing date.

This component of the LSTA proposal would also require that the agencies remove the cashflow limitation for holders of an eligible horizontal residual interest, as discussed in section IV. *See supra* pp. 16–17. As noted above, this requirement is unworkable for CLOs no matter which party holds the credit risk retention. Necessarily, then, the requirement would have to be eliminated to enable third party anchor equity holders to serve as a CLO "sponsor."

The approach proposed above would impose far fewer costs on borrowers, financial sector participants, investors, and the public at large than would the options outlined in the

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[91] *See id.* at 58026.

[92] *See id.* at 57952–57959.

[93] *See id.* at 57962 ("[T]he agencies believe that the CLO manager is a 'securitizer' under section 15G of the Exchange Act because it selects the commercial loans to be purchased by the CLO issuing entity for inclusion in the CLO collateral pool, and then manages the securitized assets once deposited in the CLO structure.").

originally proposed rule or the re-proposed rule. This approach would allow relatively more CLOs to support important loan markets. That result, in turn, would – relative to the consequences of the agencies' proposed approach – preserve liquidity for syndicated loans (initially and in the secondary market), increase competition in the provision of credit, lower borrower costs, and increase the availability of credit.

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The LSTA appreciates the agencies' consideration of these comments and would be pleased to provide additional information or assessments that might assist the agencies' decision-making. Please feel free to contact Elliot Ganz at (212) 880-3003 or Meredith Coffey at (212) 880-3019 if you have questions regarding these observations and proposals.

Sincerely,

R Bram Smith

R. Bram Smith
Executive Director