Morgan Stanley

October 30, 2013

VIA ELECTRONIC MAIL

Department of the Treasury
Legislative and Regulatory Activities Division,
Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218,
Mail Stop 9W-11
Washington, DC 20219

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Attn.: Elizabeth M. Murphy, Secretary

Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attn.: Robert deV. Frierson, Secretary

Federal Housing Finance Agency
Eighth Floor
400 7th Street, NW
Washington, DC 20024
Attn.: Alfred M. Pollard, General Counsel

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attn.: Comments, Robert E. Feldman,
Executive Secretary

Department of Housing and
Urban Development
Regulations Division
Office of General Counsel
451 7th Street, SW, Room 10276
Washington, DC 20410-0500

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

Ladies and Gentlemen:

Thank you for the opportunity to submit comments to the joint notice of proposed rulemaking (the "Proposing Release") issued by your agencies (the "Agencies") on August 28, 2013, relating to credit risk retention as mandated by Section 15G of the Securities Exchange Act of 1934 (as amended, the "Exchange Act"), added pursuant to Section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The issue of risk retention is an important one if we are to protect against a recurrence of the recent financial

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

crisis, and we thank you for your efforts in this regard. We understand that you were given a very difficult task and that you have devoted significant thought and resources to improving upon the initial version of the joint notice of proposed rulemaking released on March 29, 2011. We appreciate that you have tried to avoid the "cookie cutter" approach of a "one size fits all" rule and have taken into consideration the nuances of the securitization market as a whole and the specific asset classes within it. However, we believe that certain asset classes, specifically collateralized loan obligations ("CLOs") and tender option bond programs ("TOBs"), are still being unnecessarily captured and penalized by the Proposing Release. We have provided input to, and generally support, the comment letters being submitted by the Securities Industry and Financial Markets Association ("SIFMA"), the Financial Services Roundtable, the American Bar Association, the Structured Finance Industry Group ("SFIG"), the Commercial Real Estate Finance Council and The Loan Syndications and Trading Association The objective of our comment letter is to provide additional analysis and information that we believe will be useful to you in your deliberations in making changes to the Proposing Release.

We ask that you revisit the Proposing Release as it pertains to CLOs, a securitization asset class that we believe is very important to the financial system and the availability of credit to corporate borrowers. We believe the Proposing Release, as currently constructed, would irreparably and unnecessarily harm the CLO market and, in turn, such borrowers.

We also ask that you revisit the Proposing Release as it pertains to TOBs. We are of the strong view that a general exclusion from the risk retention rule is more than warranted for TOBs, for the reasons explained in this letter. However if the Agencies do not approve a general TOB exemption, (a) we urge the Agencies to adopt, as part of the final risk retention rule, a special provision applicable solely to tax-exempt TOB transactions and similar municipal bond repackagings ("MBRs") as will be discussed in this comment letter, and (b) we cannot stress enough the potentially detrimental effects on the only widely available funding product for municipal bonds and by extension, the municipal bond market at large, of any mandatory first loss requirement upon a Tender Option Termination Event, even on a prospective basis, absent IRS/Treasury confirmation that such a requirement would not affect the pass-through of tax-exempt income to TOB investors. As noted above, we have participated in the SFIG and SIFMA comment letters and agree with the general direction that we understand is being taken in a letter to be submitted by the Investment Company Institute on behalf of many of our clients that invest in TOBs, including both TOB floater and residual investors. The additional comments in this letter serve to address directly and in greater detail certain key elements of TOBs and MBRs including their use, the roles and retained risks of the participants, the logic supporting an exclusion, the partnership analysis and critical components thereof, and the importance of prospective treatment.

EXECUTIVE SUMMARY

Section I: Collateralized Loan Obligations

In the case of CLOs, the Proposing Release identifies various ways in which risk retention may be held, namely, by a sponsor through standard risk retention in the form of an eligible vertical interest or an eligible horizontal residual interest,[2] or by a lead arranger of CLO-eligible loan tranches in an open market CLO transaction.[3] We welcome the Agencies willingness to consider alternate forms of risk retention for CLOs and, for the reasons discussed herein, we encourage additional flexibility for the continued vitality of the CLO market. Our discussion of CLOs is divided into the following four parts:

- **Part 1** outlines the statutory authority given to the Agencies in Section 15G(e) of the Exchange Act to provide relief to the CLO market, as well as the arguments for providing such relief.

- **Part 2** describes the characteristics of CLOs that distinguish it from other securitization transactions. We believe these characteristics explain the CLO market's resilience through the recent financial crisis, already address the concerns that Congress sought to remedy in Section 941 of the Dodd-Frank Act, and justify the Agencies' adopting a flexible approach to the risk retention requirements for CLOs.

- **Part 3** highlights our specific proposals for how risk retention might be implemented to achieve Congress' goals within a framework that will not result in fewer CLO issuances and less competition in this sector – two goals that the Agencies identified in the Proposing Release.[4]

- **Part 4** sets forth the specific text that we propose to implement the recommendations discussed in Part 3.

Section II: Tender Option Bonds

Absent the granting of a general exclusion for qualifying Tender Option Bonds (TOBs), we urge the Agencies to adopt, as part of the final risk retention rule, a special provision

[2] §__.4.
[3] §__.9(b).
[4] Proposing Release, page 145.

applicable solely to tax-exempt TOB transactions and similar municipal bond repackagings (MBR).

In support of that result, our discussion of TOBs will:

(a) highlight certain structural features of TOBs,

(b) briefly explain the economic benefits and risks of TOBs to various participants,

(c) provide some specific market information,

(d) supplement the SFIG comment letter regarding satisfaction of a risk retention requirement by a residual holder if a 5% risk retention requirement were imposed, and

(e) urge you to grandfather existing TOBs and other MBRs that would not comply with any new requirements.[5]

[5] While this letter focuses on the characteristics of tax-exempt TOBs, we also support SFIG's comments regarding application of the risk retention rules currently proposed for tax-exempt TOBs to a broader range of municipal repackaging transactions, including taxable repackagings, preferred shares, and other products or features that do not include a liquidity facility, tenders, or tender option termination events ("TOTEs").

SECTION I – COLLATERALIZED LOAN OBLIGATION

Part 1 – Statutory Authority to Provide Relief to the CLO Market

The Agencies have been granted the authority under Section 15G(e) to make exemptions, exceptions or adjustments to the standard risk retention approach. Section 15G(e)(2) of the Exchange Act sets out the following criteria:

(1) Ensure high quality underwriting standards; and
(2)(a) Encourage appropriate risk management practices; or
(b) Improve access to credit on reasonable terms; or
(c) Otherwise be in the public interest and for the protection of investors.

We note that the above standard requires criteria (1) to be met and only requires one of the three criteria in (2) to be satisfied. However, we believe that the existing CLO market actually satisfies all four of the criteria set out above.

High Quality Underwriting Standards. In the context of open market CLOs, the assets collateralizing the CLOs are originated through negotiations between the borrower and arrangers of the corporate loans and then purchased on an arms-length basis in the open market by the CLO issuing entity.[6] Because the assets are purchased in the open market, the CLO manager (acting on behalf of the CLO) independently selects the assets to be purchased and sold by the CLO issuing entity in accordance with the investment criteria set forth in the governing documents for the CLO.

In contrast to a balance sheet CLO manager,[7] an open market CLO manager can only decide whether to purchase the loan based on the investment criteria that it disclosed to investors of the CLO securities; however, it has no ability to modify any of the terms of the loan.

[6] We fully agree with the LSTA and SFIG comment letters that the proposal allowing the arranger to hold the risk retention is not feasible given the current regulatory constraints placed on assets that cannot be effectively hedged or managed.

[7] A balance sheet CLO involves an originator selling or contributing loans that it originates to a CLO issuing entity that it controls. We agree that the manager of a balance sheet CLO is likely the sponsor of the securitization and, therefore, would be an appropriate party to retain risk because its affiliate arranger has the ability to negotiate the terms of the corporate loans securing the balance sheet CLO. In this letter, references to CLOs will be to open market CLOs unless otherwise specified.

Therefore, we believe that applying risk retention requirements to an open market CLO manager will have no effect on ensuring high quality underwriting standards for corporate loans.[8]

The existence of a robust, active and transparent secondary market for corporate loans differentiates the asset class of corporate loans from other securitized asset classes. CLO managers compete with a large number of sophisticated investors (including, insurance companies, retail investors, hedge funds, mutual funds and banks) to purchase corporate loans, unlike other asset classes (such as residential mortgages) where the pool of potential investors is more limited. The robust and transparent secondary market for corporate loans serves as a market check on the quality of the corporate loans because an arranger who fails to negotiate a high quality corporate loan will have difficulty selling such loan in the secondary market. As we discuss below, CLO managers (just like any registered investment adviser for an investment fund) are already incentivized to choose high quality assets that are not likely to default. The presence of many small and independent CLO managers strengthens the discipline of the origination process to ensure the origination of high quality corporate loans.

Risk Management Practices. Risk management practices are already encouraged through the compensation mechanism that is used in CLOs, which were tested and performed as expected during the financial crisis. A material portion (i.e., all but a small fixed portion equal to approximately 0.50% of the principal amount of the CLO's assets) of the CLO manager's compensation is tied to the performance of the CLO and only payable upon the investors receiving current payments of principal and interest plus, in the case of the most subordinated investors, a specified return on their investment. Additionally, overcollateralization ratio tests[9] must be satisfied before distributions can be made to the CLO manager. Consequently, the economic interests of the CLO manager are aligned with those of investors, creating a compelling incentive for CLO managers to carefully manage the risk in a CLO.

Access to Credit on Reasonable Terms. Like most asset managers, CLO managers lack the capital to purchase and own a significant portion of their assets under management and therefore we believe that a large number of CLO managers are unable to hold risk retention as contemplated by the Proposing Release. If relief is not provided to CLO managers, there will be a contraction in the number of CLO managers and fewer buyers for corporate loans in the secondary market. This will result in increased costs for small and medium sized companies, assuming credit will even be available to such companies.

[8] We also note that a CLO manager's ability to effect any modest changes through its secondary market activities is limited by the fact that it typically purchases less than 5% of the outstanding amount of any corporate loan.

[9] An overcollateralization ratio is defined specifically for each CLO, but is roughly represented by the aggregate par amount of assets divided by the aggregate par amount of rated liabilities.

For securitization asset classes that suffered during the financial crisis due to the "originate to distribute model" that eroded underwriting standards, the imposition of risk retention could reasonably be expected to restore confidence in the market. Investors in CLOs however did not suffer a lack of confidence and CLO securities were issued because existing CLO securities performed well during the financial crisis.[10] CLO securities that were issued with an investment grade rating did not suffer any losses[11] and investors in below investment grade CLO securities also fared well.[12]

Protection of the Investor. The sophisticated institutional investors that invest in CLO securities understand that their interests are best protected by decreasing losses in the CLO portfolio, not necessarily reducing the number of defaults. They choose to invest in CLOs managed by CLO managers that demonstrate the ability to decrease losses through their own credit processes, which include identifying loans to purchase at a discount to build overcollateralization to protect investors from losses (as opposed to defaults). We therefore believe that focusing on defaults of corporate loans is not the appropriate way to protect investors of CLO securities.

In terms of protecting investors from losses, during the credit crisis, investors in CLO securities suffered less losses than investors who directly purchased corporate bonds comparable to the ones purchased by CLO managers. A typical CLO is structured with approximately 90% senior notes and 10% subordinated notes. When a default of a corporate loan occurs, any losses that remain after all the structural enhancements are depleted are allocated to, first, the subordinate notes, and then to the senior notes. During the credit crisis, there were almost no defaults of the senior notes of CLOs compared to defaults of the underlying corporate loans.[13] During the same time period, more than 80% of the investors in CLO subordinated notes completely recovered their investment.[14] Generally, the subordinated notes are supported by the excess cash flow generated by the difference between the interest payments received on the corporate loans owned by the CLO and the lower interest rates paid to the CLO senior notes.

Qualifying Commercial Loans. Given the strong performance of CLOs through the financial crisis relative to other securitization asset classes, it is counterintuitive to market participants that the risk retention framework could potentially contract the industry if no relief is

[10] For example, there were only a handful of RMBS issuance from 2008 to 2012, while CLOs, which are not part of the originate to distribute model, saw issuances of $89 billion during the same period.
[11] Moody's, Morgan Stanley Research.
[12] Moody's, S&P, Morgan Stanley Research.
[13] See Annex 1.
[14] See Annex 2. CLO subordinated notes do not have principal balances and therefore cannot default. Investors use the metric of "return on investment" like an equity investor.

provided. Although the Agencies have provided for a qualifying commercial loan exemption, only a small number of outstanding corporate loans would satisfy the criteria in the Proposing Release, which is a far smaller percentage than the percentages of residential mortgages expected to qualify for an exemption from the proposed risk retention requirements. For this exemption to be meaningful, we believe that qualifying commercial loans should be judged on a debt to total capitalization ratio, and not a leverage ratio, and ask the Agencies to consider using a 60% debt to total capitalization ratio. We believe that the total capitalization ratio looks at the loan to value of a company and can therefore be applied across industries, whereas a leverage ratio would differ significantly from one industry to the next due to the stability and predictability of cash flows

Part 2 – The Importance of Liquidity and Transparency

The legislative history of Section 941 of the Dodd-Frank Act demonstrates that Congress sought to address two specific problems that emerged in the financial crisis that began in 2007: first, Congress sought to remedy the conflicts imbedded in the "originate to distribute" model that was being utilized in many types of securitization transactions and, second, Congress wanted to improve transparency of securitization transactions for investors in the transaction and thereby allow investors to enforce discipline upon the origination process.[15] Congress' method for addressing these two issues is, of course, risk retention. However, in crafting the Dodd-Frank Act, Congress directed both a one-size-fits-all approach to risk retention while at the same time recognizing that specific asset classes could require adjustments to the one-size-fits-all approach.[16]

It is well-documented that one of the major causes of the problems in the securitization markets was the originate to distribute model used by originators and securitizers of residential mortgages. The standard risk retention options set forth in Section __.4 of the Proposing Release represent the one-size-fits-all approach that Congress adopted to achieve its goals to remedy this model. The approach in Section __.4 of the Proposing Release is sufficiently tailored to achieve this goal because securitizers in originate to distribute transactions are both easily identifiable and able to influence the underwriting standards creating the assets collateralizing the asset-backed securities. In an originate to distribute securitization, where the securitized assets are traded in pools and are individually illiquid, third party investors are unable or unwilling to analyze the credit quality of each asset in the pool and have to rely on statistical characteristics of the pool of assets. The residential mortgages that make up the pool of assets are too small and too numerous to make it economical to diligence them on an individual basis. As a result of this

[15] S. Rep. No. 111-176 (2010), at 128.
[16] Exchange Act, Section 15G(c)(2)(A).

opacity, investors are unable to determine a market price for the individual assets reflective of their credit quality, and investors cannot enforce discipline in the credit origination process at the individual loan level. When the asset-backed securities for originate to distribute structures failed, a major cause for such failure was the origination process, i.e., the extension of credit to borrowers who were unable to repay their loans. For a Congress viewing the failed securitization transactions, the most effective way to ensure sound underwriting standards for the underlying assets was to regulate at the point of origination of the credit because there is no alternative check on the credit quality of the assets.

In contrast, the syndicated corporate bank loans that serve as collateral for CLOs are both transparent and liquid on an individual basis. Loan dealers and pricing services quote prices for such loans on a daily basis (and, in the case of dealer quotations and pricing services, often several times during the business day), providing a market-based evaluation of the credit quality of such assets. A CLO manager will also negotiate a purchase price paid by the CLO issuing entity for such loans based upon its analysis of each loan's credit quality. Furthermore, investors can assess a loan's credit quality because the obligors are corporate entities for which financial statements and other information can usually be readily obtained. In situations where the assets underlying an asset-backed securities transaction are liquid and credit quality is transparent through an active and robust secondary market, as is the case with a CLO, investors of the asset-backed securities are not dependent on originators or securitizers to assess the credit quality of each asset in the pool because they have the information to make this determination for themselves and thereby enforce credit origination discipline upon the corporate bank loan market.

In addition, the approach of regulating credit quality at the point of origination as a means to achieve Congress' goal of improving the underwriting standards of the underlying assets is less likely to be effective in the context of CLOs. In discussing the approach taken under Section 941 of the Dodd-Frank Act, the legislative history indicates that Congress chose to assign risk retention to securitizers (as opposed to originators) because of the expectation that "originators will come under increasing market discipline because securitizers who retain risk will be unwilling to purchase poor-quality assets."[17] A CLO manager is not like a securitizer in an originate to distribute model. Instead, a CLO manager (just like any investment manager) affects the credit quality of assets indirectly, if at all,[18] through asset selection and its bid price for the

[17] S. Rep. No. 111-176 (2010). at 129.

[18] As a singular purchaser in a liquid market. an individual collateral manager likely does affect the credit quality of a loan. A collateral manager's bid price for a loan may express a view as to the credit quality, but by definition, a liquid market absorbs the views of all participants. The collateral manager's influence in a CLO is over the credit quality of the ABS interest issued. By purchasing assets at the proper price, the collateral manager ensures the proper level of overcollateralization for the ABS interest.

asset acquired by the CLO in the secondary market. In fact, many CLO managers purchase for retail funds and other separately managed accounts the same assets that they purchase for CLOs.

The Agencies have been granted the authority to make exemptions, exceptions or adjustments to the standard risk retention approach to help ensure high quality underwriting standards and to improve the access of business to credit on reasonable terms.[19] A more flexible approach to risk retention in CLOs will accomplish these aims.

Part 3 – Outline of Specific Proposal

We propose that, in addition to risk retention being satisfied by a CLO manager, the Agencies permit one or more voluntary sponsors to serve the role of "sponsor" of a CLO and to satisfy the risk retention requirement for CLOs. Part 4 to this Section I sets forth specific text we propose to implement our recommendations discussed in this Part 3.

Voluntary Sponsor Alternative

In the Proposing Release, the Agencies stated their belief that a CLO manager is a sponsor of a securitization transaction because such entity "organizes and initiates a securitization transaction by indirectly transferring assets to the issuing entity."[20] We propose that one or more third-party purchasers be permitted to voluntarily act as a sponsor of a CLO, notwithstanding the fact that such third-party purchasers do not meet the definition of sponsor. The primary reasons to allow a person other than a CLO manager to act as sponsor are:

- *Many CLO managers may be unable to act as sponsors*: we believe most asset management firms acting as CLO managers will not be able to hold the required risk retention specified in the Proposing Release. Many CLO managers are small businesses with fewer than 50 employees and do not have the financial capacity to meet the risk retention requirement. Without a sponsor alternative, these managers would be forced to exit the market, resulting in reduced CLO issuance volume and a corresponding increase in the cost of and decrease in the availability of credit to large, non-investment grade companies in the U.S. economy.

- *CLO managers do not fall squarely within the definition of sponsor:* while the Agencies believe that a CLO manager is a sponsor of a CLO, numerous comment

[19] Exchange Act, Section 15G(c)(1) and (2).
[20] Proposing Release, page 144.

letters have been submitted to the Agencies arguing that a CLO manager is not a sponsor under the plain language of the Dodd-Frank Act.

- *Economic ownership of CLO assets by investors*: investors purchasing first-loss positions in CLOs, rather than a CLO manager, may be viewed as persons for whom the CLO is being organized because these investors have economic ownership of the securitized assets in the form of a residual horizontal interest; accordingly, these investors are appropriate parties to act as sponsors of CLOs in addition to, or in lieu of, a CLO manager.[21]

- *Risk retention may not be needed to align parties' interests in a CLO*: the legislative history of Section 941 of the Dodd-Frank Act reflects Congress' expectation that the risk retention regulations will "recognize the differences in the assets securitized, in existing risk management practices and in the structure of asset-backed securities,"[22] and CLOs contain structural features to protect investors such as a contractual priority of payments in CLO transaction documents[23] and the compensation structure of CLO managers,[24] each of which already align the interests of CLO managers with debt and first-loss investors in a CLO.

The resurgence of the CLO market (which generally began in 2011) evidences not only the strength and resilience of this securitized product during the financial crisis but also the critical importance of this product to sustaining continued national economic growth. Allowing third-party purchasers, in lieu of (or in addition to) a CLO manager, to act as a sponsor of a CLO would be a critical component in avoiding serious adverse consequences to our economy if the Proposing Release, as currently constructed, applies to CLOs. The Agencies have acknowledged in the Proposing Release that applying risk retention to CLOs will reduce the number of CLO

---

[21] While a CLO manager earns management fees for providing investment management services to the CLO. unlike in an originate to distribute model. the CLO Manager is not generally expected to sell assets to a CLO. Thus. a CLO manager does not transfer any credit risk Congress sought to make certain was retained by a sponsor.

[22] S. Rep. No. 111-176 (2010). at 130.

[23] These payment priorities do not allow cash payments to first-loss investors unless principal and interest due on the CLO's obligations and the CLO's administrative expenses are paid in full and. prior to making any distributions to first-loss investors. adequate principal overcollateralization and interest coverage exists in the CLOs portfolio of assets to protect the interest of debt holders.

[24] These compensation structures are subject to the priority of payments described in the preceding footnote 24 and require all but a small fixed portion of a CLO manager's fees to be subordinated to. among other amounts. interest payable on a CLO's debt securities service and the CLO's administrative expenses. In addition. unless and until the first-loss investors receive 100% of their investment plus a specified rate of return, a CLO manager does not receive its incentive fee.

issuances and competition among CLO managers.[25] Since CLOs provide a significant portion of the funding for borrowers in the syndicated corporate loan market, a reduction in CLO issuance would, in turn, reduce the capital available to these borrowers.[26]

The general requirements of our proposal set forth in Part 4 of this Section I include:

- *Voluntary Sponsor*: a sponsor's risk retention requirement would be satisfied if one or more third-parties or the CLO manager of the related CLO agrees to hold an eligible vertical interest or eligible horizontal interest, or any combination thereof, in the CLO;

- *Scope of Transactions*: applies to CLOs that are a securitization of corporate debt and servicing assets but would specifically prohibit the inclusion of ABS interests (i.e., re-securitizations similar to the "CDO" and "CDO squared" transactions);

- *Independent Credit Risk Review by or on behalf of Voluntary Sponsor*: unless the voluntary sponsor is the CLO manager of the related CLO, the third-party purchaser conducts an independent review of the credit risk of each securitized asset, but may satisfy this obligation if it appoints an entity (a "credit review party"), which may be the CLO manager of the related CLO, to perform this review as long as either (1) such credit review party is a registered investment adviser under the Investment Advisers Act of 1940 and acts as the investment adviser of the third-party purchaser in connection with its investment in the CLO or (ii) such credit review party contractually agrees to act in a fiduciary capacity to the third-party purchaser based upon an assumption that such third-party purchaser is acquiring the securitized assets for its own account;

- *Risk Retention Amount*: the eligible vertical interest and/or the eligible horizontal residual interest acquired by third-party purchasers, when added to the eligible vertical interest and/or eligible horizontal residual interest retained by all other sponsors of the CLO (if any), must equal at least 5% of the fair value of the ABS interests in the CLO issuer;

[25] We acknowledge that the Agencies have proposed an alternative to requiring CLO managers to hold risk retention, namely the open market CLO framework where lead arrangers retain a portion of CLO-eligible tranches of term loans. However, for reasons not discussed herein, we do not believe that this will be a viable option and, therefore, CLO managers will still be expected to hold the required risk retention.

[26] Institutional investors are the primary purchasers of securities issued by CLOs. A reduction in CLO issuance would result in reduced funding provided by these investors to the syndicated corporate loan market.

- *Duration of Retention Period*: the voluntary sponsor must agree to hold the risk retention amount for the period described below under "*Alternatives to Hedging/Transfer and Cash Distribution Limitations*"; and

- *Disclosures*: the CLO manager would provide specified information to CLO investors prior to their investment about the investment experience of each third-party purchaser (or, if a credit review party has been appointed to perform the independent review discussed above under "*Independent Credit Risk Review by or on behalf of Voluntary Sponsor*", information about such credit review party and a description of such entity's experience in conducting credit risk reviews of corporate credit obligations).

Alternatives to Hedging/Transfer and Cash Distribution Limitations

In addition, two other parts of the Proposing Release will have a negative impact on the continued issuance of CLOs:

- the duration of the hedging and transfer restrictions set forth in §__.12(f)(1) of the Proposing Release[27] (referred to herein as the "Hedging/Transfer Limitation"); and

- the limitation on cash distributions to an eligible horizontal residual interest set forth in §__.4(b)(2) of the Proposing Release[28] (referred to herein as the "Cash Distribution Limitation").

With respect to the Hedging/Transfer Limitation, the retention period imposed upon a sponsor of a CLO does not appear appropriate in light of how CLOs operate. A CLO typically has a "reinvestment period" of 4 years whereby principal received on the underlying assets of the CLO is reinvested, and principal repayments on the CLO securities does not begin until after the end of such period. In addition, CLOs allow a specified percentage of first-loss investors to vote

[27] §__.12(f)(1) of the Proposing Release prohibits the hedging or transfer of the sponsor's required risk retention amount until the latest of: (i) the date on which the total unpaid principal balance of the securitized assets has been reduced to 33% of the total unpaid balance of the securitized assets as of the closing date of the securitization transaction. (ii) the date on which the total unpaid principal obligations under the ABS interests issued in the securitization transaction has been reduced to 33% of the total unpaid principal obligations of the ABS interests at closing of the securitization transaction and (iii) two years after the date of the closing of the securitization transaction.

[28] §__.4(b)(2) of the Proposing Release requires a sponsor certification that the Closing Date Projected Cash Flow Rate for each payment date does not exceed the Closing Date Projected Principal Repayment Rate for such payment date (as such terms are defined in §__.4(a)).

to redeem the CLO securities following a non-call period (typically two years) as long as the liquidation value of the CLO's assets would be sufficient to repay the CLO debt in full. As a result, whether the first loss investors vote to redeem the CLO is dependent on the performance of the CLO assets during the non-call period. If the portfolio of assets performed sufficiently well through the end of the non-call period, debt investors can be assured that they will be repaid in full if the first-loss investors exercise their redemption right. Conversely, if the portfolio of assets exhibited poor credit quality and are not sufficient to repay the debt investors in full following the expiration of the non-call period, not only will first-loss investors be prohibited from exercising their redemption right, but if the first-loss investors attempted to sell their positions, they would feel the impact of the portfolio's poor credit quality in the form of a reduced sale price for their position.[29] Thus, the relevant date in a CLO where the effects of poor credit selection are of most importance is the end of the non-call period since it is the first date on which the first-loss investors may, if the debt investors are repaid in full, cause a redemption of the CLO. However, the risk retention period for a CLO under the Hedging/Transfer Limitation runs well beyond this period because principal amortization in a CLO does not occur for many years after the end of the non-call period. We believe that the duration of the Hedging/Transfer Limitation should continue until the date on or after the end of the non-call period when first-loss providers can cause a redemption of the CLO securities where the debt investors are repaid in full; we believe such duration would result in meaningful risk retention by a voluntary sponsor.

Therefore, to address our concern and provide an alternative to the Hedging/Transfer Limitation set forth in the Proposing Release:

- our proposal set forth in Part 4 of Section I provides that the Hedging/Transfer Limitation for a voluntary sponsor of a CLO expire on the earlier of (1) the date (if any) on which the ABS interests issued by the CLO issuer may be redeemed at the option of the CLO issuer's investors pursuant to a redemption where all investors (other than the class of securities belonging to the investors exercising the option) are repaid in full and (2) the date otherwise required by the Hedging/Transfer Limitation.

With respect to the Cash Distribution Limitation, we believe this limitation as applied to CLOs should be eliminated or modified in the manner we suggest below because it is not necessary and it would effectively eliminate the ability to sell the first loss piece to a third party investor. CLOs are structured to provide a current cash return to first-loss investors while

[29] In discussing the transferability of the B-piece in CMBS transactions, the Agencies explained their rationale for requiring a five-year holding period is because "after a five-year period, the quality of the underwriting would be sufficiently evident that the initial third-party purchaser ... would suffer the consequence of poor underwriting in the form of a reduced sales price for such interest." Proposing Release, page 130.

providing significant structural protections to protect the CLO's debt holders. In a CLO, cash distributions to investors are governed by a priority of payments that prohibits cash payments to first-loss investors unless principal and interest due on the CLO's obligations and the administrative expenses of the CLO are current. Further, prior to making any distributions to first-loss investors, adequate principal overcollateralization and interest coverage must exist in the CLO's portfolio of assets to protect the interests of debt holders. The overcollateralization test in a CLO is much more protective than in an asset-backed securities transaction (including CDOs) because any mark to market losses are immediately recognized in the overcollateralization test upon certain events: a non-payment of a CLO asset, a non-payment of a debt related to a CLO asset, a bankruptcy or credit downgrade to "CCC/Caa" of the obligor on a CLO asset, or upon a CLO manager's determination that a default on a CLO asset has occurred. The losses are immediately recognized in the overcollateralization test. The CLO overcollateralization test functions as a much better protective feature in comparison to other asset-backed securities transactions primarily because the assets in a CLO are liquid (i.e., provide for price discovery, which serves as a check on the statistical rating agency recovery rate) and transparent (i.e., assets have default events that are certain and public).

In a typical CLO transaction, the Cash Distribution Limitation will prohibit any distributions being made to a voluntary sponsor until principal is repaid to senior debt investors (which typically does not begin until 4 years after the closing date of the securitization transaction) and, as a result, will act as a major disincentive for any such investors or a CLO Manager to act as a sponsor. To have a properly functioning CLO market, the existence of both debt and first loss investors are required; the Cash Distribution Limitation would severely and negatively impact the number of first loss investors willing to invest in CLOs. The Cash Distribution Limitation represents a dramatic and somewhat punitive change to the economic returns of first loss investors without any reduction in the risk assumed in their CLO investment. Without any modification to the Cash Distribution Limitation, we would expect that many first loss investors would exit the CLO market and the volume of CLO issuance would be significantly curtailed.

To address our concern and provide an alternative to the Cash Distribution Limitation set forth in the Proposing Release, while still addressing the Agencies belief that the Cash Distribution Limitation is necessary to establish economically meaningful horizontal risk retention that aligns the sponsor's incentives with those of investors:

- our proposal set forth in Part 4 of Section I would prohibit (i) cash distributions on any payment date to third-party purchasers in excess of 30% per annum of the original principal balance of the eligible horizontal residual interest for the 24-month period beginning on the date such eligible horizontal residual interest was issued and

(ii) cash distributions on any payment date to third-party purchasers if the annualized percentage rate of par erosion occurring on the securitized assets in the CLO on a cumulative basis exceeds 4% of the unpaid principal balance of such securitized assets.

We believe our proposed changes to the Cash Distribution Limitation would not be a material impediment to first loss investors participating in the CLO market.

Part 4 - Proposed Rule to Permit Risk Retention by Voluntary Sponsors in CLOs

§ ___.[__] Voluntary Sponsors of CLOs.

(a) Definitions. For purposes of this §___.[__], the following definitions shall apply:

CLO means a transaction pursuant to which a CLO issuer issues ABS interests.

CLO issuer means a special purpose entity that (1) issues debt and residual interests (however denominated), (2) whose assets consist primarily of corporate credit obligations that are securitized assets and servicing assets and (3) whose assets are managed by a CLO Manager.

CLO Manager means an entity that (1) selects assets to be purchased and securitized by a CLO issuer and manages such assets on behalf of a CLO issuer, and (2) is registered as an investment adviser under the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-1 et seq.), or is an affiliate of such a registered investment adviser and itself is managed by such registered investment adviser.

Corporate credit obligation means an obligation (1) of a borrower organized as a corporation, partnership, limited liability company, statutory trust or similar entity and that is engaged in one or more business activities, and (2) that is not an ABS interest.

(b) Voluntary sponsor. A sponsor of a securitization transaction that is a CLO may satisfy all or a portion of the risk retention requirements of a sponsor under § __.3 of this part if (1) one or more third-parties (including the CLO Manager of the related CLO) agree to hold for their own account an eligible vertical interest or eligible horizontal residual interest, or any combination thereof, in the CLO issuer and (2) all of the conditions of paragraph (c) of this section are met. A third-party purchaser who meets the requirements of this section shall be deemed a sponsor even though such third-party does not meet the definition of sponsor set forth in § __.2 of this part.

(c) Conditions to be met. A third-party purchaser may be a sponsor of a CLO if all of the following conditions are met:

(1) Credit risk review. Unless the third-party purchaser is the CLO Manager of the related CLO, the third-party purchaser conducts an independent review of the credit risk of each securitized asset prior to the acquisition thereof by the CLO issuer. A third-party purchaser may satisfy its obligations under this paragraph (c)(1) by appointing an entity, which may be the CLO Manager, to perform the independent review required by this paragraph (c)(1) as long as either (i) such entity is a registered investment adviser under the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-1 et seq.) and is acting as the investment adviser of the third-party purchaser in connection with its investment in the CLO or (ii) such entity agrees in writing to act in a fiduciary capacity to the third-party purchaser based upon an assumption that such third-party purchaser is acquiring the securitized assets for its own account.

(2) Amount of Retained Interest. The eligible vertical interest and/or the eligible horizontal residual interest acquired by a third-party purchaser, when added to the vertical interest and/or eligible horizontal residual interest retained by all other sponsors of the CLO (if any) must equal at least 5% of the fair value of the ABS interests in the CLO issuer.

(3) Source of funds. Each third-party purchaser pays for the eligible vertical interest or eligible horizontal residual interest, or any combination thereof, in cash at the closing of the CLO or such later date on which the CLO issuer issues such interests.

(4) Affiliation.

(i) Except as provided in paragraph (c)(4)(ii) of this section, at the time of its purchase of its eligible vertical interest or eligible horizontal residual interest, or any combination thereof, in the CLO issuer, no third-party purchaser is affiliated with any party to the CLO (including, but not limited to, a sponsor or depositor) other than investors in the CLO, the CLO Manager or another third-party purchaser.

(ii) Notwithstanding paragraph (c)(4)(i) of this section, a third-party purchaser may be affiliated with one or more originators of the securitized assets, as long as the assets originated by the affiliated originator or originators collectively comprise less than 10 percent of the unpaid principal balance of the securitized assets included in the CLO at the time at which such third-party purchaser becomes a sponsor under paragraph (b) of this section.

(5) Disclosures. The CLO Manager provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the CLO and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form under the caption "Credit Risk Retention":

A description of each initial third-party purchaser's experience in investing in CLO securities or, if the third-party purchaser has appointed an entity to perform the independent review required by paragraph (c)(1) of this section, the identity of such entity and a description of such entity's experience in conducting credit risk reviews of corporate credit obligations.

(6) Hedging, transfer and pledging.

(i) General rule. Except as set forth in paragraph (c)(6)(ii) of this section, each third-party purchaser must comply with the hedging and other restrictions in § __.12 of this part.

(ii) Exceptions.

(A) Duration of the hedging and transfer restrictions. Notwithstanding paragraph (f)(1) of § __.12 of this part, the prohibitions on sale and hedging pursuant to paragraphs (a) and (b) of § __.12 of this part applicable to a third-party purchaser who is a sponsor under paragraph (b) of this section shall expire on the earliest of (1) the date (if any) on which the ABS interests issued by the CLO issuer may be redeemed at the option of the CLO issuer's investors pursuant to a redemption where all investors (other than the class of securities belonging to the investors exercising the option) are repaid in full and (2) the date otherwise specified in paragraph (f) of § __.12 of this part.

(B) Transfer by third-party purchaser. At any time, an initial third-party purchaser that acquired an eligible vertical interest or eligible horizontal residual interest, or any combination thereof, in accordance with paragraph (b) of this section, may transfer its interest to a different third-party purchaser that complies with the conditions set forth in paragraph (c) of this section, provided that the obligations under paragraph (c)(1) of this section that apply to third-party purchasers shall only be applicable to securitized assets purchased by or transferred to the CLO issuer after the date the initial third-party purchaser transferred its interest and the obligations under paragraph (c)(5) of this section that apply to third-party purchasers shall be satisfied by delivering the disclosure referred to therein to investors a reasonable period of time prior to the effectiveness of such transfer.

(d) Alternative limitation on distributions to voluntary sponsors. The provisions of paragraph (b)(2) of § __.4 of this part (requiring a certification that the Closing Date Projected Cash Flow Rate for each payment date does not exceed the Closing Date Projected Principal Repayment Rate for such payment date) shall not apply to a third-party purchaser acquiring an eligible horizontal residual interest in accordance with paragraph (b) of this section if, at any time that any securities of the CLO issuer having a right of principal repayment senior to such interest are outstanding, the terms of such interest prohibit (i) cash distributions on any payment date to such third-party purchaser in excess of 30% per annum of the original principal balance of the eligible horizontal residual interest for the 24-month period beginning on the date such eligible horizontal residual interest was issued and (ii) cash distributions on any payment date to third-party purchasers if the annualized percentage rate of par erosion occurring on the securitized assets in the CLO on a cumulative basis exceeds 4% of the unpaid principal balance of such securitized assets.

(e) Duty to monitor compliance. A CLO Manager relying on this section:

(1) Shall maintain and adhere to policies and procedures to monitor each third-party purchaser's compliance with the requirements of paragraph (c) of this section; and

(2) Shall promptly notify, or cause to be notified, the holders of the ABS interests issued in the CLO of any noncompliance with the requirements of paragraph (c) of this section.

SECTION II: TENDER OPTION BONDS

We cannot stress enough the potentially detrimental effects on the only widely available funding product for municipal bonds, and by extension the municipal bond market at large, of any mandatory first loss requirement upon a Tender Option Termination Event (TOTE), even on a prospective basis, absent IRS/Treasury confirmation that such a requirement would not affect the pass-through of tax-exempt income to TOB investors.

1. **TOB Purpose, Design and Economics: Source of Tax-Exempt Financing for Investment in Municipal Bonds**.

(a) ***Parties***. To assist in our presentation of MBR structures and their use, we provide the following summary of the names and roles of the participants in a TOB transaction.

- Floater Holder – equity partner, short term investor, effective lender;
- Residual Holder – equity partner, bond investor, borrower, initiates transaction, owns risk (at start through unwind), and backstops or provides liquidity (see Liquidity Provider below);
- Trustor – administrator, facilitates and directs transaction;
- Remarketing Agent – broker-dealer, places the floaters with investors, usually same entity as or affiliate of Trustor;
- Liquidity Provider – regulated financial institution (*e.g.* a bank) offering a liquidity facility to provide funds for tendered floaters that are not, or cannot be, remarketed.

The residual holder may be the same entity as, or an affiliate of, the liquidity provider.

The remarketing agent and liquidity provider earn servicing fees over the life of the transaction; however, neither participates in any change in value of the bond(s), namely those attributable to a change in market yields or credit quality, as the residual holder retains all of the economics associated with being the bondholder. Moreover, the trustor does not extract any value at the inception of the transaction, meaning the sum of the parts (floaters + residuals) have the same value as the bond(s) at the deposit date and through and including the withdrawal date. As such, none of the trustor, remarketing agent, and the liquidity provider fit the traditional role of a sponsor or securitizer.

(b) ***TOB Structure***. The TOB product is a secondary market vehicle that is used to finance some or all of an investment in municipal bonds. TOBs do not employ an "originate to distribute" model but rather they are initiated by an existing bondholder. Furthermore, the creation of a TOB does not result in an expected transfer of credit or any other market risk. Using the TOB structure:

- The bondholder is able to borrow funds in the capital markets (typically, but not necessarily, from tax-exempt money market funds), at short-term, tax-exempt interest rates that generally are (i) lower than the tax-exempt, typically long-term, interest rates on the bond(s), and (ii) lower than the taxable interest rate otherwise available from other funding sources[30] (because the bondholder is not a governmental or not-for-profit entity that would be eligible to borrow funds and allow the funding source to receive tax-exempt interest).
- The bondholder deposits one or more bonds into a trust or other pass-through vehicle, with the ownership interest in the bond(s) split into two classes of equity ownership interests that share in the tax-exempt cash flows from the bond(s).
- Two classes of receipts are created to evidence the two classes of ownership interests: a floating rate receipt for the investors ("floaters") and a residual receipt for the original bondholder ("residual").
- The proceeds from the sale of both classes of receipts are equal to and used to pay the bond(s)' deposit price, which is equal to the market value of the bond(s).
- Cash flow from payments of principal and interest on the bond(s) is used to pay principal and interest payments on the receipts.
- The interest rate on the floaters is a market clearing rate, and interest on the residual is equal to the remaining bond coupon after payment of interest on the floaters.
- When the floating rate receipts are subject to optional or mandatory tenders, the bond(s) are sold and the purchase price (at least 100%) of the tendered floaters will always be payable before any amounts are distributed to the residual holder, such that the residual holder retains all, and not just a pro rata share, of the risk of the bond(s).
- In the Morgan Stanley program and most other programs, the purchase price of tendered floaters is paid from the proceeds of sale of the bond(s), and any shortfall is paid by a draw under a liquidity facility provided by a regulated financial institution;[31]

[30] Such as a repurchase agreement.
[31] In some programs, the floaters are paid from a draw under the liquidity facility in the first instance and the proceeds of sale are used to reimburse the liquidity provider for the draw.

- In all programs, if the bond(s) are sold upon an optional or mandatory tender, any gain on the bond(s) is shared between the floaters and the residual.[32]
- The tender option and the related liquidity facility are subject to automatic termination upon the occurrence of certain TOTEs.[33]
- Should a TOTE occur: (i) if the bond(s) are worth less than the face amount of outstanding receipts, the bond(s) are distributed in-kind, pro rata, between the floaters and the residual, and (ii) if the bond(s) are worth as much as or more than the face amount of outstanding receipts, the bond(s) are sold and any gains are shared by the floaters and the residual (typically 5-10% of gain being allocated to the floaters).
- The market for tax-exempt bonds is strengthened, particularly for bonds with long maturities and fixed interest rates for which there may not otherwise be sufficient market demand, and by augmenting the supply for investors in short-term bonds.

The floating rate receipts are treated as equity for tax purposes (*i.e.*, the TOB trust is a partnership for tax purposes so that both classes of receipts jointly own undivided interests in the bond(s) for tax purposes). However, for accounting purposes the residual holder is treated as the owner of the bond(s) and the floating rate receipts are treated as debt of the residual holder.

(c) Why Bondholders/Residual Holders Use TOBs. By accessing the market at a low tax-exempt cost of funds, the bondholder is able to:

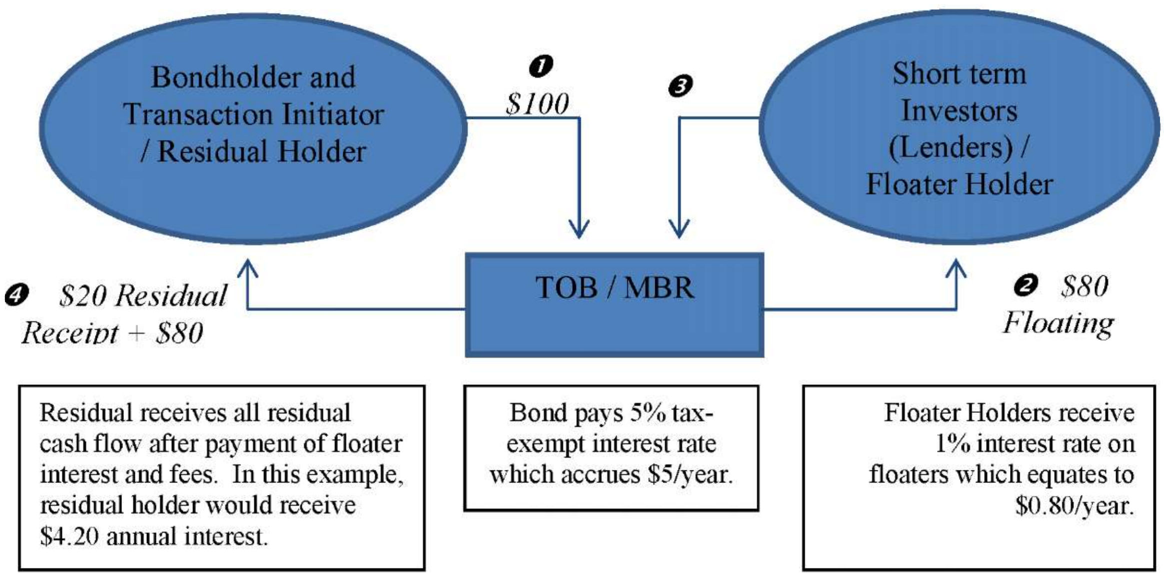
- use less of its own capital to support its ownership of the bond(s),
- increase the yield on its investment, and
- use its remaining capital to make other investments.

The following diagram illustrates a TOB structure for a transaction with a Proportionality of 80%, meaning the floating rate receipts and residual receipts comprise 80% and 20%, respectively, of the total receipts. Through the TOB structure, the bondholder is able to reduce its capital investment significantly, while also substantially increasing its tax-exempt yield per dollar invested.

---

[32] It is important to note that any gain on the bond(s) always is shared with floaters, whether or not a TOTE has occurred, in contrast to losses, which are shared only upon the occurrence of a TOTE.

[33] TOTEs result from a bankruptcy, default, downgrade below investment grade, or event of taxability relating to the underlying bond(s) and other principal credit sources.



(d) Why TOBs are Attractive Investments for Floater Investors. Investors in the floating rate certificates (typically, but not necessarily, tax-exempt money market funds) are seeking to invest their cash in short-term, high grade products that yield tax-exempt interest. Other products comparable to TOBs in some respects for purposes of their investment criteria include municipal variable rate demand bonds and commercial paper. However, the TOB structure offers an even more attractive investment to floater holders when compared to a similarly rated tax-exempt variable rate bond in the primary market because:

- The short-term rate on a TOB floater is typically higher than the rate on a floating rate bond of the same principal credit source in the primary market, because the TOB floater rate includes a slight premium to reflect the complexities of the secondary market structure.
- A primary market bond does not include any gain share feature or other potential upside participation in the bond(s) for investors.
- If an investor were to buy a variable rate demand bond in the primary market, the investor would bear all of the risk of loss on the bond, whereas in the TOB structure (a) the risk of loss is shared pro rata with the residual holder and only upon the improbable occurrence of a TOTE, and (b) the residual holder and liquidity provider are additional parties who have an economic incentive to actively monitor the

underlying bond so that the bond can and likely will be withdrawn from the trust well before any losses are realized by the floater holders.

- Bonds deposited into a TOB typically are long-term fixed rate bonds not secured by a letter of credit and therefore are subject under SEC rules to initial and ongoing issuer disclosure requirements much more robust than the disclosure requirements for a primary market tax-exempt variable rate demand bond with respect to the underlying municipal credit, thereby making it easier for investors to monitor the credit strength of the muni issuer; whereas variable rate demand bonds, in contrast, are typically secured by a letter of credit, so the initial disclosure and credit focus are directed more at the bank providing the letter of credit than the issuer, and variable rate demand bonds are not subject to any ongoing disclosure requirements under the securities laws because the bondholders have a tender right.
- The supply of variable rate demand bonds in the market has decreased dramatically in the past couple of years, as banks have offered to purchase bonds directly for their own portfolios rather than securing them with letters of credit or liquidity facilities; as a result, there are fewer bonds in the market that satisfy the requirements under § 2a-7 of the Investment Company Act of 1940 (the "'40 Act") for investment by tax-exempt money market funds.

2. **Roles of Financial Institutions**.

(a) Trustor and Fee-Based Services. A number of financial institutions serve as trustor for TOB programs, in which case they oversee the formation of the TOB trust, engage counsel to prepare disclosure for floater investors, and continue to perform certain administrative functions throughout the term of the trust, such as tax recordkeeping and reporting. Many TOB users refer to the trustor as the "sponsor," though this is inaccurate in the context of the risk retention rule definition of "sponsor." The trustor is not a "sponsor" as typically defined in the context of the '40 Act, nor is the trustor's role comparable to that of the sponsor in common credit tranching securitizations. We shall sometimes refer to the trustor as an "arranger" so as to avoid confusion. Most trustors, whether directly or through an affiliate, also may provide liquidity facilities, credit enhancement for the bonds, and/or remarketing services for floaters.

(b) Investor. Some financial institutions use TOB programs to finance their own proprietary trading, municipal bond investment portfolios, and lending facilities for municipal issuers.

(c) Third Party Programs. Whether or not a trustor/arranger invests in TOB programs for its own proprietary investments, it may provide TOB funding for "third party" investors, such as mutual funds, insurance companies, and other banks. The third party selects the bond(s) for investment, purchases the bond(s) in the market, and initiates the request for TOB financing. Moreover, if the investor is a bank, it may provide its own liquidity facility (either directly or through an affiliate). We note that for a number of reasons, our third-party customers strongly oppose any definition of "sponsor" that would include or designate the residual as the sponsor. Therefore we strongly support the SFIG suggestion that a residual holder be recognized as a party who may satisfy any risk retention requirement without being designated as a "sponsor".

3. **Morgan Stanley TOB Program.**

Morgan Stanley's TOB program, which has been in existence since the mid to late 1990's, is primarily a third party program, as it is not currently used to finance investments in municipal bonds by Morgan Stanley for our own account.[34] Through several affiliated entities, we serve as trustor/arranger and remarketing agent in all of our TOB trusts; we provide liquidity in cases where our customer cannot provide its own liquidity; and we sometimes provide credit enhancement for the bond(s) if credit enhancement is needed to obtain a higher credit rating on the trust receipts.

At the present time:

- All of the third party investors who use the Morgan Stanley TOB program are sophisticated investors who initiated each of the TOBs;
- All of the third party investors who use the Morgan Stanley TOB program and do not provide their own liquidity are Registered Investment Companies (mutual funds) who typically request a residual certificate sized between 20% and 50% of the TOB;
- We remarket approximately $9.5 billion of floaters, which we estimate to represent approximately 10% of the outstanding floater market;
- We provide approximately $2 billion of TOB liquidity facilities;
- In cases where we provide the liquidity facility, we typically require that the residual interest be equal to at least 20% of the deposit value of the bond(s) and/or that the residual holder agree to reimburse the liquidity provider for any draws

[34] Stated another way, none of the currently outstanding residual interest certificates in the Morgan Stanley TOB Program are held by a Morgan Stanley entity.

and, where applicable, post collateral to secure such reimbursement obligation; and

- In cases where a third party investor provides its own liquidity facility, the residual interest at inception typically is less than a 5% interest, as residuals generally seek to finance nearly all of the bond value and recognize that they retain the bond risk regardless of the size of their dollar investment at inception.

4. **Risks Borne by Residual Holder under Current Structures**.

In this section we highlight the risks borne by the residual holder in current TOB structures:

First, the residual holder selects the bond(s) to be deposited, may withdraw the bond(s) upon notice at any time, and typically has a right of first refusal to buy the bond(s) at their market value if they are required to be sold from the trust. For accounting purposes, the residual holder is required to treat the deposited bond(s) as its assets and the TOB financing as its debt.

Second, the residual holder bears the risk of any drop in the market value of the bond(s) (*e.g.*, as a result of an increase in interest rates or any credit deterioration of the bond(s)) between the date of their deposit and the date of their withdrawal from the trust, because (a) prior to the occurrence of a TOTE, if the bond(s) are withdrawn from the trust the floaters always are paid in full prior to payment of any distributions to the residual, so the residual's entire equity investment is at risk of loss, and (b) if the liquidity facility is drawn to pay the floaters: (i) the residual also will bear any additional loss resulting from such liquidity draw (thereby exposing the residual holder to risk of loss that may far exceed the amount of its investment in the residual certificate and that may be as high as the full value of the bond(s) in the trust), and (ii) if the liquidity facility is provided by an unrelated liquidity provider, the residual's obligation to reimburse the liquidity provider for any draws may be required to be collateralized, with up-front and variation margin.

Third, a TOTE event is a sudden, calamitous event that, to our knowledge, has never occurred in the industry since the inception of the TOB product in the early 1990's, despite bond insurer downgrades and failures, bank downgrades and failures, and municipal bond defaults. This is so because the bond(s) always have been withdrawn from a TOB trust prior to the occurrence of any TOTE events (whether as a result of protective triggers embedded into a transaction by the liquidity provider and/or the residual holder, or as a result of diligent monitoring of the bond value and creditworthiness by the liquidity provider, floater holders and/or the residual holder).

In sum, across tens of thousands of TOB transactions during at least the past 25 years, the residual holder, who is the TOB participant whose role is economically closest to that of a "sponsor" in the context of the proposed risk retention rule, always has been subject to 100% of any and all loss (market risk in addition to credit risk) on the underlying bond(s). This is risk retention that far exceeds the requirements under the proposed rules. And this is true regardless of the Proportionality of a TOB, meaning that the predominance of the bond risk is borne by the residual whether its interest is sized at 50%, 5%, or 0.05% of the transaction. In fact, the residual holder's retained risk in the current TOB structure is multiples of the risk that the residual holder would face under either the proposed qualifying horizontal or vertical interests.[35] Moreover, should a TOTE occur, the current TOB structure provides for a pro rata distribution of the bond(s) such that the residual holder still retains a risk of loss commensurate with its investment. The pro rata sharing of losses is required for tax reasons and the floater holders accept and manage this risk so as to achieve comfort on the partnership treatment and thus the characterization of their interest as tax-exempt, which is critical for investors such as tax-exempt money market funds. To our knowledge floaters have never suffered any losses in any of the more than $1 trillion in executed TOBs. And finally, TOB and MBR participants universally concur that the residual holder should bear the predominance of the risk on the underlying bond(s) and that it is neither appropriate or acceptable for the trustor, remarketing agent, or liquidity provider retain an interest in the form of a trust certificate.

Based on the foregoing, it should be clear (and it is our strong view) that TOB trusts as currently structured do not present the type of risk that the risk retention rule was designed to address, and modifications to the existing TOB structure could cause significant market disruption and even the possible demise of a significant portion of the market for tax-exempt bond(s) and other municipal securities. Accordingly, we strongly support the SFIG letter's request for an exemption for the reasons stated in the SFIG letter and explained in greater detail in this letter.

5. **Satisfaction of Risk Retention Requirement**.

We submit that (a) TOB trusts, as presently structured, already satisfy the requirements and intent of Section 941(b)of the Dodd-Frank Act, namely that the securitizer[36] retain an economic interest in a portion of the credit risk for the assets that the securitizer, through the issuance of an asset-backed security, conveys to a third party (the floater investors); (b) the residual holder is the appropriate party under the TOB to satisfy any new risk retention requirement that may be

[35] While the maximum loss on a 5% qualifying horizontal or vertical interest would be 5% of the transaction, in the current TOB structure the residual interest holder already bears 100% of the credit and rate risk of the transaction under all non-TOTE scenarios.

[36] With TOBs, the residual holder chooses the bond(s) to be securitized and directs the structure of the transaction.

imposed[37]; and (c) if a 5% risk retention requirement of the Act were to be imposed on TOB programs as a matter of equity investment rather than simply holding an interest that retains at least 5% of the credit risk, it would be fully satisfied if the residual holder's interest were equal to at least 5% of the total unpaid balance of all ABS interests in the trust that are outstanding.

In our view, the existing TOB structure is analogous to, but even more compelling than, the proposed seller's interest, because (i) pro rata sharing of losses in the TOB structure occurs only after the occurrence of a TOTE (which has never even occurred and the likelihood of which is remote), and (ii) prior to the occurrence of a TOTE, the floaters always are paid in full before any distribution is made to the residual. We also note that the floaters are legally entitled to share in any gain on the underlying assets under all circumstances when an underlying asset is withdrawn from the trust, regardless of whether or not a TOTE has occurred, so to the extent that the floaters may bear any risk of loss they also have a corresponding but even more significant right to payment of any gain; and unlike the possibility of any floater losses, which is remote, the gain opportunity is very real and in many cases very likely. Indeed, distributions of gain to floaters are common and often substantial.

Given the considerable technical challenges inherent in attempting to satisfy the requirements of any existing proposed compliance categories (such as horizontal or seller's), if a risk retention requirement is imposed we strongly support the SFIG approach, which proposes a method of compliance designed specifically for TOB programs, rather than a rule that would require TOB programs to be modified (if that is even possible) to satisfy any proposed methods that are incompatible or irreconcilable in many ways with the TOB structure.[38] Doing so would create significant uncertainty and confusion in the marketplace as to whether or not the requirements of such other categories can be or will have been satisfied.

In addition, if a risk retention requirement is imposed, we feel that it would be appropriate to recognize the value of collateral posted by a residual holder as security for a liquidity facility, since such collateral is very much at risk to absorb losses, on a first loss basis, if the value of the bond drops below its market value at the time of deposit. Accordingly, we suggest that, for purposes of satisfying any risk retention requirement, the residual holder's interest be calculated as the sum of (a) the face amount of the residual certificate (which represents the amount of cash investment in the TOB trust that is made by the residual) and (b) the market value of collateral posted by the residual to secure the liquidity facility.

---

[37] Apart from the actual risk retention component, it may be appropriate for the trustor to be the party who directs that the required disclosure for complying with the rules be included in the TOB and MBR offering documents.

[38] For example, although the concept of the seller's interest is analogous in some ways, TOB programs are not master trust revolving pools; all assets in each TOB trust series secure both the floaters and the residual interest; and deposits of interest-only and premium bonds are common.

In addition, if it would help to better align a new TOB compliance method with the analogous seller's interest, we suggest that, if necessary, the residual amount be equal to at least 5% of the total principal balance of all outstanding ABS interests in the trust, calculated as of the time of closing and thereafter at any time that Proportionality is changed in any way that would decrease the residual percentage.

Finally, and most importantly, we would like to explain our concern about any potential requirement that the residual holder take a first loss, rather than a pro rata loss, after the occurrence of a TOTE, since a first loss after a TOTE would directly contradict the longstanding partnership tax analysis that is used to pass through the tax-exempt interest on the bond(s). Specifically, a first loss requirement could jeopardize the tax-exempt TOB market if the IRS or any tax counsel for the various parties involved is not comfortable with a first loss structure[39] (or if, for purposes of the partnership tax analysis, any tax counsel may require other program modifications, such as higher gain share paid to the floaters, to compensate for any increase in floater loss protection, which in turn could have economic ramifications for residuals).

6. **<u>Prospective Application of Risk Retention Rule</u>**.

If a new risk retention requirement of any kind will be imposed, we strongly urge the Agencies to provide for prospective effectiveness of the risk retention rule for TOBs (*i.e.*, with an effective date no earlier than the date of publication of the final rule). We estimate that there are approximately $90 billion of TOB Floater Certificates outstanding, issued by thousands of existing trusts that are administered by more than 20 unrelated trustors, none of which has given rise to abusive practices or a transfer of credit risk. Most TOB trusts are used as a long-term funding vehicle for investments in bonds with 20-30 year maturities, and many of the outstanding trusts have many years remaining until their Designated Termination Dates.[40] For example, Morgan Stanley's existing TOB Program includes bonds that were deposited as long ago as 2005, as well as trusts with bond maturities as late as 2053 and that are thus scheduled to terminate as late as 2044.

[39] In fact, we recently have consulted with prominent tax counsel who represent parties in TOB transactions (including floater investors). These experts have expressed concerns about proceeding with any TOB transactions with a post-TOTE first loss structure unless IRS and Treasury guidance can be obtained, particularly in light of the current IRS scrutiny of loss sharing rules as they relate to the analogous partnership analysis in tax credit transactions.

[40] The Designated Termination Date is generally the date that is 80% of the expected average life of a bond and is a necessary component of the partnership analysis in that it provides for the potential for a sharing in capital gains.

If the risk retention rule does not grandfather existing trusts, TOBs in the market will be affected as follows:

(a) Minimum 5% Residual Interest. If a minimum 5% residual interest were to be required, in cases where the residual interest is currently less than 5% the residual holder would be required to increase its residual interest by injecting more capital into each trust, which would reduce the percentage of floaters outstanding and increase the residual interest commensurately. This can be accomplished with existing TOB mechanics, so the primary considerations will be (i) the economic impact of requiring a capital infusion by the residual holder, and (ii) the market and economic effects caused by forcing money market funds and other short-term investors to divest some of their floater investments. In addition, depending on a residual holder's access to capital, its cost of funds, and the value of each bond, some residual holders may prefer or be forced to liquidate some or all of their bond investments rather than continue with the TOB financing. In that case, bonds will be withdrawn from the TOB trusts and sold into the market, forcing residual holders to realize a gain or loss on each investment at a potentially inopportune time depending on each bond's value, as well as creating downward pressure on bond prices which translates into increased borrowing costs for the municipalities and authorities of state and local governments.

(b) Changes to Post-TOTE Loss Allocations. If the risk retention rule were to require any changes to the existing pro rata loss allocations required after a TOTE (*e.g.*, if the residual holder were to be required to bear the first 5% loss or to acquire a 5% interest in the floaters), such a requirement would be contrary not only to existing documentation, but also contrary to a fundamental tenet underlying tax opinions that were rendered at the time of closing. We therefore urge the Agencies to consult with the Internal Revenue Service and those responsible for tax policy at the U.S. Treasury to inquire as to whether a first loss requirement after a TOTE would jeopardize the equity tax treatment of TOBs, and specifically whether TOBs would still qualify for monthly closing elections under IRS Revenue Procedure 2003-84.[41] Assuming that (i) favorable guidance can be obtained from the IRS or U.S. Treasury, (ii) all of the tax counsel for each of the trustors, the floater investors, and the residual holders universally were able to become comfortable with the proposed change, (iii) each residual holder were amenable to amending its trusts, and (iv) each trust were to be amended to make the necessary changes, our program documents (which may or may not be representative of other programs on the market) would require for each trust:

- residual holder consent to the proposed amendment,

[41] As noted above, a first loss requirement after the occurrence of a TOTE also is potentially extremely damaging and potentially devastating for the TOB market and the US municipal bond market, even if the risk retention rule is prospective.

- tax and securities law opinions as to no adverse effect,
- rating agency confirmations,
- a workable operational procedure to provide for the residual holder to be out of pocket for the first loss, and
- sufficient time to allow floater holders to tender back their certificates before the effective date of the amendment if these investors chose not to continue their investment after the effective date of the amendment.

If for any reason any one of these conditions could not be satisfied for any trusts, such trusts would have to be collapsed, in which case potentially tens of billions of dollars of bonds would be sold into the market and gains and losses would be required to be recognized. Such amendments would be very cumbersome and expensive as they would impact tens of thousands of outstanding TOBs and hundreds of investors.

* * * *

Contact Information.

We greatly appreciate your consideration of the views set forth in this letter, and we would be pleased to have the opportunity to discuss these matters further with you or with any member of the staff of any of the Agencies.

For any inquiries or other follow-up with respect to Section I of this letter, please contact the undersigned at 212-761-2335, or James Y. Lee, Esq. at 212-762-6148, and with respect to Section II of this letter, please contact Eric M. Vandercar, Executive Director, Manager of Municipal Funding & Liquidity, at 212-761-1573.

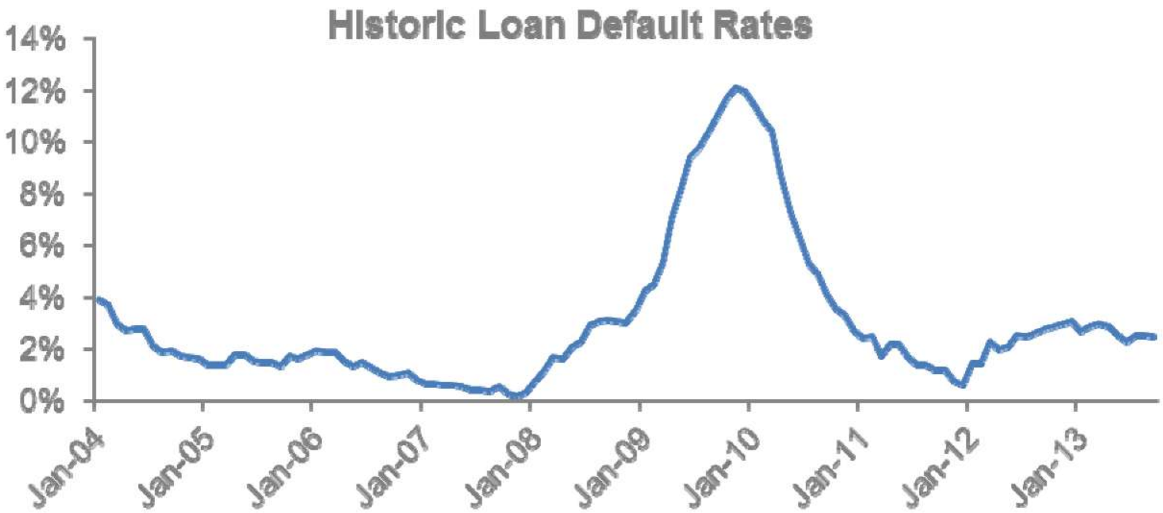
Very truly yours,

Robert Hershy

Robert Hershy
Managing Director
Morgan Stanley

ANNEX 1

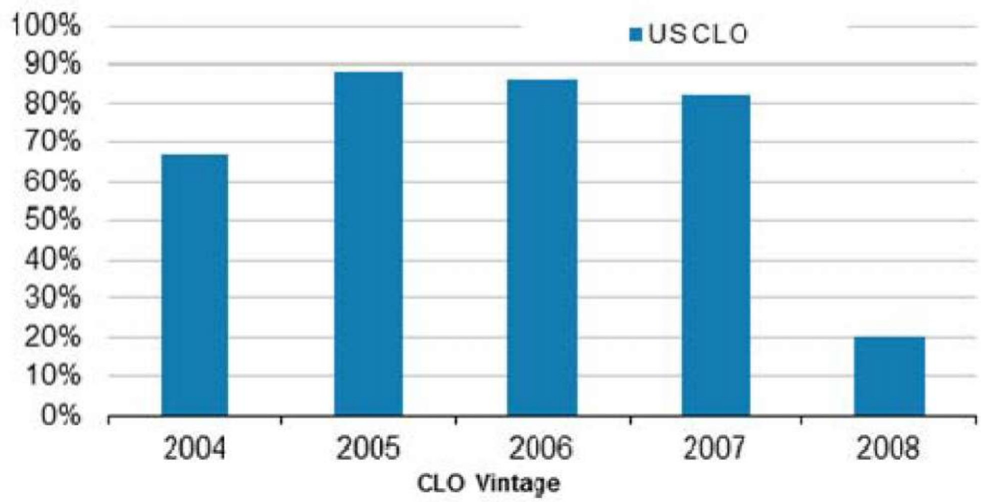
Historical loan default rates for leveraged corporate loans.



Source: Standard and Poor's LCD

ANNEX 2

Percent of CLOs by vintage in which subordinated note investors received 100% of their investment.[1]



Source: Morgan Stanley Research

[1] The percentage for the 2008 CLO vintage is low primarily due to the shorter period of time since inception compared to the other CLO vintages.