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VIA ELECTRONIC MAIL

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Board of Governors of the
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Attn: Robert deV. Frierson, Secretary

Federal Housing Finance Agency
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Federal Deposit Insurance Corporation
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Attn.: Comments, Robert E. Feldman,
Executive Secretary

Department of Housing and
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Re: Credit Risk Retention: Proposal for CLO Exemption, Exception or Adjustment pursuant to Section 15G(e)of the Exchange Act

SEC (Release No. 34-64603; File No. S7-14-11); FDIC (RIN 3064-AD74); OCC (Docket Number OCC-2013-0010); FRB (Docket No. R-1411); FHFA (RIN 2590-AA43); HUD (RIN 2501-AD53)

Ladies and Gentlemen:

We appreciate this opportunity to submit our comments on the joint notice of proposed rulemaking (the "**Proposal**") issued by the Office of the Comptroller of the Currency of the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (collectively, the "**Banking Agencies**"), the Securities and Exchange Commission (the "**SEC**"), the Department of Housing and Urban Development and the Federal Housing Finance Agency (together with the Banking 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**"). The Exchange Act was amended to add Section 15G pursuant to Section 941(b) of the

Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").[1] Our comment letter focuses on the provisions of the Proposal relating to managed collateralized loan obligation funds ("**CLOs**"), which in their most common form are securitizations of below investment grade loans.[2]

We are sympathetic to the Agencies' attempt to reconcile the purpose of the statute with the difficult language provided by Congress, and we expect that numerous market participants will submit comment letters with specific risk retention proposals for CLOs in response to the Agencies' Proposal. This comment letter does not offer a specific CLO proposal, but instead analyzes the securitization and CLO markets and the legal basis under which CLOs may qualify for an exception, exemption or adjustment to the basic risk retention requirement in accordance with legislative history of Section 941 of the Dodd-Frank Act and Section 15G(e)(2) of the Exchange Act.

Overview

Two key features of the assets underlying a CLO are liquidity and transparency – qualities that we believe provide a rationale for an exemption, exception or adjustment under Section 15G(e)(2) of the Exchange Act to the basic risk retention requirement. There are many arguments parties can make as to why CLOs successfully withstood the recent financial crisis and performed better than other securitizations (including collateralized debt obligations ("**CDOs**"), but almost every line of reasoning can be tied to the liquidity and transparency of the loans underlying the CLO structure. The liquidity and the transparency of the underlying assets allow for thorough credit analysis, which acts as a stronger investor protection than those offered by the statistical cash flow models alone and results in high quality underwriting standards[3] for CLOs. In essence, the liquidity and transparency of a CLO's assets give investors the necessary tools to enforce discipline upon the CLO market.[4]

In order for the Agencies to be able to rationalize any exemption, exception or adjustment to the basic risk retention requirement for CLOs, we believe they must first recognize the significant differences between CLOs and "CDOs" and "CDOs squared", both of which are specifically mentioned in the legislative history of Section 941 of the Dodd-Frank Act and in testimony to Congress about the failures

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

2 Throughout this letter we discuss CLOs that are leveraged investment funds, where the underlying assets have been purchased in the leveraged loan market – sometimes these CLOs have been referred to as "Open Market CLOs" or "Arbitrage CLOs." Our definition of a CLO does not include "Balance Sheet CLOs", which are therefore not addressed by this letter.

3 Section 15G(e)(2)(A) of the Exchange Act refers to ensuring "high quality underwriting standards" for "assets that are securitized or available for securitization." In markets where liquid assets are securitized, we have assumed that the Agencies have the authority to ensure "high quality underwriting standards" of the asset-backed securities issued – not just the underlying assets themselves; otherwise, the Agencies would lack authority to grant exception, exemptions or adjustments where the securitizer cannot influence the origination process. Presumably, the Agencies have already reached the same conclusion in identifying the CLO investment manager as a potential sponsor of a CLO transaction. The Proposal notes that the CLO investment manager is usually responsible for "selecting the assets and directing the CLO ... to purchase and sell ... assets," which alone would not affect the origination standards for the assets selected, but could have an effect on the quality of the asset-backed securities issued in a CLO.

4 We are not suggesting that the ability of the market to enforce underwriting standards will always mean the market will effectively enforce those standards. "Economic bubbles", i.e., when markets over-pay for assets, are likely inevitable. In addition, we acknowledge that selling, as opposed to holding, assets may in itself result in a different standard of credit origination. In any market, a person is likely to sell when they perceive the sale price as better than the relative value of holding the asset; the key issue is whether the buyer has the necessary information to enforce a minimum level of credit discipline upon the seller and the sophistication to make the purchase decision.

in the securitization process.[5] We discuss some of key differences between CLOs and CDOs in the context of the Dodd-Frank Act's text and legislative history in both narrative and summary form in Annex A.

For completeness and ease of reference, we have also included (1) as Annex B the text of Section 15G(e)(2) of the Exchange Act, where Congress provided the Agencies an ability to grant exceptions, exemptions and adjustments to the risk retention regime of the Dodd-Frank Act and (2) as Annex C a brief summary of a portion of the legislative history for Section 941.

Exemptions, Exceptions and Adjustments

The authority for the Agencies to promulgate an exemption, exception or adjustment to the risk retention regime is set forth in Section 15G(e)(1) of the Exchange Act, and the legislative history appears to encourage its use.[6] Section 15G(e)(2) of the Exchange Act contains the standards to be applied by the Agencies in granting any such exemption, exception or adjustment, and includes the requirement to help ensure high quality underwriting standards for securitizers and originators. Below, we discuss how securitizations involving liquid assets with high transparency[7] help meet the goals identified in the statute.

A. *Ensuring High-Quality Underwriting Standards.*

Securitizations of liquid assets such as CLOs are unique compared to other securitizations, in that their primary purpose is typically investment on a leveraged basis, as opposed to raising capital for funding asset creation. In a securitization of liquid assets, (1) none of the key participants of such securitization necessarily originates the credit (e.g., the bank loan) underlying the securitization and (2) a person unrelated to the originator of the securitized assets has the ability to analyze and trade the assets on an individual, rather than pool-wide, basis in order to collateralize the issuance of an asset-backed security. In a CLO transaction, the CLO issuer purchases the underlying bank loans in a liquid loan market as just one of many purchasers, which thereby eliminates, or severely limits, the ability of a CLO

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5 Because "collateralized debt obligations" or "CDOs" include the broad term debt, and a "loan" is a type of "debt", a CLO fits within a broad definition of a CDO. As used in Section 941's legislative history and in common market terms, however, a CDO is typically a resecuritization of asset backed securities. See S. Hrg. No. 111-397 (2009) at 35 ("Typically, a CDO consisted of junior tranches of RMBS from different offerings, sometimes paired with other types of asset-backed securities involving receivables from things like credit cards or auto loans."); id at 128 ("Lenders were able to hedge their equity tranches or shed them by resecuritizing them as CDOs."); Senate Report at 128 ("[I]t proved impossible for investors in asset-backed securities to assess the risks of the underlying assets, particularly when those assets were resecuritized into complex instruments like collateralized debt obligations (CDOs) and CDO-squared."). We acknowledge that the similarity of the legal structures of CLOs and CDOs complicates the regulatory analysis to create a clear distinction between the transactions, which is why Annex A provides a detailed substantive comparison.

6 The legislative history for Section 941 of the Dodd-Frank Act contained in S. Rep. No. 111-176 (2010) (the "**Senate Report**") includes the following testimony cited by the committee: "[P]olicymakers must ensure that any regulatory reforms are tailored to address the specific needs of each securitization asset class." Senate Report at 130. Furthermore, the committee emphasized their expectation was that "regulations will recognize differences in the *assets securitized*, in existing risk management practices and in the structure of asset-backed securities, and that regulators will make appropriate adjustments to the amount of risk retention required." Senate Report at 130 (emphasis added). These concepts were codified in Section 15G(e)(1) of the Exchange Act, which is the statutory authority for adopting exemptions, exceptions and adjustments to the basic risk retention requirements. The fact that CLOs are securitizations of an asset class that is traded in a liquid market where investors are able to thoroughly analyze the underlying credits is a defining characteristic that supports a nuanced treatment under Section 15G(e)(1) of the Exchange Act.

7 While the primary focus of this letter relates to CLOs, the logic applies to any securitization of highly transparent and liquid assets where investors have sufficient information to make informed investment decisions and a liquid market to buy and sell the assets underlying a securitization.

(or the CLO investment manager) to influence the underwriting standards used in the origination of the loans. In a liquid market, neither a CLO nor a CLO investment manager can directly influence the creditworthiness of the loans available for sale because the CLO's only influence is (1) the decision of whether or not to purchase a loan and (2) the price paid for a loan.

As we understand it, part of the Agencies' logic behind the CLO investment manager risk-retention and the proposed arranger retention options is to improve credit standards. However, we believe the link between risk retention and credit standards in this context is speculative because the future effect of a smaller CLO market on the liquid leverage loan market is not easily predicted. We note that if CLOs were no longer purchasing leveraged loans because of unfavorable credit characteristics or because regulations result in a contraction of the CLO industry, the market includes a number of other buyers (including domestic and foreign banks, insurance companies, pension funds, unleveraged funds, retail mutual funds, sovereign wealth funds, etc.) who might provide additional credit, resulting in little or no change to credit standards – or alternatively, the amount of credit available to borrowers may shrink or become more expensive, and credit standards may or may not change. At a minimum, the impact of a shrinking of the CLO market is likely to be unpredictable and to have unexpected consequences.[8]

Whether or not intentional, the Dodd-Frank Act does not appear to contemplate securitizations of financial assets that trade in transparent liquid markets ("**Liquid Assets**"). Its language and legislative history while not necessarily exclusive, primarily address origination of the underlying credits and distribution of the risk of those credits in opaque pools. As set forth below, Liquid Asset securitizations offer protections to investors that securitizations of opaque asset pools lack. If the Agencies were to take a more flexible approach towards risk retention for securitizations with underlying financial assets that are Liquid Assets, they would still meet the statutory objective of high-quality underwriting standards because liquidity is evidence that the market is able to enforce underwriting standards through pricing mechanisms that express a view as to the quality of the underwriting.

1. <u>Why Asset Liquidity Matters</u>.

The legislative history for Section 941 of the Dodd-Frank Act emphasized the legislators' goal of addressing securitizations of originate-to-distribute assets[9] (the "**OTD Model**") that individually are illiquid and are typically only able to be sold when bundled into asset pools. Section 15G of the Exchange Act addresses securitizations in the OTD Model. Neither the statute nor the legislative history, focuses on securitizations of Liquid Assets, which differ substantially from securitizations of illiquid assets or asset pools.

a. *Background.* We believe it is worthwhile to review some of the fundamental problems with securitizations in the OTD Model. It is well understood that financial institutions extended credit to borrowers who were incapable of repaying loans and that those same financial institutions had no intention of holding those obligations on their respective books. In almost all cases, the originators of such loans earned fees primarily at the time of loan origination and went on to distribute those loans without regard to credit quality. Loans of this type usually traded in pools, further reducing transparency for investors with respect to any individual loan. Typically speaking, the loans were too small for any

[8] We do not believe it is possible to predict the precise reaction of the credit markets to a shrinking CLO industry. While we believe that risk retention will result in a smaller CLO industry, whether that in turn will result in stronger credit origination appears speculative.

[9] The Revised Proposed Rules acknowledge as much when addressing Federal Deposit Insurance Corporation Securitizations: "Such receivers and conservators do not originate loans or other assets and thus are not engaged in 'originate to distribute' activities that led to poorly underwritten loans and that were a significant reason for the passage of section 941 of the Dodd-Frank Act." <u>Revised Proposed Rules</u> at p. 213.

buyer to justify reviewing on a loan-by-loan basis and/or borrower-by-borrower basis to make a determination about the creditworthiness of the borrowers. For institutions using the OTD Model, the securitization of loans was a means to raise capital, allowing them to continue to extend credit and generate origination fees with no long term exposure to the assets and therefore no risk to the originator.

When the loans were repackaged into securitization transactions, the third-party investors invested in those securitizations primarily based upon the statistical characteristics of the pools backing those securitizations, not the creditworthiness of the individual loans. Again, the individual loans were too small and numerous (sometimes numbering in the thousands for a particular transaction) to be reviewed by investors (i.e., there was no qualitative and quantitative analysis of the underlying borrower), and therefore the investment process did not act as a market check on the creditworthiness of the selected loans. Ultimately, when the securitizations failed, the primary culprit was the origination process – the extension of credit to borrowers who were unable to repay the loans. This result was not surprising considering that the only person reviewing the credit profile of the loan had no exposure to the risk of default.

On the opposite end of the spectrum, Liquid Assets (such as the loans held by CLOs) trade in a transparent and liquid market and allow for price discovery, in part because each asset is typically large enough to justify due diligence by many parties around the creditworthiness of the borrower. Often, public information, including financial statements, about the creditworthiness of the underlying obligor is available to investors. Investors are very familiar with loan documentation and structural features and will use all of this information and diligence to present their view of the creditworthiness of a Liquid Asset by assigning a lower or higher price to each individual credit. CLO investment managers and investors have access to information about individual assets when managing or considering an investment in a CLO portfolio. Because this transparency and liquidity exists, investors are not dependent upon the origination process itself to protect their investment, but they rely instead upon their own ability to assign a relative value (i.e., price) to the loan.

b. *Securitization of Liquid Assets.* Liquid Assets present a unique situation for securitization. On a case-by-case basis, a person or entity seeking to securitize such assets may select Liquid Assets that they believe have a low risk of default for a specific price, ***or alternatively***, they may select Liquid Assets with a higher risk of default, but at a significantly reduced price.[10] What is important to note is that there are two opportunities to create a financially sound securitization: (1) at the time of the extension of the credit that becomes a Liquid Asset (i.e., at origination of the loan) and (2) at the time of purchase of the Liquid Asset through a lower purchase price. Buying Liquid Assets at a discount allows the securitization to purchase more Liquid Assets to over-collateralize the securitization by a greater par amount (through a lower purchase price for each asset). Low credit risk and high credit risk Liquid Assets are equally reasonable investments – at the right price – by the securitization, so long as the credit risk *relative to the price* is factored into the structure.

Liquidity in a securitization's underlying assets allows market participants to assess an asset-backed security's creditworthiness by assessing the creditworthiness of each asset underlying the securitization (i.e., a "bottom up" approach). In the OTD Model, where loans are small, the pool is opaque and there is no liquidity (or price discovery) for individual assets, the only form of credit check in the securitization is the statistical model used to estimate the likelihood of repayment of asset-backed

10 For example, a loan manager may choose to buy a loan for a securitization that is priced at 60% of the face value of the loan, believing if the loan were to default, in a liquidation scenario the loan would pay back 75% of the face amount. The point is that a loan manager has the data and ability to conduct this analysis and investors choose to invest with specific loan managers for their expertise and credit selection process.

securities issued. In a securitization of Liquid Assets, investors and other participants (including credit rating agencies) decide whether the price of the asset is a good value relative to the likelihood of repayment (usually based upon the credit analysis performed on each asset as discussed below). Liquidity, or the collective actions of the market pricing the Liquid Assets, allows the market to express a view as to the creditworthiness of both the underlying Liquid Assets and, building from the bottom up, any asset-backed security supported by Liquid Assets.

Ultimately, securitization of Liquid Assets allows for two separate assessments of cash flows: one predicted by a statistical payment model and one predicted by a collective market view through the assignment of market values, which are a product of the asset's liquidity. Asset-backed securities having the benefit of the two assessments have higher quality underwriting standards because two separate analyses are simply more thorough than a single analysis. However, as we will next discuss, the liquidity that provides the market view assessment cannot exist without transparency: the ability of an investor or other party to perform credit analysis on, and assess the creditworthiness of, the assets traded.

2. Why Transparency Matters.

The legislative history of Section 941 of the Dodd-Frank Act identified a lack of transparency as a specific cause of the financial crisis as it related to securitizations.[11] Liquidity, which we have discussed the importance of above, and transparency go hand in hand. When sufficient information is available about a particular asset, market participants can take informed views on potential scenarios that may affect the short- and long-term value of the asset. Consistent with this reasoning, the SEC has a long history of promoting the frequent and timely release of information about companies in order to promote active and efficient markets, which can use the information to perform timely investment analysis.[12] When many parties have access to information about an asset, opinions will undoubtedly differ about the asset's value, which thereby contributes to the desire and ability to buy and sell the assets.

In the context of securitization, transparency matters at two levels: (1) transparency at the securitization level (i.e., investors in the securitization have access to the assets collateralizing the securitization) and (2) transparency in the underlying assets (i.e., investors have access to the information necessary to perform a credit analysis of the assets collateralizing the securitization). Transparency at one level, without the other, will significantly reduce or eliminate an investor's ability to perform a "bottom up" credit analysis. Transparency at the securitization level, without transparency in the underlying assets, allows an investor in the securitization to perform a statistical analysis of cash flows from the pool, but does not allow the investor to do a credit-by-credit analysis of the pool of assets in the bottom up approach. Transparency in the underlying assets, without transparency at the securitization level, would leave investors blind to the identity of the underlying Liquid Assets in the pool and unable to perform credit analysis on an asset-by-asset basis. Transparency at both levels allows investors to know what assets are in the pool and to perform an asset-by-asset analysis of the pool.

a. *Structural Transparency.* CLOs are an excellent example of a securitization of Liquid Assets with structural transparency. While most securitizations provide disclosure about the pool of assets included in the securitization, CLOs often report their holdings on a name-by-name basis (i.e., identifying the company attached to each loan/credit exposure within the securitization pool), allowing

[11] Senate Report at 128.

[12] Although borrowers under loans are not always SEC-reporting companies, covenants in loan agreements will typically require financial statements and cash flow analysis similar to what is required by the SEC for public companies, as well as scheduled calls between lenders and management.

investors to seek out additional information on the assets collateralizing an investment. In addition, CLOs will typically hold exposure to far fewer borrowers than other securitizations, which eases the burden of monitoring the underlying credits in the transaction. CLO investment managers compile performance reports on the CLO at least quarterly and often as frequently as monthly, and the trustees for CLOs often maintain password protected websites to allow investors timely access to this information. Finally, other tools are available in the market – such as Intex software – to assist investors in evaluating the cash flows on CLOs. While similar tools may be available for other securitizations, the identification of the individual borrowers in a CLO, together with the underlying asset transparency discussed below, allows investors in CLOs to actively monitor investments, make their own assessments and make frequent buy, hold or sell decisions for their investments.

b. *Underlying Asset Transparency.* In the context of CLOs, information is available about the underlying assets (i.e., the loans) from several sources. First, most loan agreements require quarterly financial statements and audited annual financial statements to be made available to the lenders and prospective lenders. Some loan agreements require additional reporting beyond quarterly and annual financial statements, especially in the context of a distressed credit. Research may be available on the borrowers and their industries from independent investment banks, rating agencies and other sources. Borrowers may have their own websites, providing information about their companies, their products and their services. In some cases, other securities of the borrower may be subject to periodic reporting with the SEC and provide significant information to the public through the related filings.

B. *Meeting the Statutory Standards and the Legislative Intent.*

Section 15G(e) of the Exchange Act sets out explicit considerations for the Agencies if they want to grant an exception, exception or adjustment to the basic risk retention requirement for any asset class. The first is to ensure high quality underwriting standards for the assets that are securitized.[13] Liquidity is a justification for providing an exemption, exception or adjustment to the basic risk retention requirement for two reasons. First, liquidity allows the market to express a view as to the originator's underwriting standards and to enforce enforce high quality underwriting standards; a low price or a declining price expresses a market's view as to deficiencies in the originator's underwriting standards. Second, liquidity encourages risk management. Investors who are not satisfied with the quality of a credit may promptly dispose of it.

The transparency in CLOs and their underlying assets also support a justification for an exemption, exception or adjustment to the basic risk retention requirement pursuant to Section 15G(e)(2) of the Exchange Act. Transparency is the means by which investors can enforce market discipline on loan originators and loan managers and engage in asset-by-asset credit analysis – a distinct and separate investment analysis from pool-wide statistical cash flow analysis relied upon in other securitizations. In making those individual assessments and investment decisions, CLO investors are enforcing market discipline on the CLO investment managers and in turn on the originators of the leveraged loans. Thus, transparency (1) allows investors to perform their own diligence and enforce high quality underwriting standards upon investment managers and in turn upon loan originators and (2) encourages risk

[13] As noted above, in a liquid market, with many buyers and sellers of the same assets, it is not possible for one class of buyers to influence the underwriting standards of the underlying asset at the time of origination of the underlying asset. The Agencies may therefore seek to meet the statutory objective by ensuring that the securitized assets are within the appropriate credit standards for the specific securitization. In a liquid market, with no ability to affect the standards of the initial underwriting, "high quality" standards must be applied to the selection of assets appropriate for the specific asset-backed securities. See Footnote 3.

management by allowing investors sufficient information to monitor the investments in CLOs and make buy, sell or hold decisions with adequate information.

An excellent example of the importance of liquidity and transparency in ensuring high quality underwriting standards may be found in the comparison of CLOs and CDOs/CDO squared. While the performance of assets during the credit crisis was significantly different, as a legal and structural matter, CLOs and CDOs look very similar. The capital structures look similar. Both have investment advisors and rated and unrated classes of securities. Both have independent trustees, periodic reporting, and require payments to be made in accordance with a principal and interest waterfall. The salient differences lie in the liquidity of the underlying assets securitized and the transparency surrounding the assets.

Conclusion

Prior to passing the Dodd-Frank Act, Congressional leaders listened to significant testimony and reviewed numerous written reports detailing the severe financial fall-out attributable to CDOs. However, a review of the legislative history suggests that CLOs, even though they resemble CDOs structurally, were not the CDOs Congress intended to regulate. On the surface, the names and legal structures look similar, but the fundamental building blocks of a CLO compared to a typical CDO are very different in key respects. We discuss those differences in Annex A.

When looking to grant an exemption, exception or adjustment pursuant to Section 15G(e)(2) of the Exchange Act, the Agencies must ensure that proper underwriting standards and appropriate risk management measures are inherent in the structure benefiting the exemption. Due to the liquid and transparent nature of CLO assets and the CLO structure, we believe that the Agencies have a clear path to finding for an exemption, exception or adjustment for CLOs. We thank you for your time and consideration. Please contact David Thatch or Charles Pesant with any questions.

Best regards,

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ANNEX A – CLOs and CDOs

1) Comparing the CLO Model to the Originate-to-Distribute CDO Model

The legislative history is clear that Congress sought to regulate the originate-to-distribute model of financial asset creation through capitalization in the securitization markets. As discussed above, we believe that CLOs are distinguishable from CDOs and other originate-to-distribute securitizations in many important respects. For ease of reference, we provide a comparison table at the end of Annex A.

a. Purpose of a Securitization Transaction

The originate-to-distribute model (the "**OTD Model**") involves the use of the securitization markets as a means of capitalizing businesses for the creation of financial assets. In the OTD Model, there is no gatekeeper between the asset's originator and the investor that becomes exposed to the asset's credit risk. The originator's primary incentive is to raise capital to promote the business of creating additional loans. The Senate Report acknowledged as much:

> By selling the mortgages, the originator thus gets more funds to make more loans. However, the ability to sell the mortgages without retaining any risk, also frees up the originator to make risky loans, even those without regard to the borrower's ability to repay.[1]

In other words, the OTD Model involves a securitization whose primary purpose is the funding of loan creation by issuing securitized debt to raise the needed capital with little concern for the creditworthiness of the borrower. In such securitizations, no third-party selects or monitors assets with the intention of protecting the securitization from losses.

In contrast, the primary purpose of a CLO is to provide investors the ability to make an investment in corporate bank loans on a diversified and leveraged basis. Investors who desire leveraged loan exposure choose an investment adviser – typically after a rigorous diligence process – to assist the investor in selecting a loan portfolio to leverage. The diligence process may include meetings with the investment manager, a review of the proposed investment characteristics (often including a list of proposed credits), a review of the default performance and often a review of the CLO investment manager's overall performance in managing leveraged loans.

The CLO investment manager initially selects and continually manages and monitors the loans in the CLO, and the CLO investment manager typically will perform a loan-by-loan credit analysis for each of the CLO's assets. The CLO investment manager is highly concerned with the quality and performance of those loans throughout the life of the transaction; indeed, the fees the investment adviser receives are directly tied to the successful performance of the CLO assets. The CLO investment manager's partners and employees are typically experts in analyzing corporate credit; they adhere to disciplined investment processes and often have rigorous investment committees. The CLO investment manager invests heavily

[1] Senate Report at 41 n. 121.

in human capital in order to run a strong business. Indeed, the CLO investment manager's ability to attract new business is closely tied to its performance track record and long-term reputation.

In contrast, CDOs appear to have been part of the capital raising process for the mortgage finance industry.[2] While investment advisers were engaged to select assets for the CDOs, the asset selection was not based upon a loan-by-loan credit analysis of the assets underlying the CDO. Instead, due to the small size of the individual loans in the CDOs, investment advisers were forced to rely on analysis other than a "bottom up" approach reviewing the quality of the underlying assets – perhaps looking at ratings, FICO score[3] or other pool characteristics. The reliance solely on statistical models – by rating agencies, investment adviser and investors – is in stark contrast to the reliance in a CLO on both a statistical model and a "bottom up" credit analysis.

b. Underwriting Standards

The assets identified in the legislative history as originate-to-distribute assets are originated by a single financial institution to a single borrower (collectively **"OTD Assets"**) and sold to a single securitizer. Common examples include home mortgages, commercial mortgages, commercial loans, and auto loans. Typically, these OTD Assets are generated *en masse* with form documents and little substantive review. Very few OTD Assets are subject to meaningful financial or legal diligence at the time of origination. OTD Assets offer little to no transparency for investors hoping to make an informed decision and are bundled in such volumes as to make any meaningful diligence nearly impossible.

However, CLOs primarily hold syndicated bank loans, not OTD Assets. Each syndicated bank loan involves extensive documentation, which is typically highly customized for the specific transaction and is generally subject to a robust credit approval process prior to origination. The underwriting process for syndicated bank loans is much more extensive and of a higher quality than the underwriting process for OTD Assets, involving multiple lenders, their credit committees and often external law firms examining the borrowers and the related documentation. The borrower's creditworthiness in a syndicated bank loan is generally easier to verify before loan origination and easier to monitor thereafter through their audited and unaudited financial statements.

In a syndicated bank loan, the lead lender will most often arrange, together with the borrower, a syndicate of lenders, who will each be party to the initial loan documents as an initial lender to the borrower. Each lender in the syndicate will typically have its own credit approval process. Often lenders in the syndicate will review and comment on the loan transaction documents and pose additional financial and legal diligence questions. The final loan documentation is typically drafted by the lead lender's counsel, with input from the syndicate lenders, their credit committees and sometimes their internal or external counsel.

A CLO essentially becomes a direct lender to a borrower once the CLO investment manager selects a loan after credit analysis and investment diligence. By basing its selection process and bidding prices on relative credit quality, the CLO investment manager enforces credit standards by assigning lower bid prices to less creditworthy borrowers. The collective market also enforces a similar discipline –

2 See Chapter Five, Accidental Capitalists in "The Big Short: Inside the Doomsday Machine" by Michael Lewis for an illuminating narrative of how this process worked. Lewis, M. (2010). *The Big Short: Inside the Doomsday Machine*. New York, N.Y.: W.W. Norton & Company, Inc.

3 "FICO Score" (from investopedia.com): A type of credit score that makes up a substantial portion of the credit report that lenders use to assess an applicant's credit risk and whether to extend a loan. FICO is an acronym for the Fair Isaac Corporation, the creators of the FICO score.

many other lenders are also monitoring the same borrower – using market values disclosed through dealers and pricing services to provide a market view of the borrower's credit. There are no similar quality enforcement mechanisms in place on originators of OTD Assets, which are illiquid and opaque, and in part necessitated the risk retention regime.

2) Transparency and Risk Assessment in CLOs

Congress also focused on the inability of investors to properly evaluate securities due to complex and convoluted market structures:

> [I]nvestors in asset-backed securities could not assess the risks of the underlying assets, particularly when those assets were resecuritized into complex instruments like collateralized debt obligations.[4]

In essence, investors cannot enforce discipline against originators of financial assets if those investors cannot fully review and understand the credit underlying the assets. If the structure is easily understood, and the investors can accurately assess the risks, then investors will presumably act in their own self-interest and purchase securities in transactions with the better risk-adjusted returns. However, unlike a CDO, a CLO is ***both*** a highly transparent structure and a holder of highly transparent underlying assets.

The loans included in CLOs are most often made to medium to large companies (rather than individuals or complex securitization pools) and are subject to a robust credit approval process prior to the origination of such loans that disseminates information about the borrower. Initially, a potential borrower will often engage a lead lender (or its affiliate) to "commit" to provide funding to the borrower, with the initial commitment being subject to a number of significant conditions that, among other things, are designed to allow the lead lender to become comfortable with the creditworthiness of the borrower. Generally, the lead lender will perform financial diligence on the borrower, and the lead lender's external law firm will perform legal diligence on the borrower. In some instances, an information memorandum is prepared by the lead arranger for the borrower, which information memorandum is used to disseminate information to the potential lenders.

The periodic reports provided to investors in a CLO typically identify the syndicated bank loans collateralizing the securities and are compiled by a third party to the transaction, such as a trustee. Most of the syndicated bank loans trade regularly in the market, and pricing for the loans is generally available. The borrowers on the underlying loans typically provide audited financial statements, which are publicly available to investors in the CLOs when the obligor is a public filer with the SEC. Investors often also have access to ongoing information on the loans, such as third-party credit ratings and compliance certificates.

In contrast, other securitizations may have credit structures that are opaque, especially in the case of a CDO or a CDO-squared. Those re-securitizations may include thousands of unidentified obligors (whereas CLOs, which are primary securitizations rarely have more than 200 identifiable obligors). Generally, there is no market, or ability, for investors or investment advisors to truly value the underlying loans or the underlying mortgage backed securities.

[4] Senate Report at 36.

"CLOs" and "CDOs" Comparison Table

Much of the information provided above has been summarized in the table below and included here for ease of reference and comparison.

While the acronyms may appear quite similar, the transactions comprising a typical "collateralized loan obligation" fund and a "collateralized debt obligation" fund[5] were quite different in many respects. The differences are material to the Agencies' ability to provide and exception, exception or adjustment under Section 15G of the Exchange Act and its legislative history.

	Collateralized Loan Obligation	**Collateralized Debt Obligation Or CDO - Squared**	**Legislative Implication**
Underlying asset	A corporate loan or bond, typically involving an issuance of at least $125 million per debt instrument. Typically less than 200 loans are in a CLO.	An asset backed security, most often ultimately backed by pools of mortgages. Underlying mortgages were more typically in the thousands.	CDOs typically involved re-securitizations of existing securitization creating opacity and an inability to analyze the underlying credits. In CDOs, investors cannot ensure high quality underwriting standards where investors lack transparency to the underlying assets to protect their own interest. In contrast, in the CLOs, investors can analyze the underlying securities and protect their own interests. §15G(e)(2)(B).
Model of distribution	***One*** corporate credit (loan or bond) is created for syndication in the primary market ***to be broken up among several investors.***	***Many*** mortgage loans are sold in ***one*** pool to create mortgage backed securities that are pooled into CDO securities and pooled again into CDO squared securities.	A mortgage loan typically has far fewer parties involved in the origination primarily due to the size of the loan. For corporate debt, during the origination process multiple parties are typically involved, including bank counsel, borrower counsel, lead arrangers, syndicate banks and first investors, which helps ensure high quality underwriting standards in the corporate loan and bond market. §15G(E)(2)(A).

5 There is not one common definition of a "CDO". A "CDO" and the "CDO Squared" transactions typically were thought of as mortgage-related re-securitizations. There are, however, some examples of corporate credit securitizations that are referred to as "CDO" transactions. The ambiguity is around the word "debt" being broad enough to cover many different types of transactions. As discussed above, in the legislative history for Section 15G, the focus appears to be primarily on the originate-to-distribute model involving consumer credit.

	Collateralized Loan Obligation	Collateralized Debt Obligation Or CDO - Squared	Legislative Implication
Transparency after securitization	Trustee reports typically identify by borrower information each credit allowing investors to continually monitor their investment.	Trustee reporting may include identification of securities purchased, but names reference other securitizations and typically no loan-by-loan data.	Transparency post-securitization allows investors to exercise ongoing productive monitoring and risk management techniques. In a CLO transaction, the risk management may be prospective – allowing investors, for example, to sell if the investor believed the transaction had too much exposure to a particular obligor, country or industry. §15G(e)(2)(B).
Information available on underlying assets	Borrowers and issuers of the underlying assets typically have audited financial statements, websites and reporting obligations under their debt documents. In addition, research may be published on the individual companies and/or issuance by investment banks and/or rating agencies.	Limited information is available on individual borrowers underlying the issued securities. Pool information is available providing average FICO scores.	The abundance of information for corporate loans and bonds allows investors the ability to see through to the underlying assets, exercise effective risk management practices and invest only where their interest is protected. §15G(e)(2)(B).
Method of credit analysis on the underlying asset	Investors analyze individual companies and their credit profile (i.e., credit analysis on each asset).	Investors typically look at averages of the pool and do not look at individual loans (i.e., statistical analysis of the pool).	The ability to do a loan by loan investment analysis (i.e., a "bottom up approach") in CLOs typically ensures a higher quality credit analysis. §15G(e)(2)(A). CDOs lacked the ability to perform loan by loan analysis because information was either not available or uneconomic to perform due to loan size. CLOs have the benefit of two forms of analysis: credit analysis on an asset by asset basis and statistical analysis of the pool of cash flows. CDOs had primarily statistical analysis of the cash flows.

	Collateralized Loan Obligation	Collateralized Debt Obligation Or CDO - Squared	Legislative Implication
Liquidity	Corporate debt trades frequently providing actual transfer pricing.	Individual mortgage loans are not typically traded.	Asset liquidity allows for trades that assess the creditworthiness of the asset. It can encourage high quality underwriting standards by forcing purchasers of poor credits to absorb losses upon trades and helps identify originators who produce poor quality assets as reflected in the market prices for the trades. §15G(e)(2)(A). More frequent trading in the underlying assets allows investors the transparency to evaluate the performance of the underlying assets, make risk assessments and, when desired, to sell assets consistent with the investor's risk management practices. §15G(e)(2)(B).
Price Discovery	Corporate credit is typically marked daily by pricing services and dealers, providing a market view of the value.	Individual mortgage loans are typically not marked at all.	Price discovery helps assess the creditworthiness of the asset. It can encourage high quality underwriting standards by identify originators who produce poor quality assets as reflected in the market prices of willing buyers. §15G(e)(2)(A). Price discovery also allows investors to evaluate the performance of the underlying assets against market sentiment, make risk assessments and, when desired, to sell assets consistent with the investors' risk management practices. §15G(e)(2)(B).
Diversity	Diversified across industries – typically with no one industry constituting more than 15% of the transaction.	Highly concentrated in housing and real estate.	Diversification of assets in a portfolio provides protection to investors by reducing exposure to any one sector of the economy. While CDOs tended to have exposure in the real estate sector, CLOs are much more diversified as required by the rating criteria ensuring higher quality underwriting standards for the CLO securities. §15G(e)(2)(A).

	Collateralized Loan Obligation	Collateralized Debt Obligation Or CDO - Squared	Legislative Implication
Classification of Defaulted Asset	A corporate credit typically becomes a "defaulted asset" for (i) non-payment of the debt, (ii) non-payment of a related debt, (iii) bankruptcy, (iv) a rating downgrade or (v) upon a CLO manager's determination that a default has occurred.	An ABS interest owned by a CDO typically becomes a "defaulted asset" for (i) if it fails to pay interest for an extended period, (ii) it becomes under-collateralized, (iii) a rating downgrade or (iv) upon a CLO manager's determination that a default has occurred.	Determining when a default has occurred in a CLO's asset is more transparent to the market than determining when a default has occurred in a CDO's asset. The corporate credit events are typically promptly reported in the news or are otherwise made public. In addition, there is little lag time between the asset's underperformance and the recording of the default. The speed of information and flow and the transparency allows investors to implement risk management measures, including selling the investment, in a timely manner. §15G(e)(2)(B).
Borrowing base treatment of defaulted assets	When a default occurs in a CLO's asset, the asset is typically held in the overcollateralization test at the lower of the market value and the statistically assigned recovery rate.	When a default occurs in a CDO's asset, the asset is typically held in the overcollateralization test at the lower of the market value and the statistically assigned recovery rate.	While the tests in a CLO and a CDO look quite similar on the face of it, the CLO's estimated value for the overcollateralization test is much more likely to have "downside" protection. The liquid market for corporate debt provides a floor value to recovery on a CLO's assets while a CDO's asset may not have a liquid market for disposition of the defaulted asset. Therefore, the CLO's overcollateralization test, due to the liquidity of its underlying assets, provides more protection to CLO's senior securities. §15G(e)(2)(A).

ANNEX B: Statutory Basis for Permissible Exemption, Exception or Adjustment

Section 941 authorized the Agencies to grant exemptions, exceptions and adjustments which authority was codified in Section 15G(e) of the Securities Exchange Act. Clause (2) of Section 15G(e) sets forth the standard for any exemption, exception or adjustment:

> Any exemption, exception, or adjustment adopted or issued by the Federal banking agencies and the Commission under this paragraph shall –
>
> > (A) Help ensure high-quality underwriting standards for the securitizer and the originator of assets that are securitized or available for securitization; and
> >
> > (B) Encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of the investor.

ANNEX C: Legislative History

When considering whether or how CLOs fit into the risk retention regime, it is important to first be clear on what issues Congress intended Section 941(b) to address. The legislative history of Section 941 is not extensive. The primary piece is the Senate Committee on Banking, Housing, and Urban Development's Report on the Dodd-Frank Restoring American Financial Stability Act of 2010, S. REP. NO. 111-176 (the "**Senate Report**"), which includes a section-by-section analysis of the Dodd-Frank Act and cites nine authorities in Section 941's legislative history. Six of the authorities were testimony before the committee and three were written reports.

The Senate Report's discussion of Section 941(b) (i) identifies the problems leading to the financial crisis that the section is meant to address, (ii) states the section's general purpose, and (iii) describes how the Senate majority expects the section to operate, including with respect to the Agencies writing regulations under it. The overall purpose of the risk retention requirement in Section 941(b) as summarized by the Senate Report is to provide securitizers with "a strong incentive to monitor the quality of the assets they purchase from originators, package into securities, and sell."

As explained in the Senate Report, Congress designed the risk retention regime to address two specific problems that contributed to the financial crisis of 2008. First was the originate-to-distribute model ("**OTD Model**") of extending credit, where "loans were made expressly to be sold into securitization pools, which meant that the lenders did not expect to bear the credit risk of borrower default." In other words, risk retention targets vehicles that were intended for capital generation for the originator rather than as true investment opportunities for investors. Section 941 places a risk retention requirement on securitizers with the goal of aligning their economic interests with those of investors in asset-backed securities. Section 941 is also intended to raise credit and underwriting standards by placing originators "under increasing market discipline because securitizers who retain risk will be unwilling to purchase poor-quality assets."

The second problem Congress sought to address with the risk retention requirement was the opacity problem: the difficulty that many investors face in assessing the risks of the underlying assets of certain securitization transactions. The Senate Report states that "[c]omplexity and opacity in securitization markets created the conditions that allowed the financial shock from the subprime mortgage sector to spread into a global financial crisis . . . ." The Senate Report specifically identified resecuritizations of asset-backed securities (or what we think of as collateralized debt obligations, or "CDOs") as examples of transactions that inhibit an investor's ability to demand market discipline from originators of financial assets.