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Tall Tree Investment Management, LLC

a Delaware limited liability company

October 30, 2013

By E-Mail Submission

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Ms. Jennifer J. Johnson
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Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
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Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: **Notice of Proposed Rulemaking, Credit Risk Retention**
SEC (Release No. 34-64148; 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:

Tall Tree Investment Management, LLC ("TTIM") is pleased to submit these comments in response to the joint Further Notice of Proposed Rulemaking, 78 Fed. Reg. 57928 (Sept. 20, 2013; originally released Aug. 28, 2013) ("FNPRM"), concerning risk retention and the implementation of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").

I. Overview.

Tall Tree Investment Management, LLC ("TTIM") submits these comments to address how the proposed risk retention regulations contained in the FNPRM would adversely affect collateralized loan obligations ("CLOs") and the commercial loan market, how features of CLOs already provide extensive and adequate incentives that align CLO Managers' interests with those of CLO investors as required by Section 941, and how, if regulation is deemed necessary, other alternatives would protect investors without causing extensive harm to CLOs, loan markets, credit markets, and competition.

In particular, Tall Tree Investment Management, LLC ("TTIM") is very concerned that the proposed regulations would significantly and adversely affect the formation and continued operation of CLOs, along with the support they provide to the commercial loan market and the United States economy. CLOs present none of the risks presented by the originate-to-distribute model that Section 941 was designed to address, and a range of incentives ensure that CLO Managers act consistently with investors' interests. CLO performance during the recent financial crisis confirms the robustness of these incentives, and the subsequent resurgence of the CLO market clearly demonstrates investors confidence that their interests are fully protected in the CLO market today. For these reasons, additional regulation requiring CLO Managers to retain more credit risk would produce no benefits and would substantially harm competition and the public. This result would be especially unfortunate because various alternatives are available that would far better advance the public interest.

II. Our Experience with CLOs and Commercial Loan Markets.

For background, Tall Tree Investment Management, LLC (TTIM) was founded in July 2005 and is based in Chicago, Illinois. TTIM is an independent, employee owned, specialty asset manager that is focused on non-investment grade credit investments particularly senior secured loans. TTIM recently manages three CLO funds, Founders Grove CLO Ltd; Grant Grove CLO, Ltd and Muir Grove CLO Ltd. Our AUM was $826MM as of July 15, 2013. TTIM is an investment advisor registered with the Securities and Exchange Commission ("SEC").

TTIM was formed by ten former members of the Senior Loan Group of Morgan Stanley Investment Management Inc. (MSIM). The investment professionals of TTIM have worked together since 1999, as a part of the team that in the early 2000s managed $17Billion of primarily senior secured loans held by public mutual funds, CLO funds and separate accounts. The funds managed included the Van Kampen Senior Loan Fund, Van Kampen Senior Income Trust, Morgan Stanley Prime Income Trust, Van Kampen CLO I, Van Kampen CLO II and three institutional separate accounts.

TTIM team members have extensive experience in secured lending and high yield securities including: senior loans (widely syndicated and middle market), asset based lending, structured finance, fixed income securities (high yield and investment grade corporate and municipal bonds), real estate, project finance, vendor finance and leasing. As the Managing Member and founder of this firm, I have personally managed CLO related funds for 15 years and have been involved with CLO technology for over 20 years.

Tall Tree Investment Management, LLC's market role and experience provides us with a clear understanding of the current CLO market, CLOs' performance during and since the recent financial crisis, and the likely adverse effects of the proposed regulations. That said, we would like to offer a few observations about the CLO structure as in many of my discussions with regulators there seems to be a misunderstanding of the mechanics of these vehicles. The structure of a CLO is sound and meets the intent of the proposed risk retention rules as the structure was based on that of a commercial bank. As with a commercial bank the basis of investor protection is FUNDED subordination particularly due to the fully FUNDED EQUITY required in a CLO. Like a bank, the funded equity of a current CLO is approximately 10% at the closing of a CLO. Once the equity is funded, it cannot leave the vehicle except through the absorption of realized credit losses. During the reinvestment period until the CLO notes are fully redeemed, if required subordination or interest coverage tests that protect the debt investors are not met, (through realized losses or imposed haircuts to the carrying value of underperforming loans) the interest waterfall ensures that the equity cushion will be increased by diverting interest proceeds from distributions to the equity to instead purchase additional collateral and if that action is insufficient to restore required cushions then interest proceeds are further used to repay the most senior notes (AAA) until the CLO is de-leveraged into subordination compliance. Either action is an infusion of cash equity into the CLO. The second investor protection is that the collateral base of a CLO is composed of widely syndicated loans that are well understood, sound and transparent collateral. The borrowers are significant companies that are well known, many are SEC public filers with public debt and equity securities. Loans have an active secondary market with visible and verifiable prices. The third investor protection is transparency. The collateral is well understood and visible to the market; investor reporting by an independent trustee is performed monthly and quarterly; investor payment date reports and compliance with the waterfall is determined by the Trustee working with the CLO Manager and is reviewed and approved by independent auditing firms under agreed upon procedures. Finally, collateral selection and reinvestment within the CLO is actively managed by a SEC registered investment advisor that has a fiduciary duty to all investors in the CLO. Alignment of interests of the CLO Manager with the entire capital structure is provided through the structure of the vehicle, the terms of the Collateral Management Agreement and the regulations governing the CLO Manager. The structural protections of collateral eligibility, quality tests, interest diversion and FUNDED subordination all work together to insulate the CLO debt investor from excessive risk. There is no better example of how durable this structure is than the performance results of the CLO 1.0 transactions that operated during the financial crisis and survived with virtually no loss to rated notes and cumulative cash flows to the equity averaging over 20% per annum AFTER interest diversion to buy collateral or to redeem senior notes, even though many of the equity interests and managers did not receive any subordinated distributions during the height of the financial crisis.

III. The Proposed Rules Would Adversely Affect Us, Other CLO Managers, Commercial Lending, Borrowers, and Investors.

Our experience in the CLO market leaves us with no doubt that the proposed rules would significantly and adversely affect the formation and scope of future CLOs.

The requirement that CLO Managers retain five percent of the face value of the CLO's assets – in addition to the very significant credit risks already assumed through the CLO Managers' compensation structure – would very adversely affect CLO formation. Many CLO Managers, including us, are too small to secure or devote funds of that magnitude for positions that cannot be disposed of or hedged – no matter what the competing business opportunities or demands. For other CLO Managers that might have the financial capacity to hold such a significant position, doing so would require a restructuring of current business models and anticipated returns – making a once viable business much less profitable, requiring that CLO Managers instead devote those funds to other, more productive uses. A final point on the proposed structure of risk retention is that under any risk retention scheme, the equity component of the retained risk MUST be able to receive some current payment during the reinvestment period and through the amortization period from excess cash flow if all protective tests are being met or the economic incentives for a manager to participate in CLO formation will simply not exist as the cost of the retained risk will exceed the economic return from the management activities.

It is essential to understand that the proposed risk retention regulations are in no way reasonably proportionate to the CLO Manager's financial incentives and control of credit risk. Regulators have suggested that the CLO Manager controls credit risk because they select the assets. We strongly reject that notion. The underwriting banks in the loan syndicate control the entire process of loan underwriting and distribution as a CLO Manager is specifically prohibited from participating in underwriting activities and cannot define the terms of a loan. The CLO Manager is duty bound to the CLO investors to keep the CLO fully invested subject to the agreed upon collateral eligibility critera. The primary tool used by the CLO Manager to manage the conflicting demands of being fully invested while manageing loan underwriting risk that is more agressive than desired is to decline certain loans and to broadly diversify those that are accepted. CLO Managers have proven through CLO performance that they have skillfully balanced those competing demands. In terms of proportionality to financial incentives, the 5% proposed risk retention requirement represents at least <u>10 years</u> of full fee gross earnings of a CLO Manager before expenses and taxes. A very efficient asset manager has direct costs of more than 50% for people and overhead to provide their services (and small managers may have direct cost percentages approaching 90%) due to the inefficient nature of the commercial loan asset class. In the FNPRM, it is suggested that a CLO Manager should be able to provide the needed capital for the proposed risk retention through debt or equity financing of the management company. However, it is clear that obtaining the financing for debt financing of risk retention capital cannot be supported with what would become an implied EBITDA leverage of more than 20X. In addition it would not be feasible for such a CLO Manger to be accepted as counterparty for a repo facility to finance the debt portion of vertical risk retention. Similarly, raising equity capital at the manager level to fund a vertical risk retention strip would be highly unlikely. This is due to the fact that the vertical risk retention has a return of less than a portfolio of unlevered loans due to the requirement that the equity component cannot receive a current yield therefore, with a total return of less than 5% it is unlikely that the verticle risk retention will have a sufficient current yield to attract equity investment capital. Lastly, the proposed horizontal risk retention is not feasible as a fee for service investment manager is NOT an investment company and has no practical way to fund and retain such credit risk.

Our market assessment is that the proposed regulations would cause a dramatic decrease in the size and functioning of the CLO market as a whole. We are aware of the survey of CLO Managers that indicated that the decrease in CLO offerings is anticipated to be in the order of 75 percent.[1] We generally agree with that assessment, and are concerned that it may well be too optimistic particularly considering the impact of the European rule 122A that has effectively shut down the European CLO market entirely. We are also aware of the broad range of comments and record evidence that establish that the proposed rules would adversely affect the formation and continued operation of the CLO market.[2] We agree with the factors identified in those comments and assess that those factors will contribute to the magnitude of the decrease in CLO formation identified in the LSTA survey. Indeed, the FNPRM itself anticipates these adverse effects on CLOs and competition.[3]

Our experience also indicates that this resulting decrease in the formation of CLOs would have profoundly negative implications for the commercial loan market. CLOs are vital to supporting the loan syndication process and to providing liquidity necessary to the efficient functioning of many of the most important sectors of the commercial loan market and thus the United States economy. If the proposed rules were implemented and adversely affected CLOs in the manner we anticipate, then borrower costs would increase, many borrowers would be shut out of the loan market altogether, the secondary market would become considerably less liquid, and many floating rate investors would be denied a valuable and attractive set of investment opportunities. Competition in the provision of loans and investment products would decrease. Those adverse results pose broad risks to the efficient functioning of the loan markets, and the adverse effects on borrowers would have further adverse effects on production efficiency, innovation, employment, and consumer prices.

Lastly, TTIM has met directly with the Federal Reserve of New York and the Federal Reserve Board of Governors (on October 3, 2013) and the Federal Deposit Insurance Corporation (on October 28, 2013) to discuss the structure of CLOs, the commercial loan market, small managers and proposed risk retention rules. A copy of the materials presented to and discussed with these institutions is attached for the record. In this document, we have included abundant background information and detailed financial anlysis of the proposed risk retention rules and the impact on the loan and CLO markets.

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

[2] *See* LSTA Letter Comment, Aug. 1, 2011 at 14–17; LSTA Letter Comment, Apr. 1, 2013 at 14–16; LSTA Letter Comment, July 29, 2013 at 3–9; SIFMA Letter Comment, June 10, 2011 at 70; American Securitization Forum Letter Comment, June 10, 2011 at 137; JP Morgan Chase & Co. Letter Comment, July 14, 2011 at 50; Financial Services Roundtable Letter Comment, Aug. 1, 2011 at 32; Bank of America, Letter Comment, Aug. 1, 2011 at 29-30; Wells Fargo Letter Comment, July 28, 2011 at 29; White & Case Letter Comment, June 10, 2011 at 2.

[3] *See* 78 Fed. Reg. 57962.

IV. Additional Regulation of CLOs Is Inappropriate and Unnecessary.

A. Commercial and Regulatory Factors Already Align the Interests of CLO Managers and CLO Investors.

The proposed credit risk retention rules fail to account for the very significant factors that already ensure that CLO Managers select and manage CLO assets prudently and in investors' interests. CLO Managers do not employ the "originate-to-distribute" model of securitization that contributed to the financial crisis and prompted Congress to enact Section 941. The nature of CLOs, and their role in the commercial loan market and in the provision of securities to investors, ensures that they operate independently and that managers' interests are completely aligned with CLO investors' interests. This alignment of interests, and related lack of any need for risk retention regulation to further align those interests, arises from the following characteristics of CLOs.

First, CLO Managers act independently of loan originators and managers and exercise independent judgment in selecting among loans originated by unaffiliated entities. They are free from potential conflicts and disincentives related to the originate-to-distribute model and attract investors based in large measure on this independence, the resulting quality of asset selection and their investment track record. This provides a strong incentive for continued selection of higher-quality assets.

Second, CLO Managers bear significant risk through their deferred, contingent compensation structure that has been shaped and ratified by the market. CLO Managers receive their primary sources of compensation only if they deliver returns and maintain credit loss protection for their investors: they are compensated principally as the most subordinated CLO investors secure their returns, and a large component of their compensation is received only after the CLO has performed well over most of its life for all classes of investors, including those whose securities are most at risk. CLO Managers' compensation structure places a premium on careful selection and management of assets, aligning their interests with investors' interests. Indeed, investors and the competitive process have shaped and ratified the compensation structure of CLO Managers. In this very fundamental sense, CLO Managers already have a significant portion of their compensation as skin in the game – and creating that alignment of interest, which already exists in the structure of CLOs, is the entire point of the proposed regulations. The FNPRM recognizes and acknowledges this alignment of investor and CLO Manager interests created by the compensation structure in CLOs.[4] This should be recognized and not disregarded.

Third, almost all CLO Managers are registered investment advisors, with associated fiduciary duties – and potential liabilities for failure to comply with those duties – to their investors and the SEC. This status triggers a separate and quite effective regulatory and supervisory regime that also provides incentives for careful selection and management of assets.

Fourth, the assets selected by CLO Managers have been evaluated through multiple

[4] *See* 78 Fed. Reg. 57963.

layers of underwriting and market decisions. These include the loan arrangers' decisions in underwriting the commercial loans, the market's evaluation in pricing and syndicating the commercial loans, and the CLO Manager's decisions in selecting or not selecting certain commercial loans for the CLO to purchase. Often, the assessments reflected in secondary market pricing also contribute to the selection of high-quality assets.

Fifth, CLO Managers actively manage their loan portfolios for much of the life of a CLO. This active role is unlike that for many other types of ABS, and further protects investors. Through this active management, CLO Managers can limit losses and secure additional gains. As a result of the short life of a commercial loan, of 20-22 months, the CLO Manager will be active in redeploying principal received as commercial loans payoff over the life of the transaction. In this management role, the CLO Manager exercises independent judgment and has every incentive to act only in the best interest of CLO investors.

Finally, CLO Managers select – and CLO investors demand – commercial loans with features that protect investors. Prominently, CLO Managers select senior secured loans. This often ensures complete or very substantial recovery and loss protection even in the event of default, and is an important reason why CLOs protected investors so well during the recent financial crisis. The commercial loans are senior to other lenders to the borrowers, and receive significant recoveries on default.

B. CLO Performance Confirms the Adequacy of Existing Incentives and Investor Protections.

The historically strong performance of CLOs demonstrates the concrete and practical results of these unique features of CLOs. Despite the massive financial crisis that resulted in widespread losses among other asset classes, CLOs performed exceptionally well. Although CLOs experienced ratings downgrades, the vast majority of CLO notes that were originally rated AAA retained ratings of AA or higher during the crisis.[5] And most significantly, CLOs experienced *de minimis* events of default and even lower rates of financial loss.[6] The Board of Governors of the Federal Reserve has acknowledged the low default rate among CLOs during the financial crisis, which it attributed in part to the incentive alignment mechanisms inherent to CLOs.[7] In addition, the capital structure of CLOs helped protect investors during the financial crisis. When the prices of the commercial loans fell, the par value coverages tests declined and payments under the CLO waterfalls were redirected to pay down the senior notes of the CLO until the par value tests were again satisfied. Payments to subordinate notes and the CLO Managers were suspended and the subordinate portion to the CLO Managers were suspended until such tests again were satisfied.

We are aware of numerous comments submitted in this rulemaking that confirm the

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[5] *See* LSTA Letter Comment, August 1, 2011 at 7.

[6] *Id*.

[7] *See* Board of Governors of the Federal Reserve, Report to Congress on Risk Retention 62, Oct. 2010.

strong performance of CLOs during the financial crisis.[8] Our experience as direct participants in the industry accords with these views. We believe that this record of performance demonstrates that the existing safeguards and incentive alignments in the CLO industry more than adequately meet the goals of Section 941.

C. In Light of These Incentives and Performance History, Additional Regulation Would Provide No Public Interest Benefits.

Because existing commercial and regulatory incentives fully align the interests of CLO Managers and CLO investors, additional risk retention requirements would not redress any market failure or further align those interests. Because CLO Managers select assets independently of loan originators, and do not operate as part of an "originate-to-distribute" model, the operations of CLOs present none of the risks to investors that Section 941 was designed to address. As set out above, the recent performance of CLOs confirms that no additional risk retention requirements are needed.

We agree with other commenters that have analyzed the language and purpose of Section 941 and have shown that Congress did not intend to impose risk retention requirements on CLO Managers.[9] Presumably, Congress did not intend to do so precisely because CLOs present none of the problems Section 941 was designed to fix. Because CLO Managers facilitate the CLOs' purchase of assets, they do not directly or indirectly sell or transfer assets to the CLO – and are thus not within the scope of the statutory definition of "sponsor" as the FNPRM incorrectly asserts.[10]

We also agree with that, in light of the high costs and absence of benefits arising from imposing credit risk retention requirements on CLO Managers, the FNPRM should be revised to exempt CLO Managers from the credit risk retention requirements – assuming that those requirements even apply.[11] If the agencies believe that certain types of CLOs pose a risk to

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[8] *See* LSTA Letter Comment, Aug. 1, 2011 at 7; LSTA Letter Comment, April 1, 2013 at 19; LSTA Letter Comment, July 29, 2013 at 2 and Appendix A; American Bar Association Business Law Section Letter Comment, July 20, 2011 at 90-93; American Securitization Forum Letter Comment, June 10, 2011 at 134-135; SIFMA Letter Comment, June 10, 2011 at 69; Morgan Stanley Letter Comment, July 27, 2011 at 18; Bank of America Letter Comment, Aug. 1, 2011 at 23; Wells Fargo Letter Comment, July 28, 2011 at 29; The Center for Capital Markets Competitiveness of the United States Chamber of Commerce Letter Comment, Aug. 1, 2011 at 4; Cong. Himes and other Members of Congress Letter Comment, July 29, 2011 at 2.

[9] *See, e.g.*, LSTA Letter Comment, Aug. 1, 2011 at 7–14; LSTA Letter Comment, Apr. 1, 2013 at 17–19; LSTA Letter Comment, July 29, 2013 at 9–10; American Bar Association Business Law Section Letter Comment, July 20, 2011 at 93–95; SIFMA Letter Comment, June 10, 2011 at 68–69; American Securitization Forum, June 10, 2011 at 135–136; JP Morgan Chase & Co. Letter Comment, July 14, 2011 at 53–60; The Financial Services Roundtable Letter Comment, Aug. 1, 2011 at 31–32; Morgan Stanley Letter Comment, July 27, 2011 at 21; Bank of America Letter Comment, Aug. 1, 2011 at 23–30; Wells Fargo Letter Comment, July 28, 2011 at 26–29; White & Case Letter Comment, June 20, 2011 at 1–7; Cong. Himes and other Members of Congress Letter Comment, July 29, 2011 at 1–2.

[10] *Compare* 78 Fed. Reg. 57962.

[11] *See, e.g.*, LSTA Letter Comment, Aug. 1, 2011 at 17–19; LSTA Letter Comment, Mar. 9, 2012; LSTA Letter Comment, Apr. 1, 2013 at 23; American Bar Association Business Law Section Letter Comment, July 20, 2011 at

investors, or that further restrictions on which CLO Managers can qualify for an exemption are appropriate, a commercially sensible set of "ring-fencing" qualifications has been proposed in comments already submitted.[12]

V. Other Regulatory Alternatives Would Be Preferable to the Agencies' Proposed Approach.

Although we believe that the intended scope of Section 941, the Report noted in footnote 7 and the facts surrounding the operation of CLOs indicate that it would be a significant mistake to impose the risk retention requirements on CLO Managers, alternative regulatory approaches would meet the agencies' objectives of Section 941 while causing far less harm to CLOs, CLO Managers and the commercial loan markets.

We think that the Open Market CLO concept has merit in that it acknowledges the differences between CLO Managers and the ability of CLO Managers to fund such risk retention. The provisions that generally work and are consistent with market practice include (1) removing the requirement that the CLO Manager be responsible for risk retention, (2) that the CLO Manager make all loan acquisitions in the either the primary or secondary open market, (3) that less than 50 percent of assets held by the CLO are originated by affiliates (could be 0% for most managers) and (4) the restriction on ABS assets as a component of the collateral pool. Provisions that need significant reconsideration are (1) restrictions on collateral being limited to 100% CLO Eligible Loan Tranches and (2) shifting risk retention to Syndicate Banks and Loan Underwriters.

The primary feasiblity risk to this concept is that CLO Eligible Loan Tranches do not presently exist in the market today. The entire concept of the Open Market CLO as proposed is dependent on the assumption that underwriters, syndicate banks; CLO investors and borrowers will accept the costs and risks of a CLO Eligible Loan Tranche. Should this option be incorporated as a basic requirement of an Open Market CLO and not be accepted and promptly implemented by the syndicated loan market, the result will likely be a near complete shutdown of CLO formation and the resulting impact to borrowers from a credit starved marketplace. We expect that this construct is likely to be objected to by underwriters due to additional costs of administration and more important, the fact that the proposed risk retention for underwriters of CLO Eligible Loan Tranches conflicts with risk management practices of commercial banks as encouraged to date by the relevant regulators. With the additional risks and costs, underwriters may simply refuse to create such tranches syndicating loans to alternative buyers if such buyers exist (they do not at the present time) or withdrawing from the market entirely. Borrowers and particularly private equity sponsors may not accept the structure due to additional restrictions of the loan as well as the potential for higher borrowing costs. CLO equity investors may not find this an attractive notion due to the uncertainty of the continued availability of qualifying

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93–95; SIFMA Letter Comment, June 10, 2011 at 71–72; American Securitization Forum, June 10, 2011 at 138–139; The Financial Services Roundtable Letter Comment, Aug. 1, 2011 at 33; Bank of America Letter Comment, Aug. 1, 2011 at 30; Wells Fargo Letter Comment, July 28, 2011 at 29; Loan Market Association Letter Comment, Aug. 1, 2011 at 2.

[12] *See* LSTA Letter Comment, Mar. 9, 2012 at Appendix A.

collateral throughout the reinvestment period. Alternatively, if the concept is acceptable to underwriters, borrowers and investors, at a minimum there would need to be a multi-year phase in process to assure sufficient qualifying collateral in the market place to provide appropriate diversity to construct a sound portfolio.

Given the historical performance of CLOs without mandated risk retention, we suggest that additional protections could also be achieved as an alternative to risk retention through enhanced structural requirements for an eligible Open Market CLO that could include such features as enhanced waterfall schemes that maintain funded equity cushions in CLOs ensuring that realized losses will be covered from excess interest earnings throughout the life of the CLO. Other enhancements or restrictions can be incorporated into collateral eligibility tests that recognize the current practices of the syndicated loan market. "Standard" collateral eligibility rules for Open Market CLOs could be fashioned that reflect market practices and still can limit risk of the loan pools. Many of these loans are SNC rated and perhaps this is another existing standard that could provide some guidance for crafting effective, well understood, regulator examined eligibility standards.

In another alternative example, the LSTA has proposed that CLO Managers could retain credit risk, consistent with the statutory requirements, by holding a set of securities that embody the compensation structure currently endorsed by the market and purchasing an interest in the CLO's equity.[13] Both the securities and the equity interest would confirm the alignment of interests between the CLO Manager and the CLO investors. The cash outlay for the proposed equity interest may be manageable for most CLO Managers even a small manager such as TTIM. We endorse that approach as far preferable to FNPRM. While such a construct may be more acceptable generally, we suggest that there is a need to recognize the wide range of sizes and the financial capabilities of investment managers and suggest bifurcating the universe of CLO Managers between large and small institutions applying a lower standard of regulatory compliance for smaller managers than larger managers as has been the case for smaller mortgage brokers and for smaller banking institutions in many of the regulatory efforts to date.

Similarly, we endorse proposals that would reduce any risk retention requirement on a *pro rata* basis to the extent that a CLO's assets are comprised of higher-quality loans. A material portion of the loans that we and other CLO Managers select are higher-quality loans under any commercially reasonable definition, present very limited risks to investors, and should be taken into account in setting the amount of any credit risk that the CLO Manager must retain. However, we believe that the Qualifying Commercial Loan Exemption does not address the CLO market as the concept does not seem to recognize the credit market demand served by CLOs. CLOs are lenders to non-investment grade borrowers while the FNPRM suggests CLOs of Qualifying Commercial Loans would be a securitization of investment grade credit. This is not a feasible concept as the economics of the CLO liability structure is greater than the interest rate on the underlying loan pool and therefore there is insufficient cash flow to service the debt structure or to reward equity investors with an investment return. In addition, the complexity of the compliance rules suggested in the FNPRM makes an already economically challenged structure less compelling due to compliance related costs. We suggest that this concept could be

[13] *See* LSTA Letter Comment, Apr. 1, 2013.

effective if the definition of a Qualifying Commercial Loan were to be modified to include the terms of a typical well structured "BB" rated loan that would allow a significant majority of the loans held by CLOs to qualify as a Qualifying Commercial Loan today.

In addition and significantly, we support the expansion of the definition of the parties, including those that may be associated with or advised by the CLO Manager, that are eligible to hold the risk retention in a manner that would satisfy Section 941's requirements. In each of our CLO transactions, key investors in the equity of the CLO transaction played an important role in the selection of the eligibility criteria, formation of a warehouse for the purchase of commercial loans prior to the closing of the CLO, and structuring of the CLO transaction itself, in addition to funding the equity risk of the CLO transaction. Having such parties, rather than the CLO Manager, retain credit risk makes considerable sense in terms of the objectives of Section 941 and the effect on the CLO market. Because parties coordinating with the CLO Manager may contribute to the selection of the initial assets, having them retain credit risk advances the goal of improving incentives related to asset selection. Such parties often have investment, rather than investment management, as their core business, making it more appropriate that they retain the requisite risk retention interest. In addition, they may do so without causing the disincentives and adverse impacts that arise when the CLO Manager is required to retain an economic interest that is substantially in excess of its economic participation in the transaction. In essence, similar to the B-Piece Option proposed for CMBS, the provider of the cash funded equity in a CLO transaction should be allowed to qualify to provide the risk retention requirement.

Finally, in whatever form the final regulations take, we support the ability of the risk retention holder of a CLO to receive a current cash return on its invesmtent in the equity of the CLO, subject of course, to the waterfall of the CLO structure. In a CLO, unlike any asset class that involves static pools of assets such as RMBS or CMBS, before any payment is made to the equity of the CLO all of the collateral quality tests must be satisfied as to the market value of the commercial loans compared to the outstanding balance of various classes of the rated notes issued by the CLO and the interest coverage ratio with respect to the more senior classes of the notes of the CLO. If such tests are not satisfied, proceeds are utilized to purchase additional assets or pay down the most senior liabilitites until the tests are once again in compliance. This distinguishes CLOs becasue the origianl equity is not static, cash flow can be diverted to make sure the original collateral quailty tests are maintained, and increased if necessary to protect the more senior notes. Only after these tests are satisfied, can payments then be made to the equity. The FNPR limits payments to the equty further with respect to comparing those payments against payments of principal to the notes in the structure, which is unfair and does not recognize the significant benefit provided by the equity in the CLO, and the fact that the waterfall itself is the mechanism which establises the ski in the game for the equity of the CLO. Any further restriction does not recognize the significant contribution of the equity of the CLO through the waterfall and subject the CLO structures to an unfair economic burden.

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Tall Tree Investment Management, LLC appreciates your consideration of these comments and would be pleased to provide additional information or assessments that might assist in your decision-making process. Please feel free to contact William D. Lenga, Managing Member and CEO in the event you have questions regarding these observations and conclusions.

Sincerely,

s/*William D. Lenga*

William D. Lenga
Managing Member and CEO