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By Electronic Submission

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Re: Credit Risk Retention; Joint Notice of Proposed Rulemaking (the "**Reproposal**")
SEC (File Number S7-14-11); FDIC (RIN 3064-AD74); OCC (Docket Number OCC-
2013-0010); FRB (Docket Number R-1411); FHFA (RIN 2590-AA43); HUD (RIN 2501-
AD53)

Dear Ladies and Gentlemen:

A study done in 2012 based on the U.S. Census and looking at companies with revenues between \$25 million and \$1 billion states "[m]iddle market companies are the backbone of the U.S. economy; they drive growth and generate \$6 trillion in annual revenue. The middle market includes more than 100,000 companies nationwide that employ more than 30 million Americans."¹ These companies include businesses in the oil and gas, media and broadcasting, general manufacturing, healthcare, technology, retail, beverage, alcohol and tobacco, chemicals,

¹ CIT Voice of the Middle Market: Perspectives from the Heart of America's Economy, September 2012, p.1. Please note that we originate middle market loans to small and medium size businesses typically with revenues of \$500 million or less and our investment decisions are based primarily on the EBITDA of these companies, not their revenues.

plastics and rubber and wholesale industries.² Middle market CLOs currently provide more than \$20 billion of capital to middle market borrowers.³

We are middle market commercial loan originators who use collateralized loan obligation transactions (“**CLOs**”) as a source of long term balance sheet financing for portfolios of middle market loans we provide to small and medium size business borrowers.⁴ We use CLOs to provide attractive long term, match funded⁵, financing for our own portfolios generating additional capital and freeing up capacity under our line of credit facilities so that we may extend additional middle market loans. Some of us (or our affiliates) are also registered investment advisers with expertise in acquiring, managing and selling middle market loans for third party institutional investors (including insurance companies, endowments, government and private pension plans, business development companies and other private funds) who want exposure to these assets and this vital sector of the U.S. economy through privately placed middle market loan funds (“**Funds**”) that also finance their portfolios using CLOs. As you know, registered investment advisers, are regulated by the Securities Exchange Commission (the “**Commission**”) under the Investment Advisers Act of 1940, as amended (the “**Advisers Act**”) and owe a fiduciary duty to their client Funds.

In the section titled “Commission Economic Analysis” in the Reproposal, the Commission states “[b]ecause aggregated quantitative information relating to the current risk retention practices of ABS securitizers is currently unavailable, the Commission does not have sufficient information to measure the extent to which risk is currently retained . . . The Commission would benefit from additional public comment and data about historical and current risk retention practices in all ABS sectors.”⁶

This letter will provide you with information regarding credit risk retention practices for middle market balance sheet financing CLOs. We will also comment on the Reproposal as it affects us and our ability, as applicable, to continue to extend credit to, or to acquire middle market loans

² See Endnote 1.

³ See Endnote 2.

⁴ We are middle market commercial loan originators and affiliated registered investment advisers that originate middle market loans by acting as lead arranger for the loans or by performing our own underwriting and due diligence with respect to the loan obligors and loan terms prior to investing in the loans on behalf of ourselves and our consolidated subsidiaries or on behalf of private loan funds that those of us who are registered investment advisers manage. Some of us have used CLOs to finance middle market loan portfolios since 2005.

⁵ CLOs are match funded in terms of duration and basis because most of the loans that support our CLO liabilities have stated maturities that do not exceed the stated maturity of our CLO liabilities and most of the loans owned by the CLO are indexed to LIBOR as are most of our CLO liabilities.

⁶ Credit Risk Retention, 78 Fed. Reg. 57928, 58008-09 (proposed September 20, 2013).

made to, small and medium size businesses, the engines of employment growth in the U.S. economy. Although we did not have concerns with the general concept of risk retention first proposed by the agencies in 2011 and thus did not comment on them⁷, we have significant problems with the restrictions proposed on cash distributions to holders of eligible horizontal residual interests which we or our client Funds, as applicable, hold in our balance sheet financing CLOs.

Middle Market Loans

Middle market loans are commercial loans typically made to non-investment grade small and medium size businesses with EBIDTA of \$50 million or less. These businesses contribute a significant share of the job creation in the U.S. economy. These businesses are underserved by traditional sources of capital such as banks and are not of a size to efficiently access capital markets borrowing alternatives such as high yield offerings. There is unwillingness by larger banks to finance these companies due to the amount of diligence required to underwrite relatively small loans given the alternative of devoting resources to underwriting much larger broadly syndicated loans for large companies. Regional and local banks may not have the expertise or capital to originate and hold middle market loans or may be constrained in making these loans by their geographic footprint and obligor, industry or other concentration limits. As a result, the financing needs of these small and medium size businesses are met primarily by commercial finance companies, business development companies and private loan funds, many of which rely on CLOs as the most attractive and viable source of financing for their portfolios of middle market loans.

Middle market loans are typically originated by a lead arranger who may hold the entire loan or may syndicate portions of the loan to a relatively small group of middle market participants including other commercial finance companies, business development companies, private middle market loan funds, middle market CLOs and separate accounts advised by registered investment advisers. These middle market investors (or their registered investment advisers) perform their own underwriting and due diligence with respect to the loan obligor and loan terms prior to investing in a loan. Middle market loans are typically bullet or balloon loans that depend on refinancing for repayment and have stated maturities of 4 to 7 years, although many prepay

⁷ Balance sheet financing CLOs are not “open market” CLOs as defined in Section __.9 of the Reproposal since, among other things, the assets in balance sheet financing CLOs are acquired directly or indirectly through an affiliate from the sponsor thereof, not in the open market, and a balance sheet financing CLO holds more than 50 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates of the CLO. The Loan Syndication Trading Association’s CLO comment letter with respect to the 2011 credit risk retention proposal related primarily to “broadly syndicated CLOs” or “open market CLOs” that are not balance sheet financing CLOs.

earlier depending on economic and interest rate market conditions.⁸ Middle market loans have historically performed well in terms of default⁹ and recovery rates.

Middle Market CLOs Provide Attractive Long Term Financing and Performed Well During the Financial Crisis

CLOs provide attractive long term financing for middle market loan portfolios since, among other things, (a) CLOs provide efficient market rate spreads on the primarily floating rate CLO liabilities supported by the primarily floating rate loans owned by the CLOs and thus provide funding appropriately matched, in terms of basis, to the underlying loans in the CLOs, (b) CLOs are cash flow financings that do not contain market value triggers which could cause forced sales of CLO assets during a market disruption, and (c) CLOs are managed financing vehicles that allow proceeds from initial issuance of the CLO and from principal and sales proceeds received from the loans owned by the CLO to be invested and reinvested in additional eligible middle market loans in accordance with the CLO transaction documents which allows CLO liabilities to remain outstanding during the reinvestment period of the CLOs and provides CLOs with the ability to continue to acquire additional middle market loans made to small and medium size businesses when others may not be in a position to do so. As a result, CLOs dampen market volatility in the middle market loan market.

CLOs performed very well during and since the financial crisis¹⁰ both objectively and as compared to other types of asset-backed securitizations.

Types of Middle Market Balance Sheet Financing CLOs

Loan Originator Balance Sheet Financing CLOs

For those of us who are middle market commercial finance companies, we regularly use CLOs to provide long term, match funded, financing for our middle market loan portfolios and commercial lending platforms. Since we do not take deposits, we need to raise capital ourselves in order to originate middle market loans. We finance our loan origination business in part by maintaining term and warehouse line of credit facilities provided principally by commercial banks and less frequently by commercial paper conduits. These lines of credit are paid down using proceeds from the issuance of our balance sheet financing CLOs which allows us to recycle these lines of credit so we can use them to originate additional middle market loans. In addition, the net proceeds remaining from the CLO issuance in excess of the repayment of these lines of credit and principal and sales proceeds received from the loans in the CLO that are permitted to be reinvested provide us with additional capital with which to originate middle market loans. We use the cash distributions we receive on the first loss credit risk securities we

⁸ See Endnote 3.

⁹ See Endnote 4.

¹⁰ See Endnote 5.

own in our CLOs to pay taxes, for our own working capital purposes and to originate additional middle market loans.

We are seasoned sponsors and securitizers of our balance sheet financing CLOs.¹¹ We initiate a securitization transaction by selling or transferring our assets, directly or indirectly through an affiliate, to the CLO issuer which is our subsidiary consolidated on our balance sheet. We hold funded first loss subordinated credit risk CLO securities in all of our balance sheet financing CLOs.¹²

The agencies state in the Reproposal that "Congress intended the risk retention requirements added by section 15G to help address problems in the securitization markets by requiring that securitizers, as a general matter, retain an economic interest in the credit risk of the assets they securitize. By requiring that the securitizer retain a portion of the credit risk of the assets being securitized, the requirements of section 15G provide securitizers an incentive to monitor and ensure the quality of the assets underlying a securitization transactions, and, thus, help align the interests of the securitizer with the interests of investors."¹³ We have "skin in the game" and the incentive to monitor and insure the quality of the loan portfolios we finance using CLOs that we own. We are in the business of extending these loans. Our loan portfolios, leveraged in this manner, are the primary drivers of profitability in our business models.

We typically hold the first loss credit risk securities in our balance sheet financing CLOs in an amount in excess of 14 % of the capital structure¹⁴. Based on information provided by Wells Fargo Securities LLC for this letter, the equity in the capital structures for middle market CLOs closed from 2011 through the first nine months of 2013 ranged from 7% to 40% (weighted average of 22.8%) depending on how much equity the sponsor wanted to retain versus how much financing the sponsor wanted for its middle market loan portfolio. In instances in which the equity of the CLO was less than 10% of its capital structure, the sponsor also retained the next most subordinate class of CLO debt bringing the first loss credit risk retention by the sponsor in excess of 14%.

¹¹ Part __ - Credit Risk Retention, Sec. __.2, 78 Fed. Reg. 57928, 58026 (proposed September 20, 2013) defines "sponsor" to mean "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") defines "securitizer" to mean: (A) the issuer of an asset-back security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer. 15 U.S.C. Section 78o-11(a)(3).

¹² See Appendix A for a structure chart of a typical balance sheet financing CLO. Our funded first loss subordinate credit risk CLO securities include the CLO equity or a combination of the CLO equity and the next most subordinated class of CLO debt.

¹³ Credit Risk Retention, 78 Fed. Reg. 57928, 57932 (proposed September 20, 2013).

¹⁴ See Endnote 6.

This is not the type of originate to distribute model of securitization that contributed to the recent credit crisis for the following reasons.

1. Our middle market loans are carefully structured (typically including the use of appropriate leverage and financial covenants), rigorously underwritten and proactively managed based on our extensive experience and comprehensive credit underwriting and collection procedures. Our middle market loan losses have been, on average, less than .50% per year since our respective inceptions.
2. We are predominantly buy-and-hold commercial finance companies who focus on fundamental credit analysis and have the ability to perform all commercial lending and management functions internally. As noted above, CLOs provide us with stable, match funded financing of our middle market loan business. Our reputation and track record in the CLO investor community, and in the capital markets generally, directly affects our ability to finance our balance sheet lending activities.
3. We retain significant “skin in the game” in our balance sheet financing CLOs. We hold (and historically have held) our “risk retention” horizontally in the first loss position similar to other owners of assets that finance them.
4. We do not recognize any gain on sale for accounting or tax purposes when we enter into our balance sheet financing CLOs. As shown in Appendix A, the CLO issuer typically is a direct or indirect wholly owned subsidiary of ours and, as such, is a disregarded entity for tax purposes with no transaction deemed to have occurred from a tax perspective when we transfer loans to our CLO subsidiary. We remain the taxpayer with respect to income earned on the portfolio. For accounting purposes the loan portfolio transferred by us to our CLO subsidiary in a part cash sale/part capital contribution transaction remains on our consolidated balance sheet and the loans are typically accounted for under GAAP as held for investment purposes using the historical cost method including an allowance for loan loss reflecting anticipated inherent losses in the portfolio. We note on our consolidated balance sheet that we have sold the relevant loans to the CLO subsidiary. We provide footnote disclosure in our audited consolidated financial statements with respect to the fair value of our consolidated loans.
5. There is no upfront monetization of future cash flows as a result of our balance sheet financing CLOs. Like all loan originators, we make a customary loan origination fee at closing that is paid by the loan borrower which is unrelated to whether or not the loan is ever financed or securitized. We are not mortgage bankers whose profits and compensation depend on loan origination fees. Our profits primarily come from owning a diversified portfolio of well underwritten middle market loans on a leveraged basis.

Fund Balance Sheet Financing CLOs

Privately placed middle market loan Funds provide a significant amount of capital to the middle market and to small and medium size businesses. Institutional investors in these Funds include insurance companies, endowments, government and private pension funds, other private funds and business development companies who want exposure to middle market loans that are well

underwritten by experienced middle market loan originators and these middle market loans have performed well during the downturn.¹⁵ These loans provide attractive risk adjusted returns to such institutional investors.

Some of us (directly or through an affiliate) act as registered investment advisers for third party institutional investors who want exposure to middle market loans but who do not have the staff or infrastructure to originate and manage middle market loans. Typically we act as investment advisers for such institutional investors either through separate account arrangements or through privately placed middle market loan Funds.

Third party institutional investors in these Funds are investing in middle market loan funds, not in CLOs. They each receive appropriate securities law disclosure regarding their prospective investment in the Fund, typically including an offering memorandum describing the investment strategy of the Fund to invest in middle market loans on a leveraged basis and material risks attendant thereto.

These Funds are financed with lines of credit provided primarily by banks and less frequently by commercial paper conduits, which lines of credit are repaid using proceeds of a CLO issuance. The Funds and their institutional investors prefer using CLOs for match funded financing of their portfolios for the reasons specified earlier in this letter¹⁶ and since (a) managed CLOs provide the equity with attractive returns, (b) CLOs have structural features that provide significant protection to the CLO debt and equity¹⁷, and (c) CLO equity is also protected by its option to cause a redemption or refinancing of the CLO debt any time after a non-call period of typically two years.

Institutional investors are willing to invest in Funds with experienced middle market loan originators whose interests are aligned through a variety of different mechanisms that (a) may include (i) the loan originator holding a minority equity investment in the Fund and, through it, in its CLO subsidiary, (ii) a subordinate management fee paid after the CLO debt in the priorities of payment and in many cases an incentive fee which the loan originator in its role as investment manager will not receive unless the equity investors have received back all of their capital and a specified return or (iii) an agreement, in some cases by the loan originator to retain an equal or greater portion of each loan sold into the Fund or its CLO subsidiary and (b) in each such case include the fiduciary duty of the loan originator's affiliated registered investment adviser to the Fund and to its CLO subsidiary.

Such Funds are sponsors and securitizers of their balance sheet financing CLOs since they initiate these securitization transactions by selling or transferring their assets, directly or indirectly through an affiliate, to the CLO issuers which are subsidiaries of the respective Funds

¹⁵ See Endnote 4.

¹⁶ See the section titled "Middle Market CLOs Provide Attractive Long Term Financing and Performed Well During the Financial Crisis".

¹⁷ See Endnote 7 and Appendix B.

consolidated on the respective Fund's balance sheet. These Funds hold funded first loss subordinated credit risk CLO securities in all of their balance sheet financing CLOs

CLO Characteristics

Debt securities for balance sheet financing CLOs are privately placed almost exclusively to institutional investors, typically through the Rule 144A market in the U.S. or relying on Regulation S for sales to non-U.S. investors. Domestic investors are typically required to be qualified institutional buyers or institutional accredited investors that are also qualified purchasers.

Middle market CLOs typically have a capital structures with first loss credit risk securities retained by the sponsor representing over 14% of the capital structure at closing.¹⁸ In CLOs, credit risk retention is fully funded at closing by the CLO sponsor making a capital contribution to its CLO subsidiary in an amount equal to the value of the initial collateral transferred by the CLO sponsor to its CLO subsidiary that exceeds the cash purchase price of such initial collateral, which cash purchase price is sized in an amount sufficient to repay that portion of the line of credit that financed initial collateral prior to CLO issuance. This funded capital contribution is represented by the first loss credit risk CLO securities retained directly or indirectly by the CLO sponsor.

The overcollateralization provided by the CLO issuer's portfolio compared to its debt and, as a result, the percentage of the capital structure represented by the CLO equity, typically increases over the life of the CLO due to management of the portfolio and structural features in the transactions even though the equity receives cash distributions throughout the life of the CLO absent diversion of such cash flow to pay down the CLO debt as discussed below under "CLO Structural Features Protect Investors".¹⁹

Most CLO debt securities are floating rate securities indexed to LIBOR and are supported by the primarily floating rate loans indexed to LIBOR owned by the CLO issuer.

Middle market CLOs do not sell interest only securities or otherwise monetize future expected portfolio cash flows in connection with the issuance of their securities.

CLOs are managed vehicles that build overcollateralization during lengthy reinvestment periods during which no or very limited amortization occurs with respect to the CLO debt.

CLOs are not static pool securitizations. They are managed vehicles. A CLO permits the acquisition and sale of assets within the restrictions of the transaction documents including requirements that the CLO portfolio satisfy specified portfolio concentration limitations and collateral quality tests. At closing, the CLO issuer's initial loan portfolio is typically 50% or more ramped; the CLO issuer has a 3 to 9 month period after closing to invest the remaining net

¹⁸ See Endnote 6.

¹⁹ See Endnote 8.

cash proceeds from the sale of its CLO securities to complete its ramp up. After completion of ramp up, the CLO issuer typically has a 3 to 4 year reinvestment period during which it reinvests all principal proceeds it receives from scheduled and unscheduled prepayments on the loans it owns and from sales proceeds of credit improved, credit impaired and defaulted loans, as well as sales proceeds from permitted discretionary trading of approximately 25%-30% of its portfolio each year during the reinvestment period. At the end of the reinvestment period, the CLO issuer is required to start to amortize the CLO debt, although it is typically permitted to continue reinvesting unscheduled principal proceeds and sales proceeds from sales of credit impaired and, sometimes, credit improved loans. Within this framework, significant reinvestment activity takes place, particularly since middle market loans have significant repayment rates that vary year by year depending on the economic and interest rate environments.²⁰

The portfolio management and reinvestment features of cash flow CLOs provide numerous benefits. The CLO collateral manager (who is either the sponsor of the CLO or an affiliate thereof) can sell loans that are in default or that it expects to go into default. For Funds who sponsor CLOs, the reinvestment feature gives the institutional investors in the Fund a reasonable expectation that their capital will remain invested in middle market loans throughout the reinvestment period and, because of the cash flow nature of the CLO, there is no mark to market risk in the financing provided by the CLO. Most importantly, because long term cash flow balance sheet financing CLOs may reinvest in accordance with their transaction documents, these CLOs are able to acquire additional middle market Loans that have been made to small and medium size businesses when other sources of capital are not available to them. These CLOs reduce middle market loan volatility and give their equity holders the ability to efficiently invest in and leverage middle market loan portfolios.

As a result of this management, unlike other types of securitizations, CLOs typically increase the amount of their overcollateralization during the reinvestment period.²¹ Gains earned by the CLO inure to the benefit of the CLO equity (subject to the priority of payments), increase the amount of collateral in the CLO and increase the equity cushion supporting the CLO debt. Sales proceeds from the CLO collateral, including gains from sales, remain in the transaction as principal proceeds and are not distributed to the equity until the CLO debt is repaid in full (as more fully described in the discussion regarding principal waterfall priority of payment provisions in the "CLO Structural Features Protect Investors" section below).

CLO Structural Features Protect Investors.

CLOs include a number of structural features in their transaction documents that provide significant protection to the institutional investors in these transactions which, together with the robust credit underwriting, due diligence and portfolio management standards used by the collateral manager for the middle market loans in which the CLO is permitted to invest, is one of

²⁰ See Endnote 3.

²¹ See Endnote 8.

the reasons why CLOs performed so well during the recent economic downturn and continue to perform well.²²

Middle market CLOs are permitted to invest in a specified universe of eligible assets including predominantly senior secured middle market commercial loans but also including small “buckets” (expressed as a percentage of the target CLO portfolio) of first in/last out loans, second lien loans, unsecured loans, revolving and delayed draw loans and bonds, as well as servicing assets. CLOs also have concentration limitations and collateral quality tests applicable to, among other things, portfolio diversity including type of loan and industry, obligor and unrated or lower rated assets.²³

If a CLO is unable to successfully complete its ramp up, the collateral manager must invest in additional loans or the CLO debt must be repaid and the transaction de-levered (with no cash distributions to the equity) until ratings confirmation of the CLO debt is obtained. Very few CLOs fail to meet ramp up.

During the reinvestment period, the collateral manager is permitted to reinvest principal proceeds and sales proceeds received within a specified time period and subject to specified investment criteria including the CLO’s concentration limits and collateral quality tests which, if not satisfied at such time, must be maintained or improved by any reinvestment.²⁴ If the collateral manager is unable to reinvest, it may elect either to pay down CLO debt or to continue to hold the cash for future reinvestment in a transaction account held by the trustee for the transaction. Collateral managers typically do reinvest such proceeds.

CLOs track interest collections and principal collections separately, and make payments to the holders of the CLO securities under two separate waterfalls, an interest waterfall and a principal waterfall, in accordance with a contractually specified priority of payments.²⁵ The equity holders (together with the subordinate management fee and the incentive fee, if any, payable to the collateral manager) get paid out at the bottom of each of the interest waterfall and the principal waterfall after all other holders of the CLO debt securities, any hedge counterparties²⁶ and all service providers are paid what they are then due. Interest proceeds received from the CLO’s assets are paid out currently in a CLO although principal and sale proceeds are typically reinvested during the reinvestment period. Once the CLO amortization period commences at the end of the reinvestment period, principal and sales proceeds that may not be reinvested flowing through the principal waterfall and are used first to pay all CLO debt sequentially by class in full prior to any payment to the CLO equity.

²² See Endnote 5.

²³ See Endnote 7.

²⁴ See Endnote 7.

²⁵ See Appendix B.

²⁶ Most middle market CLOs do not hedge since typically all assets in the CLO are paid in U.S. dollars and a small percentage of the assets or liabilities of the CLO are fixed rate.

Throughout the life of the CLO, the CLO is subject to overcollateralization tests and interest coverage tests that are sized by classes of rated CLO debt which, if not met, divert interest that could otherwise flow through to the CLO equity (and more junior classes of CLO debt, as well as subordinate management fees, incentive management fees (if earned) and other subordinated expenses of the CLO) and, if necessary, principal, to pay down the CLO debt sequentially based on the priority of the classes of debt until these tests are back in compliance. The value of defaulted loans, loans that exceed certain concentration limitations and certain loans that have deviated beyond the CLO's modeled structural parameters are significantly discounted for purposes of calculating these tests which become more sensitive to diverting cash flow to pay down CLO debt to the extent loans are not performing, the loan portfolio experiences negative loan level ratings migration or the loan portfolio is outside of its structural parameters. Because of these features, CLOs "self-correct" for deterioration in the credit quality of the underlying loans and deviation from certain of structural parameters and consequently very few CLOs experience events of default.²⁷

Our CLOs that are clients under the Advisers Act are managed by registered investment advisers, either by us or one of our affiliates. If the CLO is a Fund sponsored CLO, the Fund is managed by the same registered investment adviser. As noted by the Loan Syndication and Trading Association ("LSTA") in their August 1, 2011 comments, registered investment advisers are registered with the SEC under the Advisers Act and are subject to recordkeeping, disclosure, supervision, Code of Ethics and other regulatory requirements applicable to SEC-registered investment advisers, as well as to SEC examinations and oversight. Moreover, under the Advisers Act and general fiduciary principles, they have duties (i) to act in the best interests of their clients and to provide investment advice in their clients' best interests, (ii) of undivided loyalty and utmost good faith, (iii) to eliminate or disclose all conflicts of interest, (iv) to provide full disclosure of all material facts to their clients and prospective clients and to present those disclosures in a fair manner and (v) to comply with Advisers Act restrictions with respect to principal trades and cross trades. With respect to principal trades or agency cross trades, the collateral manager of the CLO must obtain approval from its client, generally by means of an independent party designated by the CLO issuer to act on its behalf, with respect to the transaction (including price and other relevant terms) prior to settlement of any such trade. With respect to cross trades from one client managed by the collateral manager or its affiliates to another such client (without commission or other compensation being made to the collateral manager or its affiliates in connection therewith), the terms must be fair to both clients and at a price that represents fair value, if no market price is available.

All of these features provide meaningful and sufficient protection for CLO investors and have withstood the test of time, market volatility and dramatic changes in market conditions, including the financial crisis.

²⁷ See Endnotes 7 and 8.

Comments on the Dodd Frank Risk Retention Reproposal.

1. Cash Distribution Restriction on Eligible Horizontal Residual Interest (Which is the Standard Risk Retention in the CLO Market) Cannot be Satisfied by any CLO and Must Be Eliminated.

Equity holders in CLOs fund their fully subordinated first loss credit risk retention CLO securities at closing. In a balance sheet financing CLO, the equity investor contributes capital to the CLO issuer in an amount equal to the value of the loans transferred to the CLO issuer in excess of the cash sales price of such loans as described above under “CLO Characteristics”.

Balance sheet financing CLOs are structured with the sponsor directly or, indirectly through an affiliate, owning eligible horizontal residual interests as defined in the Reproposal. Due to the operation of the priorities of payment in the CLO interest waterfall and principal waterfall, “on any payment date on which the issuing entity [the CLO issuer] has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts paid to the eligible horizontal residual interest prior to any reduction in the amounts paid to any other ABS interest . . . ; and . . . that has the most subordinated claim to payments of both principal and interest by the issuing entity.”²⁸ As noted by the agencies in the Reproposal, “the horizontal form of standard risk retention essentially creates a fully subordinated equity tranche and represents the option that is most exposed to credit risk.”²⁹ Balance sheet financing CLOs as currently structured provide this type of risk retention, which is the best type of risk retention.

Unfortunately, in the Reproposal the agencies added a new proposed restriction on projected cash flows to be paid to the holders of the eligible horizontal residual interest which would not allow the holder of the horizontal risk retention to receive cash at a faster rate than the rate at which principal is projected to be paid to investors in all ABS interests issued in the securitization or, in a possible alternative, at a rate faster than the rate at which all payments are paid to such investors based on projections made by the sponsor at the issuance of the ABS interests.³⁰ The impetus for this appears to be concerns on the part of the agencies that without such a restriction, cash flow could be paid to the equity and not be available to provide protection for the CLO debt, that if the equity receives too much cash too early, it will lose its “skin in the game”, and that not all ABS transactions distinguish interest proceeds from principal proceeds and between principal losses and other losses. However, in a CLO, (i) interest proceeds are monitored, held and distributed separately from principal proceeds and paid out last to the equity

²⁸ Credit Risk Retention, 78 Fed. Reg. 57928, 58025-26 (proposed September 20, 2013) (defining eligible horizontal residual interest).

²⁹ Credit Risk Retention, 78 Fed. Reg. 57928, 58012 (proposed September 20, 2013).

³⁰ Credit Risk Retention, 78 Fed. Reg. 57928, 57938, 57928, 57941-42 (proposed September 20, 2013) (requesting comments regarding the Alternative Eligible Horizontal Residual Interest Proposal).

under separate waterfalls, (ii) losses fall on the equity before affecting any class of CLO debt and (iii) structural features including the priorities of payment and the overcollateralization and interest coverage tests which divert cash to pay down CLO debt if these tests are not satisfied provide significant, meaningful and sufficient protection for the CLO debt holders without the need for cash restrictions on distributions to the equity. Most importantly, as discussed earlier, the CLOs are not static pools and CLO equity is funded subordination at closing, typically the equity retained grows over time as overcollateralization grows in the CLO thus increasing the equity's "skin in the game" even though excess spread from interest proceeds is paid out currently to the equity.

Due to the reinvestment period in a CLO, no balance sheet financing CLO horizontal risk retention could qualify as an eligible horizontal residual interest notwithstanding the sponsor's funding of fully subordinate credit risk retention securities in excess of the amount required under Section __.4(b)(1) of the Reproposal, which horizontal risk retention is the customary risk retention in the CLO market and otherwise meets the definition of an eligible horizontal residual interest. This affects all balance sheet financing CLOs. Due to the reinvestment period in a CLO, a sponsor of a CLO cannot make the certification required by Reproposal Section __.4(b)(2)(ii) 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". Moreover, due to the complete subordination of interest cash flows and of principal cash flows payable to the holders of the horizontal residual interest under the separate interest and principal waterfalls and priorities of payments and the diversion of cash otherwise payable to the holders of the eligible horizontal residual interest to the mandatory prepayment of the more senior CLO debt if the overcollateralization or interest coverage tests are not met, there is no need for any further restriction on payments to the holders of an eligible horizontal residual interest in a CLO.

Sponsoring equity holders in balance sheet financing CLOs, whether middle market loan originators or third party institutional investors investing through Funds, require that excess interest spread be paid to them currently pursuant to the interest waterfall priority of payments. These CLOs will not be done if such excess spread cannot be currently paid or if it is paid at a reduced rate. Institutions providing the equity in CLOs will not do so unless they can receive an appropriate current return for the risk they are taking in the first loss position of the CLO for a number of years. For balance sheet CLOs that require a significant equity cushion in order to sell the CLO debt securities, vertical or L shaped credit risk retention is not an option.

We also do not understand how this feature in the Reproposal furthers the goal of Dodd Frank risk retention since cash that the equity cannot take out of the CLO issuer presumably will remain in the CLO issuer, continue to increase the overcollateralization and provide additional credit enhancement over and above the credit risk retention required by Dodd Frank under circumstances which have nothing to do with promoting sound underwriting of the loans going into the CLO.

Middle market loan originators who issue balance sheet financing CLOs need the excess spread from their portfolios to provide working capital needed to appropriately staff their organization to originate loans for reinvestment, appropriately manage the CLO collateral and to perform all

other duties required under the terms of the CLO. All of these actions benefit CLO note holders and our business models are not sustainable without it. If we and others like us are shut out of the CLO market, it will severely limit our ability to extend loans and materially reduce capital for small and medium size businesses. This in turn will significantly reduce employment provided by these small and middle size businesses that depend on middle market loans for their businesses and will also reduce the employment we provide to our own employees.

To add to the economic injuries that would be imposed by the cash distribution restriction, it will also result in adverse tax consequences to the equity in CLOs. Balance sheet financing CLOs are typically structured such that the equity holders are responsible for the taxes on the income of the CLO. Thus, if cash distributions to the CLO equity holders are not permitted, the CLO sponsor (or its equity holders depending on the CLO sponsor's tax structure) will be required to pay taxes currently on the taxable income earned by the CLO but will not have received cash distributions during the restricted period to pay such taxes.

CLOs will not be economically feasible if credit risk retention requires the certification required by Section __.4(b)(2)(ii) of the Reproposal or includes any restriction on cash distributions to equity investors whose equity otherwise qualifies as an eligible horizontal residual interest limiting such cash distributions to an amount proportionate to the amount of principal or principal and interest projected to be paid to all ABS interests issued in the CLO securitization transaction.

We respectfully request and strongly urge that such certification and any such restriction on cash distributions to equity investors whose equity otherwise qualifies as an eligible horizontal residual interest be removed from the final Dodd-Frank Act credit risk retention regulations, at least as they relate to balance sheet financing CLOs in which the sponsor retains a horizontal residual interest that otherwise meets the requirements of the Reproposal.

Middle market CLOs currently provide more than \$20 billion of capital to middle market borrowers³¹. This aspect of the Reproposal will significantly restrict the amount of capital available in the U.S. economy to lend to small and medium sized businesses and diminish economic growth and employment that is or could be provided by such businesses.

2. We support the requirement of credit risk retention.

We support requiring credit risk retention for balance sheet financing CLOs in an amount not to exceed 5% of fair value of all of the ABS interests in the issuing entity issued as part of the securitization transaction, determined in accordance with GAAP as of the day on which the price of the ABS interests to be sold to third parties is determined.

³¹ See Endnote 2.

3. We share certain concerns raised in the Structured Finance Industry Group comment letter submitted with respect to the Reproposal (“SFIG Comment Letter”)

We share the concerns raised in that portion of the SFIG Comment Letter entitled “Concerns with the Re-Proposal’s Requirements for Eligible Horizontal Residual Interest which are similar to our concerns with this requirement addressed above.

We agree with that portion of the SFIG Comment Letter entitled “Grandfathering of Legacy CLOs that Permit Issuances of Additional Notes or Refinancings/Re-Pricings after the Effectiveness of the Final Rule Without Complying with Risk Retention”. We also respectfully request that the final rule should include an unequivocal grandfathering for legacy CLOs (including those with options for additional notes, refinancing or re-pricings) without being required to comply with any otherwise applicable risk retention requirements.

Conclusion

A primary goal of the agencies is to ensure meaningful risk retention in a manner customary for the related ABS market so as to minimize the effect of the credit risk retention requirements to the access of consumers and businesses to credit on reasonable terms. We support that goal. With respect to middle market balance sheet financing CLOs with sponsors who customarily hold the credit risk in these CLOs and expect to provide credit risk retention under the Dodd-Frank Act, it is best achieved by eliminating any regulatory requirement or restriction on cash distributions to horizontal residual interests held by such sponsors in such CLOs that otherwise meets the requirements of a horizontal residual interest.

We appreciate the agencies’ consideration of these comments and would be pleased to provide additional information or assessments that might assist the agencies’ decision making. Please feel free to contact Cynthia J. Williams of Dechert LLP at (617) 654-8604 if you have questions regarding these observations and proposals.

Sincerely,

NEWSTAR FINANCIAL, INC.

By: 
Name: John Bray
Title: Chief Financial Officer

NewStar Financial, Inc.
500 Boylston Street, Suite 1200
Boston, MA 02116

Sincerely,

NXT CAPITAL, LLC

By: 

Name: Neil Rudd

Title: Chief Financial Officer

NXT CAPITAL INVESTMENT ADVISERS, LLC

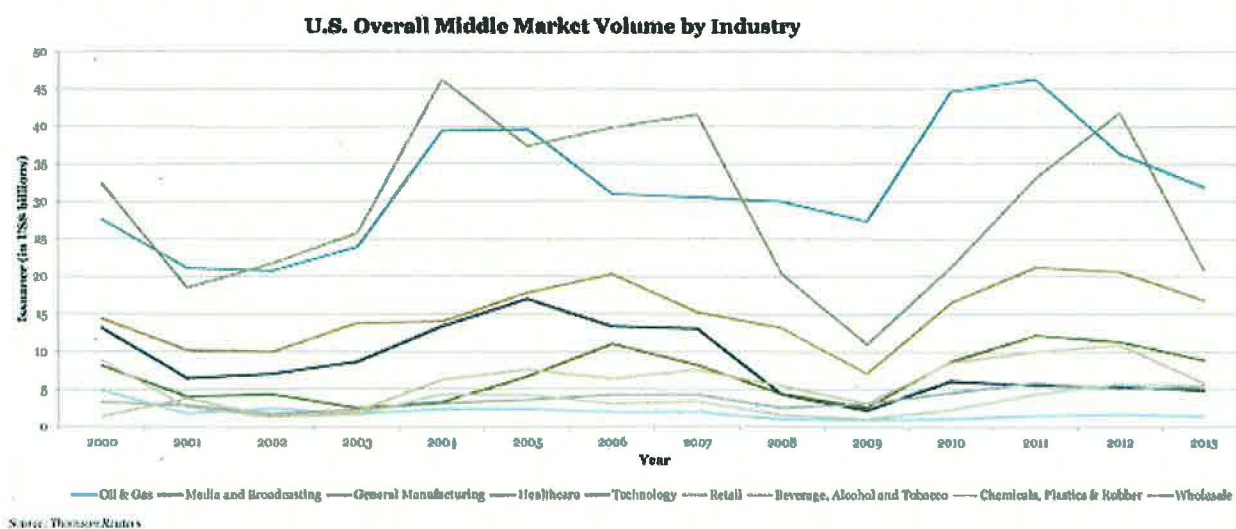
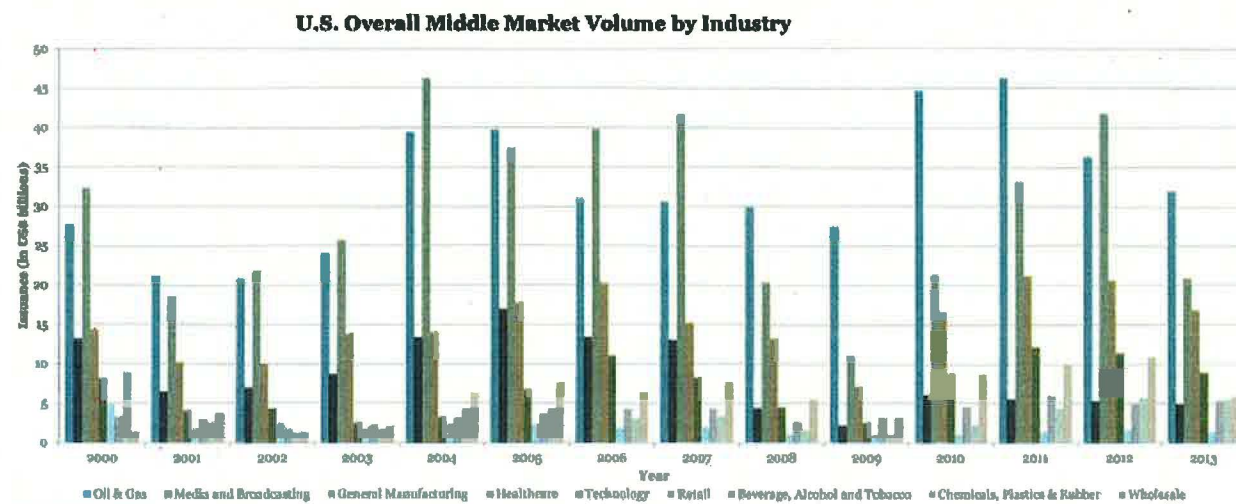
By: 

Name: Neil Rudd

Title: Chief Financial Officer and Treasurer

NXT Capital, LLC
NXT Capital Investment Advisers, LLC
Suite 1200
191 North Wacker Drive
Chicago, IL 60606

Endnote 1:



Source: Thomson Reuters

Endnote 2

MM CLO: 67 Deals / \$19.6B

	#	WARF	Curr Bal (\$mm)	% Cash	% Def.	% B3	% Caa1 - Ca	# Deals Fail IC	# Deals Fail OC	# Deals Fail Sr OC
2001	1	8,014	126	8.8%	62.4%	0.0%	28.8%	0	0	0
2002	1	5,864	26	16.5%	37.5%	9.7%	27.5%	0	0	0
2003	1	6,323	100	0.8%	40.7%	6.5%	30.7%	0	0	0
2004	3	4,909	288	13.7%	22.6%	8.0%	20.9%	0	0	0
2005	6	3,185	565	5.7%	18.9%	7.2%	9.6%	0	1	0
2006	16	3,281	3,582	1.9%	3.4%	14.0%	9.2%	0	0	0
2007	16	2,754	7,246	4.3%	2.2%	17.9%	6.2%	0	0	0
2008	1	2,562	339	3.1%	1.8%	14.1%	5.0%	0	0	0
2010	1	3,335	350	0.4%	1.5%	55.6%	15.9%	0	0	0
2011	3	2,227	944	15.1%	0.2%	7.5%	5.7%	0	0	0
2012	13	2,589	4,431	8.6%	0.2%	10.5%	7.0%	0	0	0
2013	5	2,142	1,640	4.7%	0.0%	2.1%	3.2%	0	0	0
	67	2,862	19,636	5.7%	2.5%	13.7%	7.2%	0	1	0

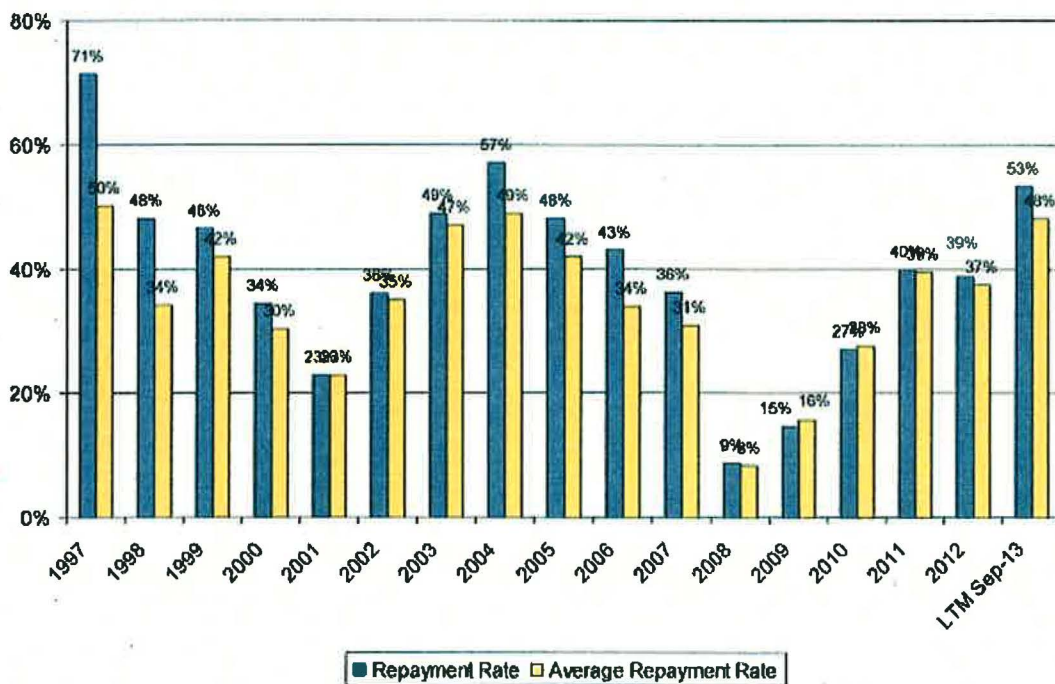
"WARF", "% Assets B3" and "% Caa1-Ca" calculations only include Moody's rated assets.

as of 9/24/2013

Source: Intex, Wells Fargo Securities, LLC

Endnote 3: Leveraged Loan Repayment Rates

S&P/LSTA Leveraged Loan Index Repayment Rates by Year



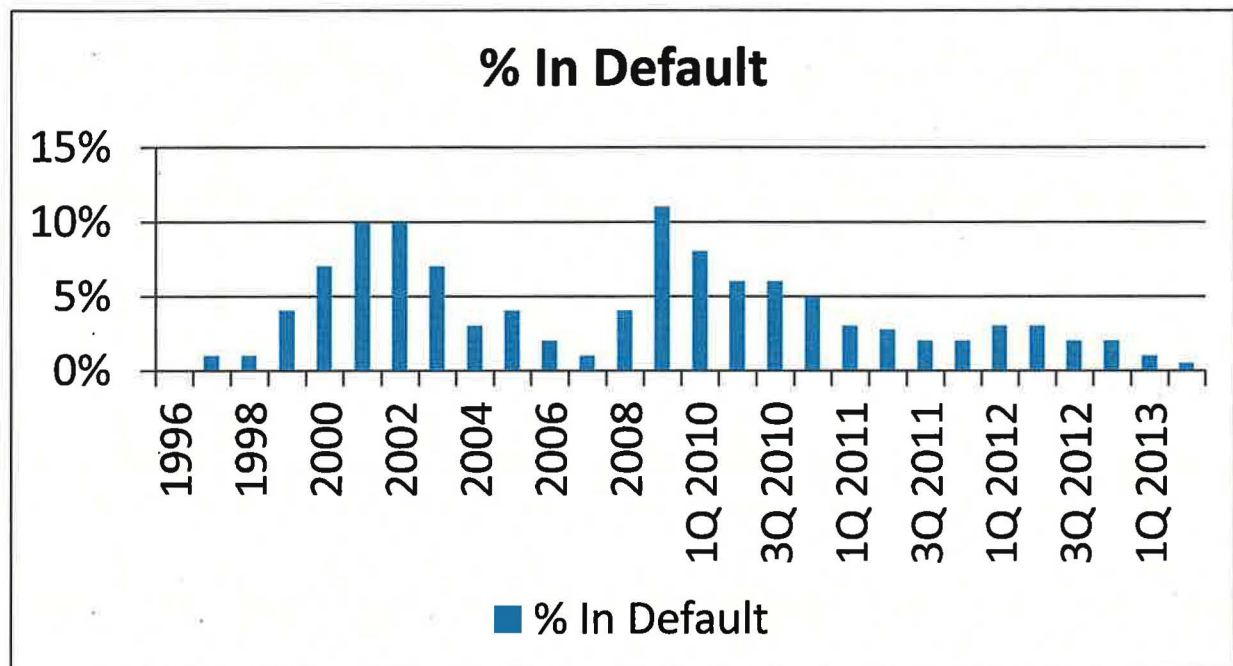
Copyright© 2013 by Standard & Poor's Financial Services LLC (S&P) a subsidiary of The McGraw-Hill Companies, Inc.



Source: S&P LSTA Index Report, September 13, 2013, p. 42.

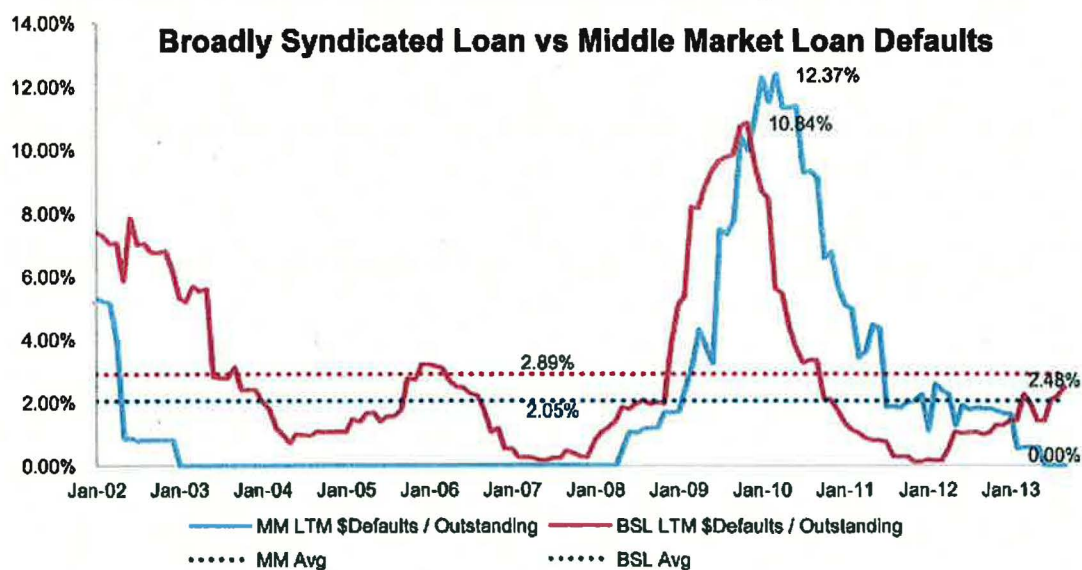
Endnote 4: Percent of Outstanding Leveraged Loans in Default or Bankruptcy

As of June, 2013 less than 1% of all leveraged loans outstanding were in default or bankruptcy.



Source: Extracts from S&P Capital IQ June, 2013, p. 197. Includes all loans including those not included in the LSTA/LPC mark-to-market service; includes predominately broadly syndicated loans since that market is substantially larger than the middle market.

Source: Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index.

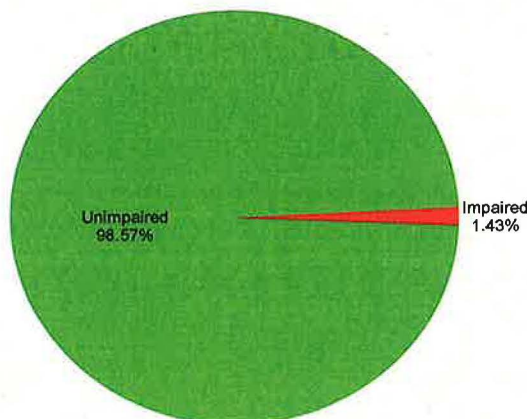


Source: S&P/LSTA Leveraged Loan Index

Endnote 5: CLO Debt Securities have suffered few Losses

Performance: CLO note impairments have been all but non-existent

Cumulative impairment rate from Jan 1996 to May 2012



- Over the course of 17 years, the cumulative impairment rate of CLOs has been de minimus – less than 1.5% in that entire time span
- Losses will be lower than impairments, because impairments can include market value EOD, distressed exchanges, etc., in addition to realized losses

Source: Moody's Investors Service

11



Source: LSTA October 17, 2013 Annual Meeting Presentation

CLOs performed well during the downturn.

“CLOs are virtually unique among pre-crisis structured products, in that their soundness was demonstrated during and after the 2008 financial crisis. The overwhelming majority of pre-crisis CLO tranches have returned to their original credit ratings, and no AAA or AA rated tranche has yet suffered a credit loss. With the model proven, investors across the risk spectrum have returned to the product, facilitating a 203% CAGR in new CLO issuance over the past eight quarters. With this growth has come a reasonably well-defined standard structure, often called CLO 2.0, that in many ways is even safer than the pre-crisis CLOs that successfully navigated the downturn. With investors of all types seeking alternatives to duration exposure, the floating-rate nature of most CLO securities (and the collateral that supports them) is well suited to today's investment environment.”

Source: Barclays Credit Research, "U.S. Credit Focus," June 28, 2013, p. 1

Exhibit 12: Middle-Market CLO Ratings Performance

Moody's Summary					S&P Summary				
	Tr. #	Higher	Same	Lower		Tr. #	Higher	Same	Lower
Aaa	69	--	93%	7%	AAA	76	--	76%	24%
Aa1	5	80%	20%	0%	AA+	2	0%	100%	0%
Aa2	37	59%	30%	11%	AA	43	44%	49%	7%
Aa3	1	100%	0%	0%	AA-	0	0%	0%	0%
A1	0				A+	1	0%	100%	0%
A2	38	50%	29%	21%	A	44	34%	45%	20%
A3	0				A-	0			
Baa1	2	50%	0%	50%	BBB+	1	0%	100%	0%
Baa2	39	33%	23%	44%	BBB	45	29%	40%	31%
Baa3	3	33%	0%	67%	BBB-	5	20%	40%	40%
Ba1	1	0%	100%	0%	BB+	0			
Ba2	33	30%	33%	36%	BB	38	18%	42%	39%
Ba3	0				BB-	0			

U.S. MM CLOs currently outstanding, per Intex
as of 8/15/2013

Source: Bloomberg, S&P, Moody's, Wells Fargo Securities, LLC

Exhibit 13: Middle-Market CLO Ratings Transition

MOODY'S CURRENT RATING (as of 8/15/2013)								
ORIG	Aaa	Aa2	A2	Baa2	Ba2	B2	Caa2	Ca-C
Aaa	93%	4%	3%	0%	0%	0%	0%	0%
Aa2	47%	51%	2%	0%	0%	0%	0%	0%
A2	18%	16%	61%	5%	0%	0%	0%	0%
Baa2	0%	11%	11%	55%	23%	0%	0%	0%
Ba2	0%	0%	3%	15%	68%	9%	6%	0%

S&P CURRENT RATING (as of 8/15/2013)								
ORIG	AAA	AA	A	BBB	BB	B	CCC	CC
AAA	76%	24%	0%	0%	0%	0%	0%	0%
AA	18%	78%	4%	0%	0%	0%	0%	0%
A	2%	20%	69%	7%	0%	2%	0%	0%
BBB	0%	4%	6%	69%	12%	6%	4%	0%
BB	0%	0%	0%	11%	61%	13%	16%	0%

U.S. MM CLOs currently outstanding, per Intex

Source: Bloomberg, S&P, Moody's, Wells Fargo Securities, LLC

Source: Wells Fargo, The CLO Salmagundi: Middle Market CLO Update, August 20, 2013, p. 10

Endnote 6: Middle Market CLO Equity

2013 MM CLOs	Average	
AAA	57.12%	
AA	9.59%	
A	8.58%	
BBB	3.37%	
BB	5.29%	} 21.34%
B	0.97%	
EQUITY	15.09%	

Source: S&P LCD CLO Databank on September 25, 2013

Exhibit 2 illustrates the structure of the average 2012–2013 middle-market CLO compared to the average BSL CLO 2.0. The AAA tranche is a smaller portion of the structure in middle-market CLOs. On average, middle-market CLOs are 5x–7x levered compared to 10x leverage in BSL CLOs. We note that the single-B tranche has become more popular in BSL CLOs as asset spreads have tightened and equity investors have looked for more leverage; almost 70% of U.S. BSL CLOs issued since the end of April 2013 have utilized a single-B tranche. Individual middle-market CLOs vary more from the average structure.

Exhibit 2: Average 2.0 Middle-Market CLO and BSL CLO Structures

2012–2013 CLO Median Structure		
	MM CLO	BSL CLO
AAA	56.3%	61.3%
AA	8.1%	11.0%
A	7.8%	7.4%
BBB	4.8%	4.8%
BB	4.9%	4.3%
EQ	14.2%	10.0%

Source: Moody's, S&P, Wells Fargo Securities, LLC

Source: Wells Fargo, The CLO Salmagundi: Middle Market CLO Update, August 20, 2013, p.4

Endnote 7: CLO Structural Features Provide Significant Protection to CLO Securityholders

Please note that these charts refer to indicative capital structures, collateral portfolio concentration limits and collateral quality tests relating to CLOs of broadly syndicated commercial loans. Middle market CLOs have similar, although somewhat more conservative, features.

No CLOs were closed between mid-2008 and March 2010. CLO 1.0 in the charts below refers to CLOs that closed prior to 2009 and CLO 2.0 refers to CLOs that closed starting in 2010.

Indicative Capital Structure of Pre-Crisis (1.0) and Post-Crisis (2.0) CLOs

Class of Notes	CLO 1.0 % of Notional	CLO 1.0 OC Ratio at Issuance	CLO 1.0 Rating (S&P/ Moodys)	CLO 2.0 % of Notional	CLO 2.0 OC Ratio at Issuance	CLO 2.0 Rating (S&P/ Moodys)
A	72%	129%	AAA/Aaa	61%	140%	AAA/Aaa
B	7%	121%	AA/Aa2	11.5%	128%	AA/Aa2
C	5%	116%	A/A2	7.5%	120%	A/A2
D	5%	111%	BBB/Baa2	5%	115%	BBB/Baa2
E	3%	108%	BB/Ba2	5%	110%	BB/Ba2
Equity	8%	NAP	NR/NR	10%	NAP	NR/NR

Note: For illustrative purposes only.

Source: Barclays Credit Research, "U.S. Credit Focus," June 28, 2013, p. 2

Typical CLO 2.0 Collateral Portfolio Concentration Limits

Collateral Type	% of Total Collateral
First lien Senior Loans	At least 90% of total portfolio
Mezzanine/Unsecured Loans or Bonds	No more than 10% of total portfolio
CCC Rated Obligations	No more than 7.5% of total portfolio
Participations	No more than 20% of total portfolio

Structured Finance Securities	None allowed
Synthetic Securities	None allowed
Fixed Rate Obligations	No more than 7.5% of total portfolio
Any Single Obligor	Nor more than 2% of total portfolio
Any Single Industry	No more than 10% of total portfolio
Covenant-Lite Loans	No more than 50% of total portfolio
DIP Loans	No more than 7.5% of total portfolio

Source: Barclays Credit Research, "U.S. Credit Focus", June 28, 2013, p. 3

Pre- and Post-Crisis CLO Collateral Quality Test Limits

Collateral Quality Test	CLO 1.0 (Pre-2008)	CLO 2.0 (2010 to Present)
Minimum Weighted Average Spread (WAS)	2.5% – 3.5%	4% - 4.5%
Minimum Weighted Average Recovery Rate (WARR)	45% – 50%	43% - 45%
Maximum Weighted Average Life (WAL)	10 years	8 years
Minimum Diversity Score (DS)	55 - 75	45 - 60

Source: Barclays Credit Research, "U.S. Credit Focus," June 28, 2013, p. 4.

Endnote 8: CLO Equity and Overcollateralization Increase over Time

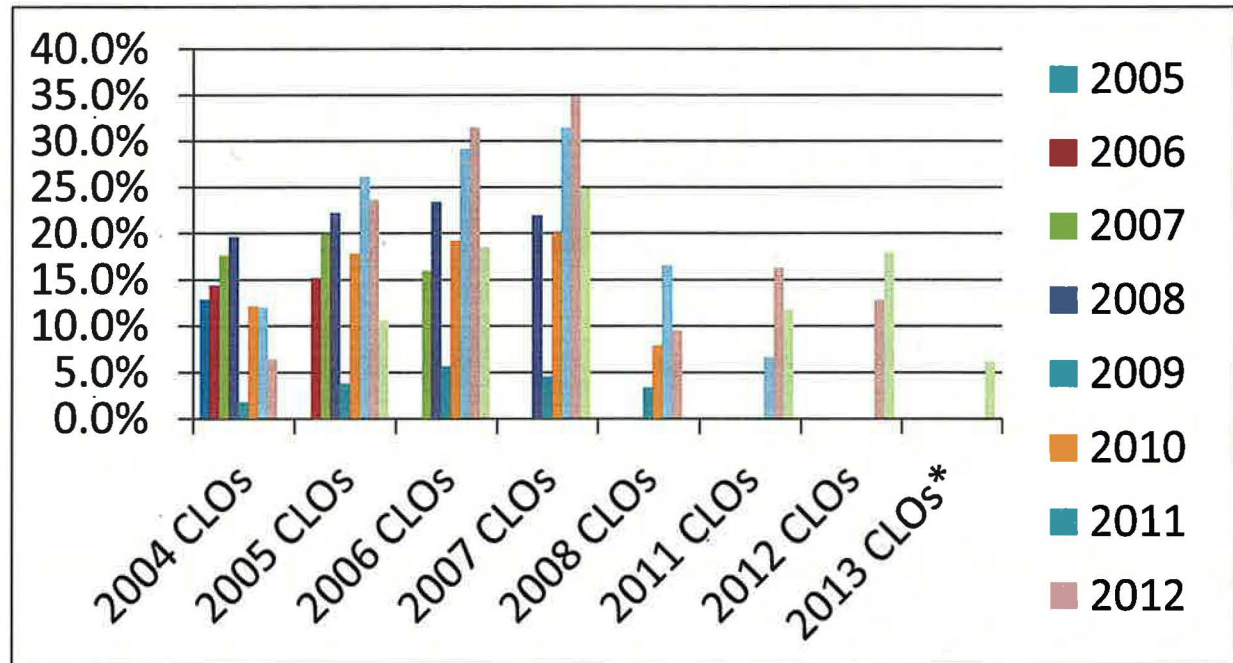
Failure to satisfy a CLO overcollateralization ("OC") ratio or CLO interest coverage ("IC") ratio prevents cash from being distributed to the equity when the performance of the CLO portfolio is deteriorating below tested levels. An OC ratio is the percentage obtained by dividing an adjusted outstanding principal balance of the CLO assets (haircut for deteriorating assets) by the outstanding balance of the CLO debt. The numerator excludes defaulted assets after three years (prior to that time defaulted assets are included at a haircut based on a recovery rate percentage value) and that portion of obligations rated below a specified level (typically CCC+/Caa1 or below) in excess of the permitted concentration limit for such obligations. The numerator may also exclude or haircut obligations that are deferring interest (other than permitted PIK obligations that currently pay cash interest at a specified minimum percentage), obligations purchased at a significant discount, obligations that mature after the stated maturity of the CLO debt securities and other types of assets that have deteriorated from the parameters on which the

transaction is structured and modeled. The denominator which is the outstanding principal balance of the CLO debt securities is increased by deferred interest thereon, if any. Currently the equity cushion in CLOs created by the OC tests is increasing.

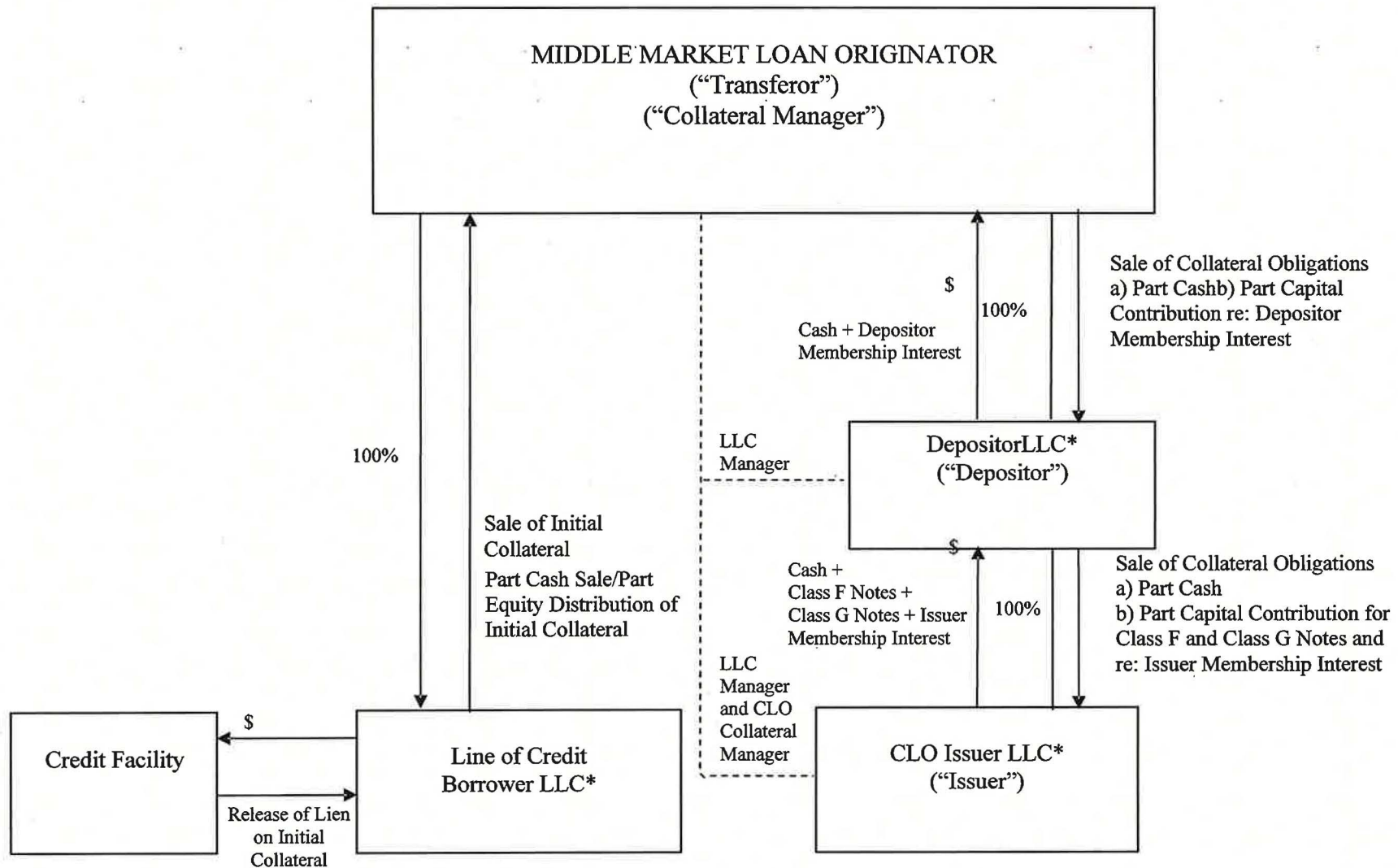
- In a study by Morgan Stanley, encompassing a surveillance universe of 425 USD denominated predominately broadly syndicated CLOs issued during 2000 through 2011,
 - Median senior OC cushions increased to 14.48% from 14.37% during the prior month.
 - Median junior OC cushions for US CLOs increased to 5.08% from 4.93% during the prior month.
 - This increase in OC cushions occurred even though the study noted that more than 80% of 2005- 2007 vintage US CLOs have received cumulative equity cash distributions more than their equity tranches' original balance (par value). *[See the chart below.]*
 - Of the 410 US CLO transactions in the Morgan Stanley sample universe, only 15 are currently failing their junior OC tests.
 - Source: Morgan Stanley Research CLO Market Tracker, September 6, 2013, pp. 9-13. Italics added.
- A recent Moody's study found that
 - Senior OC levels for CLOs in their reinvestment period have steadily increased from a low of 118% in May of 2009 to approximately 123% in January 2013.
 - Senior OC levels for CLOs in their amortization period have also increased from a low of 118% in May of 2009 to 135% in January of 2013.
 - Senior OC levels for all CLOs have increased from a low of 118% in May of 2009 to 127% in January of 2013.
 - Source: Moody's CLO Interest, May 1, 2013, page 21. Based on a sample of 189 reinvesting CLOs and 328 amortizing CLOs for a total of 517 CLOs.

Percent of Equity
 Par Amount Distributed to Equity
 by CLO Vintage
 by Year

Source: Morgan Stanley Research CLO Market Tracker September 6, 2013, pgs. 13, 14



APPENDIX A
Indicative Balance Sheet Financing
CLO Structure



*Special Purpose Bankruptcy Remote Subsidiary

APPENDIX B

Indicative CLO Priority of Payments

Priority of Payments Waterfall

