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By Electronic Submission

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

Ladies and Gentlemen:

The Loan Syndications and Trading Association ("LSTA"),[1] the Structured Finance Industry Group ("SFIG"),[2] and the Securities Industry and Financial Markets Association

[1] The LSTA, founded in 1995, is the trade association for the syndicated corporate loan market and is dedicated to advancing the interests of the market as a whole. The LSTA is active on a wide variety of activities intended to foster the development of policies and market practices designed to promote a liquid and transparent marketplace. More information about the LSTA is available at www.lsta.org.

[2] SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs.

("SIFMA")[3] are pleased to submit these comments in response to the joint Further Notice of Proposed Rulemaking, 78 Fed. Reg. 57928 ("FNPRM"),[4] concerning risk retention and the implementation of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").

At the invitation of agency staff and officials, the LSTA, SFIG, and SIFMA submit these comments to propose a further alternative approach to implementing Section 941 that is designed to meet the objectives and concerns set forth in the agencies' orders and in discussions with agency staff while also avoiding the promulgation of rules that would otherwise dramatically reduce the scope and market role of Open Market CLOs. As described below, under the proposed approach, Open Market CLOs that meet a series of criteria would qualify to satisfy the credit risk retention requirement through the Open Market CLO manager's purchase of five percent of the CLO's equity and through credit risk retained by the manager through the deeply subordinated compensation structure. The criteria are designed to protect investors and improve asset selection through loan asset and portfolio restrictions, leverage limitations, manager regulation and alignment of manager interests with investors, and transparency.

The proposed approach provides a range of protections for investors and ensures sound asset selection practices without requiring a different construction of Section 941 or a complete exemption for Open Market CLOs. At the same time, the approach provides a workable solution for most managers of Open Market CLOs while preserving the role of Open Market CLOs in ensuring credit price competition, broad access to credit markets, and varied product offerings to investors. Adoption of the proposal is well within the agencies' authority and can be implemented without seeking further comment on newly proposed rules.

I. Background.

The proposed regulatory approach set forth in this letter, like proposals previously made by the LSTA, SFIG, and SIFMA, seeks to avoid the dramatic reduction in CLOs and resulting harms to the public interest that would otherwise result from the agencies' proposed rules. As the LSTA has explained in previous letter comments, failing to adopt a workable alternative and instead requiring an Open Market CLO manager to retain five percent of the face value of the CLO's assets would cause significant harm to the market, to competition, and to the availability

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Members of SFIG represent all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. Further information can be found at www.sfindustry.org.

3 SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

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

of credit. Specifically, the LSTA has shown,[5] and numerous comments from industry participants have confirmed,[6] that requiring retention of five percent of face value of the transaction would drastically curtail CLO formation, by more than 75 percent, and effectively close a presently robust market that provides a crucial source of credit to a wide range of businesses.

This result is confirmed and elaborated by the report on CLO risk retention submitted by Oliver Wyman in response to the FNPRM. That report highlighted the significant role of CLOs in credit provision, currently representing $280 billion of credit to non-investment grade corporate borrowers (45% of the total market provision of such credit), and estimated that the imposition of the agencies' proposed risk retention rules on CLOs "would result in more than $200 BN of lost credit capacity from CLO investors."[7] That estimate was based on a conclusion that a 75 percent reduction in CLO activity was a reasonable baseline under conservative assumptions, and relaxing those assumptions was consistent with a 90 percent (or $250 billion) decline. Moreover, fully replacing that lost CLO capacity through other credit sources is unlikely, and even if possible would cost borrowers an additional $2.5 billion to $3.8 billion per year.[8] Ultimately, significant reduction in CLOs "could lead to systematically more volatile loan prices" and "could inadvertently reduce the ecological diversity of the financial system, decreasing its ultimate resilience."[9] To avoid these drastic results, the LSTA urges the agencies to adopt a workable alternative that will enable the continued operation of the CLO market and maintain the market and public interest benefits associated with the continued availability of this important source of credit.

The current proposal for CLO risk retention, like the LSTA's previous proposals, applies only to the unique class of ABS known as Open Market CLOs.[10] Open Market CLOs do not

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5 *See, e.g.*, LSTA Letter Comment (July 29, 2013).

6 *See, e.g*., BlueMountain Capital Management, LLC Letter Comment (Oct. 30, 2013); Eaton Vance Corp. Letter Comment (Oct. 30, 2013); Halcyon Loan Investment Management LLC Letter Comment (Oct. 29, 2013); WestGate Horizons Advisors Letter Comment (Oct. 30, 2013); Allison Transmission Letter Comment (Oct. 30, 2013); HCR ManorCare Letter Comment (Oct. 30, 2013); Pinnacle Foods Inc. Letter Comment (Oct. 30, 2013); Sea World Parks & Entertainment Letter Comment (Oct. 29, 2013).

7 Oliver Wyman, *Risk Retention for CLOs: A square peg in a round hole?*, at 2 (Nov. 2013) (hereinafter "Oliver Wyman Report" or, in citations, "OW Report"), *available at* http://www.sec.gov/comments/s7-14-11/s71411-535.pdf.

8 *Id*. at 21.

9 *Id.* at 22.

10 The LSTA has proposed a definition of Open Market CLO that ensures the high quality of CLO assets while accounting for the market reality that assets acquired in open market transactions often include a mix of senior, secured loans, and non-senior secured loans. *See* LSTA Letter Comment (Mar. 9, 2012) app. A at 4 (defining Open Market CLO as a CLO "(i) whose assets consist predominantly of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in open market transactions or [from other non-balance sheet CLOs] and of temporary investments, (ii) that is managed by a manager, and (iii) that is not a balance sheet CLO.") The LSTA

operate under the originate-to-distribute model, which prompted Congress to enact Section 941's risk retention requirement. *See* S. Rep. No. 111-176, at 36–37 (2010) ("Under the 'originate to distribute' model, loans were made expressly to be sold into securitization pools, which meant that the lenders did not expect to bear the credit risk of borrower default. This led to significant deterioration in credit and loan underwriting standards, particularly in residential mortgages."); *id*. at 128 (same). In addition, Open Market CLOs are actively managed by managers whose principal component of compensation is highly subordinated and dependent on the CLO's performance, and such CLOs draw their assets primarily from large syndicated corporate loans, which are subject to multiple layers of diligence and offer a high level of transparency.[11] Open Market CLOs thus comprise a unique class of ABS that lacks many of the characteristics that led Congress to enact Section 941.

In developing the current proposal, the LSTA, SFIG, and SIFMA have built upon their already extensive participation in the Credit Risk Retention rulemaking process. Through comment letters and discussions with agency officials, the LSTA, SFIG, and SIFMA have consistently sought to ensure that the final risk retention rule allows for the continued operation of a viable CLO market. The LSTA has explained how the agencies' rules proposed to date (including the new alternative approach set forth in the August 30, 2013 FNPRM) would drastically curtail CLO formation and would thereby impose significant costs and harm the public interest without providing any countervailing benefits.[12] The LSTA has also demonstrated that Section 941, as a matter of the statute's text, history, and purpose, does not apply to Open Market CLOs, which do not employ an originate-to-distribute model and for which no entity meets the definition of sponsor/securitizer.[13] And, even if Section 941's risk retention requirement applies to Open Market CLOs, a complete exemption is warranted for a class of CLOs defined by criteria that ensure that those CLOs are highly investor-protective.[14]

Finally, in the event the agencies conclude that Section 941 does apply to Open Market CLOs, the LSTA has proposed three different alternatives for the requisite risk retention. The first alternative would allow CLO managers to satisfy the risk retention requirement by holding a combination of unfunded notes and five percent of the CLO equity, resulting in retention of well over five percent of the CLO's credit risk under a construction of that term reflecting established

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continues to urge the agencies to adopt this more flexible definition of Open Market CLO. *See* LSTA Letter Comment (Oct. 30, 2013) at 4–5 n.10.

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

[12] *See id.* at 14–17: LSTA Letter Comment (Apr. 1, 2013) at 19–22; LSTA Letter Comment (July 29, 2013); LSTA Letter Comment (Oct. 30, 2013) at 11–20.

[13] *See* LSTA Letter Comment (Aug. 1, 2011) at 7–14; LSTA Letter Comment (Apr. 1, 2013) at 16–19; LSTA Letter Comment (Oct. 30, 2013) at 4–7.

[14] *See* LSTA Letter Comment (Aug. 1, 2011) at 14–20; LSTA Letter Comment (Sept. 2, 2011); LSTA Letter Comment (Mar. 9, 2012).

market practice and economic theory.[15] The second alternative would allow CLOs to reduce their level of risk retention on a pro rata basis to the extent that CLO assets meet certain criteria reflecting high quality loans.[16] The third alternative would allow a third party equity holder to retain risk for a CLO, provided that the third party has a role in setting the selection criteria for the assets held by a CLO and the power to veto any change to those criteria.[17] Each of these proposed alternatives readily satisfies both the text and purpose of Section 941.[18]

The additional alternative set out below would apply to a narrowly defined set of Open Market CLOs that meet specific criteria, including asset and portfolio quality protections, structural protections, criteria to ensure alignment of manager and investor interests, other sources of regulation of managers, and criteria to ensure transparency. Ideally, this proposal would be adopted together with, and as an alternative to, the second and third options noted above, providing Open Market CLO managers with a choice of meeting the requirements set out below (and retaining risk through the subordinated compensation plus buying and holding five percent of the CLO's equity) <u>or</u> complying with the standard credit risk retention rules, modified to permit pro rata reduction of risk retention for qualified loans and sharing of risk retention with third party equity stakeholders.

Whether or not that combined approach is adopted, adoption of the proposal outlined below is essential to the continued operation of Open Market CLOs as a robust and positive force in the credit and investment services markets. As the LSTA has confirmed since providing its earlier letter, the second and third options (pro rata risk reduction and third party risk sharing) would only somewhat mitigate the harm the rules would cause to the CLO sector. It is far from clear that a significant portion of the CLO managers that would otherwise be put out of business or have to shift their business away from CLO management could find a third party investor willing to buy and hold equity unhedged for the holding period as contemplated in the proposal, or would be able to secure and build a feasible investment vehicle with loans that would qualify for pro rata risk retention reductions. Those options, standing alone, are inadequate to avoid the principal harms the agencies' proposed rules would cause to the CLO sector, or to avoid resulting harms to competition, credit formation, access by borrowers to credit, investors, and the public interest. For these reasons and the other reasons noted above, the LSTA, SFIG, and SIFMA propose the following approach to credit risk retention regulations designed to meet Section 941's objectives, protect investors, and provide a workable solution for CLOs that ensures that they can, in fact, continue to discharge their important and valuable role in the commercial credit markets.

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[15] *See* LSTA Letter Comment (Apr. 1, 2013); LSTA Letter Comment (Oct. 30, 2013) at 7–10.

[16] *See* LSTA Letter Comment (Oct. 30, 2013) at 23–27.

[17] *See id*. at 27–28.

[18] *See* LSTA Letter Comment (Apr. 1, 2013); LSTA Letter Comment (Oct. 30, 2013).

II. The Alternative Proposal for Risk Retention by Qualified CLOs.

The following proposed approach to regulating Open Market CLOs had been raised in an initial form with agency staff and certain senior officials, and the more refined approach set out below seeks to incorporate and respond to many of the principal responses received during those meetings. At the most general level, the proposal is designed to satisfy the agencies' policy objectives, to meet Section 941's requirements without requiring the agencies to provide a complete exemption, and to create a workable solution for Open Market CLO managers that would prevent the dramatic reduction in CLO formation (and related harms to the public interest, credit markets, borrowers, and investors) that would otherwise occur.

Under the proposed approach, the rules would apply distinct risk retention requirements to a manager of an Open Market CLO that meets a series of requirements designed to ensure high quality underwriting and to protect investors. A CLO meeting the requirements would be treated as a "Qualified CLO." The manager of a Qualified CLO would be able to satisfy the rules' risk retention requirements by retaining a five percent interest in the CLO's equity – in addition to retaining credit risk through a deeply subordinated and deferred compensation structure.

A. <u>CLO Requirements</u>.

For a CLO to qualify for this modified risk retention requirement and be deemed a Qualified CLO, its governing transaction documents would have to include requirements related to: (1) asset quality; (2) portfolio composition; (3) structural features; (4) alignment of the interests of the CLO manager and investors in the CLO's securities; (5) regulatory oversight; and (6) transparency and disclosure. Requirements in each category are described below.

1. CLO Asset Quality Protections.

The CLO would be required to:

a. have at least 90 percent of its assets comprised of senior secured loans and cash equivalents;

b. have 100 percent of its loan assets issued by companies;

c. have no assets that are ABS interests (including CDO of ABS, CDO squared, or synthetic ABS) or derivatives – provided that this limitation would not prohibit an Open Market CLO from acquiring loan participations or any interest related to or in a letter of credit, or entering into derivative transactions to hedge interest rate or currency rate mismatches;

d. not purchase assets in default, margin stock, or equity convertible securities;

e. acquire only loans held or acquired by three or more investors or lenders unaffiliated with the CLO manager;

f. hold only loans to borrowers whose accounts are subject to an annual audit from an independent, accredited accounting firm;

g. have no more than 60 percent of its assets comprised of "covenant lite" loans;[19] and

h. at the time of purchase of any asset, comply with the requirements of part 1.a and 1.g and the CLO asset portfolio protection requirements in part 2 below or, if not in compliance with any such requirement, maintain or improve the level of compliance after giving effect to such purchase.

2. CLO Asset Portfolio Protection Requirements.

a. No more than 3.5 percent of the CLO's assets may relate to any single borrower.

b. No more than 15 percent of the CLO's assets may relate to any single industry.

c. No more than 20 percent of the CLO's assets may relate to non-U.S. borrowers (and no more than 10 percent may relate to borrowers outside the U.S. and Canada).

d. Each loan asset held by the CLO shall be denominated in U.S. dollars.

3. Structural Protections.

a. The CLO's equity would have to be at least eight percent of the value of the CLO's assets.[20]

b. The CLO would have to have overcollateralization and interest coverage tests, and if any such test falls below the required level specified for the

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[19] For this purpose, a "covenant lite loan" is a loan for which the underlying instruments neither (1) require the obligor to comply with any maintenance covenant nor (2) contain a cross-default provision to a financing facility of the obligor that requires the obligor to comply with a maintenance covenant (including one which may apply only upon the funding of such other loan or financing facility); provided, that if such loan is pari passu with another loan of the obligor which would not be a covenant lite loan under the criteria described above, such loan shall be deemed not to be a covenant lite loan.

[20] For purposes of this requirement (II.A.3.a) and the retention requirement in II.A.4.e, the CLO's equity is the most junior class of securities issued by the CLO (excluding any non-economic security such as the issuer's common stock) and any additional class(es) of securities junior to the rated notes.

transaction, available interest collections (and if necessary, available principal collections) must be applied to repay the CLO's debt in order of seniority until compliance with the applicable test is restored.

4. **Alignment of Managers' and CLO Investors' Interests.**

a. The CLO must be an Open Market CLO rather than a balance sheet CLO.[21]

b. The holders of the CLO's equity (excluding Manager Risk Retention Equity as defined below) must have the right to remove by vote the CLO manager for cause.

c. A majority of the CLO manager's fees, including any incentive fee, must be subordinated to payments then due in relation to the CLO's rated notes.

d. The CLO manager's discretionary sales of assets on behalf of the CLO issuer are limited each year to 30 percent of the principal amount of the CLO's assets (other than sales of defaulted or credit-deteriorated, credit-risk, or credit-improved loans).

e. The CLO manager (and/or one or more of the affiliates of the CLO manager and/or its knowledgeable employees and other employees) must buy and, during the holding period, hold (and not hedge) five percent of the CLO's equity (the "Manager Risk Retention Equity").

f. For each of the first two years, distributions related to the Manager Risk Retention Equity cannot exceed an amount equal to the sum of (i) 30 percent of the purchase price of such equity and (ii) the amount of taxes that are reasonably expected to be required to be paid with respect to the Manager Risk Retention Equity for the related period (entitlements in excess of such distribution limit may be retained in an account solely for the benefit of the holders of the Manager Risk Retention Equity).[22]

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[21] *See supra* p. 2 & n.3; LSTA Letter Comment (Oct. 30, 2013) at 4–5 n.10.

[22] This proposal does not change the objections the LSTA, SFIG, SIFMA, and numerous other industry participants have raised to the imposition of any cashflow restriction. As the LSTA has previously explained, the agencies' proposed cashflow restriction – which would prohibit the holder of an eligible horizontal residual interest from receiving cash at a faster rate than the principal payment rate – would create significant, presumably unintended, adverse effects for CLOs and thus should not apply in the CLO context. *See* LSTA Letter Comment (Oct. 30, 2013) at 16–17. This consequence arises as a result of an important investor-protective aspect of CLOs, related to the investment period, and the need for the elimination of the requirement as applied to CLOs applies to any variation of rules the agencies may adopt for risk retention by CLO managers. *See also* NewStar Financial, Inc. and NXT Capital LLC Letter Comment (Oct. 30, 2013).

g. All holders of CLO securities that are U.S. persons within the meaning of Regulation S under the Securities Act of 1933, as amended, must be Qualified Investors.[23]

5. Regulatory Oversight.

a. The CLO manager must be a registered investment adviser.[24]

b. All purchases and sales of the CLO's assets must be conducted on an arm's-length basis and in compliance with the Investment Advisers Act.

6. Transparency and Disclosure.

A monthly report will be made available to noteholders. The report shall include information regarding:

a. A list of CLO assets, including with respect to each asset: obligor name; CUSIP (or security identifier) if applicable; interest rate; maturity date; the type of asset; and market price for each asset where available;

b. With respect to the portfolio of assets: the aggregate principal balance and aggregate adjusted collateral principal amount thereof (adjusted as required by the CLO transaction documents) and the percentage of such aggregate adjusted collateral principal represented by each asset;

c. Each applicable overcollateralization test and interest coverage test (and the level of compliance in relation to each test);

d. Purchases, repayments, and sales; and

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[23] "Qualified Investor" means (1) with respect to securities that require the payment of principal and interest, an investor that is a "qualified purchaser" within the meaning of Section 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), or an entity owned exclusively by "qualified purchasers," or (2) with respect to securities that do not require the payment of principal and interest, (a) if the Qualified CLO relies on Section 3(c)(7) for its exclusion from the definition of "investment company" under the Investment Company Act, (i) a "qualified purchaser," (ii) a "knowledgeable employee" within the meaning of Rule 3c-5 promulgated under the Investment Company Act, or (iii) an entity owned exclusively by "qualified purchasers" or "knowledgeable employees," and/or (b) if the Qualified CLO relies on Rule 3a-7 for its exclusion from the definition of "investment company" under the Investment Company Act and such securities are not "fixed-income securities" as defined in Rule 3a-7, (i) a "Qualified Institutional Buyer" within the meaning of Rule 144A under the Securities Act, (ii) a person (other than any rating organization rating the issuer's securities) involved in the organization or operation of the issuer or an affiliate, as defined in Rule 405 under the Securities Act, of such a person, or (iii) any entity in which all of the equity owners come within the immediately preceding clauses (i) and/or (ii).

[24] This designation entails a range of obligations that protect investors. *See generally* http://www.sec.gov/divisions/investment/iaregulation/memoia.htm.

e. The identity of each defaulted asset.

B. <u>Scope of Modified Risk Retention Approach</u>.

The proposed approach is a narrowly targeted solution to a discrete problem and would not provide the basis for reduced risk retention requirements to be extended to other types of ABS.

Even apart from the particular protections and distinct application of the various qualifications set out above, the proposed response is directed at – and should be justified in light of – the discrete considerations related to Open Market CLOs. The proposal does not extend to all CLOs, such as balance sheet financing CLOs. As explained elsewhere, Open Market CLOs do not present the risks that Congress sought to address through Section 941 and instead function as a mechanism largely shaped by investor concerns and interests as they seek access to a valuable class of investment products.[25] That claim can be made for very few other types of ABS. The investment and performance history of Open Market CLOs also sets them apart from other types of ABS and is an important consideration that justifies and limits their distinct treatment. Unlike other types of ABS, Open Market CLOs performed extremely well and protected investors from losses even during the recent financial crisis. Investors' strong and positive response to Open Market CLOs in the aftermath of the crisis reflects that fact, as well as investors' appreciation of the performance, structural, and other protections this asset class affords them. Although the agencies needn't base their regulatory policy principally on this performance and investment history, it points to relevant policy and market considerations that do provide an important basis for limiting the proposed approach to Open Market CLOs. Similarly, the particular importance of Open Market CLOs to competition in the credit markets and to the availability of credit to borrowers,[26] as well as the unique and significant risks that application of the agencies' proposed approach to risk retention poses to the continued viability of Open Market CLOs,[27] further justifies a distinct policy and regulatory response to this asset class. Other types of ABS simply do not present the same public interest considerations.

In any event, the criteria that an Open Market CLO must meet to qualify for modified credit risk retention requirements would exclude other types of ABS even apart from the very different public interest, market, and investor protection considerations associated with Open Market CLOs. We are unaware of any other type of ABS that has a set of structural and other protections even approximately resembling the structural, asset, and portfolio limitations, the measures designed to ensure that managers are regulated and have their interests aligned with

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[25] *See* LSTA Letter Comment (Aug. 1, 2011) at 4–7, 13–14; LSTA Letter Comment (Apr. 1, 2013) at 13–14, 19–20; LSTA Letter Comment (Oct. 30, 2013) at 12–14.

[26] *See infra* pp. 13–14; *see also* LSTA Letter Comment (Aug. 1, 2011) at 16–17; LSTA Letter Comment (Apr. 1, 2013) at 22; LSTA Letter Comment (Oct. 30, 2013) at 14–15.

[27] *See supra* pp. 2–3; *see also* LSTA Letter Comment (Aug. 1, 2011) at 14–16; LSTA Letter Comment (Apr. 1, 2013) at 14; LSTA Letter Comment (July 29, 2013); LSTA Letter Comment (Oct. 30, 2013) at 15–20.

investors, and the transparency requirements set out above. CDOs, for example, may have certain active investment and manager accountability features that resemble those in CLOs, but CDOs, in contrast to CLOs, hold portfolios of assets that are generally heavily concentrated in sectors such as housing or real estate (rather than diversified across industries),[28] hold many more loan assets that include small loans to individuals (rather than loans to significant commercial borrowers, with associated underwriting and disclosure protections), hold assets that are far less liquid or include securitized assets, and fail to provide the level of transparency and disclosures to investors that are common for CLOs and required under the proposed approach. More fundamentally, CDO asset selection, unlike the CLO manager's asset choices, is not informed and supported by an elaborate underwriting and syndication process with multiple, sophisticated participants including investors purchasing such loans. Nor do CDOs play nearly as important a market role in the sectors they invest in as do CLOs in ensuring competition and access to credit markets for below investment grade rated commercial borrowers – much less any role that is similarly threatened, as is the Open Market CLO manager's role, by the risk retention requirement set out in the agencies' proposed rules.

C. Benefits of the Proposed Approach.

The criteria outlined above are designed to – and would – accomplish precisely the objectives of Section 941, related to ensuring prudent asset selection and underwriting, protecting investors, ensuring access to and competition in the provision of capital, and achieving related public interest benefits.

1. Ensuring Prudent Asset Selection and Underwriting.

Nearly all the criteria outlined above and made the prerequisite for modified credit risk retention obligations are designed to ensure prudent asset selection and underwriting, along with the associated protection of CLO investors.

This result is clearly advanced by the asset and portfolio quality requirements. For example, by ensuring that the CLO manager overwhelmingly selects loans that have a senior secured position and are made to reputably audited companies, the criteria limit the manager from selecting (or supporting the underwriting of) riskier assets. So, too, with the requirements that any selected loan be held (and thus underwritten) by at least three lenders or investors unaffiliated with the CLO manager: this prevents the CLO manager from entering into less liquid, ad hoc transactions and provides the investor protections and asset quality assurance associated with a multiple-underwriter process. The portfolio limitations on borrower and industry sector concentrations ensure that investors are protected through portfolio diversification. The limitations on non-U.S. loans also ensure that CLO managers will focus on those loans most familiar to them and those subject to the highest levels of disclosure and most thorough loan syndication processes. The criteria also bar the manager from selecting entire

[28] The real estate and housing sectors have not historically had the quality of underwriting that has been and remains true of large, broadly syndicated loans to commercial borrowers.

classes of inherently more risky assets such as ABS securities, derivatives, defaulted loans, margin loans, or equity convertible securities.

The incentives imposed on the CLO manager, both financially and as a matter of investor oversight and regulation, also increase and ensure prudent asset selection and management by the CLO manager. Buying and holding a substantial equity interest, combined with subjecting the manager to extensive credit risk through the nearly unique, subordinated, and deferred compensation structure, provide the manager with strong incentives to select assets prudently and to manage them well. This is all the more so because CLO equity is purchased at par or at a modest discount to par and thus is funded equity. The ability of owners of equity to remove the manager for cause provides all CLO investors with further protection and serves as an incentive for the manager to perform well. Similarly, by requiring that the manager be a registered investment advisor, the criteria create yet another positive set of protections and incentives based on additional regulatory requirements. For example, such advisors must adopt a code of ethics that includes a standard of business conduct that reflects the adviser's fiduciary obligations, *see* 17 C.F.R. §275.204A-1; assume affirmative obligations of utmost good faith and full and fair disclosure of all material facts to their clients, as well as a duty to avoid misleading them, *see SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); have a fiduciary obligation to obtain "best execution" of clients' transactions, *see* Exchange Act Release No. 23170, 51 Fed. Reg. 16004, 16011 (Apr. 30, 1986); and disclose to each client or prospective client their business practices, conflicts of interest and background. *See* 17 C.F.R. §275.204-3. All these obligations are subject to enforcement by Commission officials.

The criteria's emphasis on transparency and disclosure provides one of the most important assurances of prudent asset selection and underwriting. Because CLOs, unlike nearly all other types of ABS, hold a relatively limited number of assets and must under the criteria disclose extensive information regarding the nature and ongoing performance of each asset, the criteria force and enable the managers to constantly review each asset and permit investors to continue to assess the manager's performance reflected in the selection and continued management of each asset – and further permit them to influence and improve the manager's handling of the assets. As the Oliver Wyman Report emphasizes, "[b]oth the managers of CLOs and their investors can and do 'look through' the pool-level risks to make credit judgments about individual borrowers – informed by ongoing borrower-level information and price signals that are widely available … . This transparency marks a stark contrast to the securitization models that Congress and regulatory policymakers have sought to remediate." OW Report, at 11. The proposal formalizes and enhances this systemic transparency.

2. <u>Investor Protection</u>.

All these criteria directed to improved asset selection and portfolio management have as an underlying purpose and effect the protection of investors. In addition, several of the criteria are more directly addressed to protecting investors. For example, the criteria designed to ensure portfolio diversification protect investors, as do the structural limitation on CLOs' leverage and the requirement that Qualified CLOs be managed by registered investment advisers with a fiduciary duty to the CLO issuer. The requirement that the CLO manager's compensation be largely deferred and subordinated to debt investors' recovery very directly benefits such investors, as do criteria related to equity holders' ability to remove a CLO manager for cause and the requirement that CLO investors be qualified investors. Similarly, the requirements related to transparency permit these sophisticated CLO investors to perceive and assess, independently and on a continuous basis, the risks they are bearing. Finally because all U.S. investors in Qualified CLOs must be qualified investors, CLOs are sold in the U.S. to the types of sophisticated investors that the securities laws typically view as able to protect themselves when making investments and to oversee manager performance thereafter.

3. Increased Access to and Competitive Pricing of Credit.

By ensuring that Open Market CLOs remain a material component of credit markets, the proposed approach also provides enormous benefits in the form of borrowers' access to credit, competition in the provision of credit, and lower borrowing costs.

Each of these factors would be adversely affected if the agencies implemented their proposed rules or otherwise failed to provide a workable solution for CLO managers that enables CLOs to remain a vital participant in the leveraged loan markets. As noted above, both the LSTA's surveys and the work of Oliver Wyman demonstrate that, in the absence of a workable solution such as the approach set out above, CLOs will dramatically decrease as an investment channel supporting the leveraged loan market. The principal consequence would be reduced access to credit either because less capital is available to the sector or because the price of credit rises sharply. In the most likely scenario, both a reduction in capital and an increase in the price of credit would occur, with adverse consequences not only for those borrowers squeezed out of the market but also for those left within it. Oliver Wyman uses as its baseline a projection that the proposed rules would result in "a 75% reduction in credit provided by CLOs over the long term," with "a more severe scenario of a 90% reduction in credit provided by CLOs" if managers that had access to balance sheet funding nonetheless chose to deploy their capital in other sectors. OW Report at 14. The LSTA's surveys show that even such current CLO managers would, in fact, considerably decrease their investment, making the "more severe scenario" a plausible one. CLOs currently "provide nearly half of the $640 BN of the credit that the institutional leveraged loan market channels to non-[investment grade] borrowers." *Id.* at 17. Because "[i]n the current non-[investment grade] market, CLOs provide approximately $280 BN of credit to non-[investment grade] borrowers," the reduction in credit provided by CLOs would be between $210 and $250 billion. *Id.* at 15.

Although some of the reduced credit availability would be replaced by capital from other sources, that replacement would significantly increase the cost of that capital and introduce systemic instability. Assuming that CLOs' participation in the market falls by only 75 percent, and not the plausible 90 percent reduction, then "today's non-CLO leveraged loan credit providers would need to expand their holdings by approximately 60%," which depending on the elasticity of credit supply would increase spreads from between 117 basis points to 292 basis points. *See id.* at 17–18.[29] Using the more conservative estimate of increased capital costs, Oliver Wyman estimates that the additional costs to borrowers would be $3.2 billion annually. And, that figure addresses only the increased cost for the capital needed to replace CLO-sourced borrowing: it does not account for the effect on other lenders resulting from the reduced competition and higher capital costs for substitute funding. If it did so, "the increased cost to borrowers could exceed $10 BN annually." *Id.* at 21 & n.13. Of course, if the lower credit elasticity estimates or the plausible scenario of a 90 percent reduction in CLO funding were used, estimates of annual increased costs to borrowers would far exceed those figures.

Finally, the estimates above ignore systemic risks to credit markets that the agencies' proposed rule would produce – and that the proposed approach outlined above would avoid. Continued participation by CLOs in the credit markets is a stabilizing force. "[A]ny significant reduction in CLOs as leveraged loan market participants will take away a group of investors that can act as buyers when others need to sell, which could lead to systematically more volatile loan prices." *Id.* at 22. As Oliver Wyman further explained, "by constraining credit providers to a more limited set of viable liability structures and operating models, a risk retention rule that does not fit the CLO market could inadvertently reduce the ecological diversity of the financial system, decreasing its ultimate resilience." *Id.* This is especially true for CLOs, which act as a stabilizing force in the market because CLO capital is available to fund loans to commercial borrowers even during times of market dislocation when other sources of financing or refinancing are not available. CLOs are unlike other vehicles investing in loans, such as loan mutual funds and hedge funds, which may afford investors individual redemption rights or be subject to mark-to-market tests that may cause the transaction to unwind during market dislocations. In contrast, CLOs bring to the market a committed investor base that fully funds by closing with very significantly limited opportunities for optional redemptions. The lengthy reinvestment periods in CLOs and the fact that there are no mark-to-market covenants or defaults in CLOs further ensures their ongoing, stabilizing market presence. This is in sharp contrast to the hedge funds and other sources of capital that might in part substitute for CLOs in the event the credit risk retention rules drive CLOs from the market. The proposed regulatory approach set out above seeks to ensure that the resulting regulation does, in fact, fit the CLO market and thus seeks to avoid the destabilization of the credit markets that was precisely what Section 941, and the Dodd-Frank Act more broadly, sought to avoid.

4. Other Public Interest Benefits.

As the LSTA, SFIG, and SIFMA have elaborated elsewhere, maintaining CLOs as a vital source of funding provides additional benefits to investors and the public at large. Investors would continue to have an additional range of investment options, services, and styles of asset management that they have found extremely valuable – as confirmed by the resilience of the asset class and the investor demand for CLO securities in the aftermath of the financial crisis.[30]

[29] As a comparison, to the extent credit is instead available through the high yield bond market, borrowers face increased costs of approximately 200 basis points. *See* OW Report at 20.

[30] LSTA Letter Comment (Apr. 1, 2013) at 12–16; LSTA Letter Comment (Oct. 30, 2013) at 11–17.

Investors such as insurance companies, banks, pension funds, and other funds want, and through CLOs secure, access to these types of loans at various risk levels provided by CLO debt securities because these investors don't have either the infrastructure or access to the loan market that CLO managers have. They also want a diversified pool of CLO managers with different management styles to select from when choosing among investment managers.

By decreasing credit costs and increasing credit market access for commercial loan borrowers, the proposal generates a broad range of related benefits for the public. Lower financing costs and increased access to credit result in lower consumer prices and increased competition in the provision of goods and services to consumers and increased capabilities for investment in innovation and business expansion – with resulting benefits in the form of increased employment, improved services, increased productivity, and lower inflation.[31]

III. The Agencies Have Ample Authority to Adopt This Alternative Proposal.

The agencies have ample authority under each of three particular statutory sources to adopt rules implementing the approach outlined above. Section 941 of Dodd-Frank requires the agencies to shape their rules according to the public interest and provides additional, permissive exemption authority. Each of these provisions, properly construed, would encompass the proposed approach to CLO risk retention. In addition, the agencies have the authority to adopt rules implementing the proposed approach as a permissible interpretation of the term "credit risk" under Section 941. Apart from these specific sources of authority, more general statutory authorities empower the finance agencies,[32] and the Commission in particular,[33] to issue rules that would implement the proposed approach.

[31] LSTA Letter Comment (Apr. 1, 2013) at 12–16; LSTA Letter Comment (Oct. 30, 2013) at 11–17.

[32] 15 U.S.C. 78w(a)(1) provides: "The Commission, the Board of Governors of the Federal Reserve System, and the other agencies enumerated in section 78c(a)(34) of this title shall each have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter for which they are responsible or for the execution of the functions vested in them by this chapter, and may for such purposes classify persons, securities, transactions, statements, applications, reports, and other matters within their respective jurisdictions, and prescribe greater, lesser, or different requirements for different classes thereof."

[33] In addition to the exemption authority provided in Section 941, the Commission also has broad general exemption authority under the Exchange Act, which likewise readily encompasses adoption of the proposal described above. Under 15 U.S.C. §78mm, the Commission "by rule, regulation, or order, may conditionally or unconditionally exempt … any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." Among the provisions of "this chapter"—*i.e*., Chapter 2B Securities Exchanges, 15 U.S.C. §§78a–78pp— covered by this general exemption authority is the credit risk retention provision, *id.* §78o-11. For the reasons explained above, the proposal is both "necessary" and "appropriate in the public interest" and is "consistent with the protection of investors."

A. Exemption and Adjustment Authority.

Section 941 provides that the agencies "may jointly adopt or issue exemptions, exceptions, or adjustments to the rules issued under this section," including specifically exemptions or adjustments to the risk retention requirements and hedging prohibitions, where two requirements are met: the exemption must "(A) help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized …" and "(B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors." §15G(e)(1), (2).[34]

The proposed approach readily satisfies Section 15G(e)'s standard. First, the proposal satisfies in multiple respects subsection A's requirement that it "help ensure high quality underwriting standards," §15G(e)(2)(A). Nearly all of the many criteria that a CLO must satisfy have the effect of ensuring high quality underwriting and creating the incentives and imposing restrictions that ensure that Open Market CLO managers select high quality assets. *See supra* pp. 11–15 (outlining underwriting benefits of asset and portfolio limitations, criteria designed to align manager and investor incentives, regulatory measures, and transparency requirements). These are in addition to the requirements that managers buy and hold five percent of the CLO's equity as well as retain nearly five percent of overall credit risk embodied in their deferred, deeply subordinated compensation arrangement.[35] For the portion of future CLOs that would not on their own accord adopt all the criteria set forth in the proposal, the rules implementing this proposed approach would prompt those CLOs to shift to this "best practices" model (as well as to increase risk retention through additional equity purchases).

In addition, the criteria ensure high quality underwriting over time. The proposed approach draws on the "best practice" features often required by investors of Open Market CLOs launched in the immediate aftermath of the financial crisis, when investors were especially conservative and imposed a series of requirements upon the structuring and selection of CLO portfolios designed to improve underwriting and protect investors. The proposed approach also tightens and sets out in ongoing rules the conservative, best practice features as they exist in the aftermath of the financial crisis, thus "ensur[ing] high quality underwriting" for years to come.

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[34] As noted below, *see infra* pp. 17–20, this power by its terms applies to exemptions "to the rules issued under this section," which most naturally means an after-the-fact power to grant exemptions to pre-existing rules—a waiver power that traditionally exists for other administrative agencies and systems of agency rules. *See, e.g., WAIT Radio v. FCC*, 418 F.2d 1153, 1157 (D.C. Cir. 1969) (an agency's "discretion to proceed in difficult areas through general rules is intimately linked to the existence of a safety valve procedure for consideration of an application for exemption based on special circumstances"). The better reading, as the statutory language indicates, is that the "public interest" test of Section 15G(c)(1)(G)(i) applies to the fashioning of exceptions within the rules, whereas Section 15G(e) applies to later waivers of the rules' requirements.

[35] *See* LSTA Letter Comment (Apr. 1, 2013), app. A at 6 (analysis by Harvard Business School professor Victoria Ivashina).

Finally, and most importantly, the proposed approach would have systematic benefits beyond the CLO managers, ensuring continuing high quality underwriting among the loan originators as well. If, as would occur in the absence of the proposed approach, the market presence of Open Market CLOs would dramatically diminish, then their place would be taken in part by investors with fewer constraints and supervision, such as hedge funds. This displacement of Open Market CLOs would result in lessened scrutiny of origination determinations, and a less vibrant and liquid secondary market that passes continuous judgment on the originators' underwriting determinations. As a result, the incentives for loan originators' high-quality underwriting would be reduced.

The proposal likewise satisfies subsection (B)'s requirements. Under subsection (B), any exemption must encourage appropriate risk management practices, improve access to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors. §15(e)(2)(B). Because clause (B) is written in the disjunctive, it is satisfied by an exemption meeting any one of these requirements. Here, the proposed modification in risk retention requirements meets all three.

For the reasons just provided and those set out above, *see supra* pp. 10–11, the proposed approach "encourage[s] appropriate risk management practices by the securitizers and originators of assets," §15G(e)(2)(B). It creates strong financial incentives for high quality asset selection, sets restrictions on lower quality assets and on the portfolio, and establishes a best practice standard for CLO managers. The proposed approach also "improves the access of consumers and businesses to credit on reasonable terms," §15G(e)(2)(B): As outlined in the discussion of policy benefits and as set forth in the Oliver Wyman report, *see supra* pp. 13–14, the proposed approach avoids the credit constriction implications of the broader restrictions previously outlined by the agencies. And, for all the reasons that the approach outlined above would benefit the public, and specifically continue to protect investors while ensuring that they have a broader range of investment opportunities, the approach would also "otherwise be in the public interest and for the protection of investors," §15G(e)(2)(B); *see supra* pp. 11–15.

B. <u>Mandatory Exemption Authority.</u>

Congress has in fact provided far broader authority to adopt rules implementing the regulatory approach outlined above. Although the agencies have so far focused on the authority provided under Section 15G(e), the more directly applicable – and broader – authority is provided by Section 15G(c)(1)(G)(i). This authority is mandatory, and disregarding its scope while declining to exercise the agencies' exemption authority to adopt the proposed approach would reflect a significant error of statutory construction. In contrast, if the agencies exercise their authority under Section 15G(e), then the public interest standard of Section 15G(c)(1)(G)(i) has also been established and no issue of the proper interpretation of that standard would be presented for judicial review.

Under Section 941, the agencies are required to provide certain exemptions in the public interest. The rules prescribed by the agencies "shall … provide for … a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors." §15G(c)(1), (c)(1)(G)(i). For the reasons set out above, the proposed alternative for risk retention by qualified CLOs is clearly in the public interest and thus falls within the scope of Section 15G(c)(1)(G)(i). *See supra* pp. 11–15. It would protect investors, ensure high underwriting standards, enhance the availability of credit by preserving the market role of open market CLOs and their managers, and avoid the harms to competition and market stability that application of the general rule would yield. *See id.*

This exemption authority is similar to other grants of exemption authority to other agencies that the courts have construed as providing very broad powers. *See, e.g., Airmark Corp. v. F.A.A.*, 758 F.2d 685, 689, 691 (D.C. Cir. 1985) (under provision allowing exemptions if "'such action would be in the public interest,'" the FAA has broad authority to grant or deny exemptions); *Nat'l Small Shipments Traffic Conference, Inc. v. CAB*, 618 F.2d 819, 827 (D.C. Cir. 1980) (provision allowing the Board "to exempt '*any* person or class of persons' from 'the requirements of this title or any provision thereof … if it finds that the exemption is consistent with the public interest'" grants the Board "very broad discretion"). This power would exist even in the absence of an express authorization, and here strongly confirms and reflects the general principle "that an agency's authority to proceed in a complex area … by means of rules of general application entails a concomitant authority to provide exemption procedures in order to allow for special circumstances." *United States v. Allegheny-Ludlum Steel Corp.*, 406 U.S. 742, 755 (1972). Courts have construed comparable exemption powers, applicable to the SEC, as providing very broad authority. *See Schiller v. Tower Semiconductor Ltd.*, 449 F.3d 286, 296–97 (2d Cir. 2006). Indeed, they have reversed the Commission when it has failed to articulate why it is not exercising that authority. *See Am. Petroleum Inst. v. SEC*, -- F.Supp.2d --, 2013 WL 3307114, at *12–14 (D.D.C. July 2, 2013).[36]

In the NPRM, the agencies suggested an unreasonably narrow construction of this broad exemption provision. In the proposed rules, they declined to make any public interest determinations regarding securitizations. Instead, they provided in the rule for a *process* by which they might consider and provide for exemptions *in the future*. *See* §__.23(a), 76 Fed. Reg. 24090, 24173 (Apr. 29, 2011); NPRM, *id.* at 24097 ("the appropriate Agencies will jointly approve any exemptions, exceptions, or adjustments to the final rules"). They further limited the rule's exemption process to apply only to "individual securitization transaction[s]." *Id.* at 24139.

This narrow construction of the exemption authority would be inconsistent with the statute in several ways. First, Section 941 requires "the regulations prescribed" by the agencies

[36] *See also, e.g.*, ABA Letter Comment (July 20, 2011) at 88–89; *see also id*. at 70 ("The premise that the Commission [in its economic analysis] need not consider the effects of the 'existence of a risk retention requirement' but only 'alternative implementations' of a risk retention requirement is, in our view, fundamentally flawed. Section 941 of the Dodd-Frank Act does not impose a risk retention requirement on all securitizations. Indeed, Section 941(c) of the Dodd-Frank Act specifically *requires* that the Agencies 'provide for a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors.' *Therefore, the Commission should have considered the effects of the existence of a risk retention requirement for any securitization for which the Proposed Rules do not provide a total or partial exemption*.").

to "*provide*" for "a total or partial exemption of any securitization, as may be appropriate in the public interest." §15G(c)(1)(G)(i) (emphasis added). But the proposed regulations do not themselves "provide" any such exemption, instead deferring the issue and failing to address whether exemptions are appropriate in the public interest. That approach thus disregards the mandatory language that the "regulations … shall … provide" for such exemptions.

Second, the suggested interpretation of Section 15G(c)(1)(G)(i) is inconsistent with the agencies' interpretation of the parallel exemption provisions of Section 15G(c)(1)(G)(ii)–(iv). The agencies correctly interpret subsections (ii) through (iv) as requiring that the rule itself embody and set forth exemptions. Those provisions address exemptions for securitizations of assets issued or guaranteed by the federal government or state or state subdivisions, as well as the allocation of risk retention between originators and securitizers. Such exemptions, like the public interest exemption provision of Section 15G(c)(1)(G)(i), must be "provide[d] for" in the rules issued by the agencies. The agencies did just that for the exemptions required by Sections 15G(c)(1)(G)(ii)–(iv), *see* 78 Fed. Reg. at 58043–43 (§__.19), but not for those authorized by Section 15G(c)(1)(G)(i).

Third, the exemption power is not limited to transaction-by-transaction determinations. Section 941 mandates an exemption and requires it to be placed in a rule of general applicability (which does not come into effect until two years after its publication in the Federal Register). Under this structure, it would make no sense to read the exemption as limited to specific individual transactions. The provision is also more naturally read as applying to a class or type of securitization, a reading that is consistent with the use of the same term in the very next clause. *See* Section 15G(c)(1)(G)(ii) ("exemption for the securitization of an asset issued or guaranteed by the United States"). Indeed, the agencies themselves, in the FNPRM, adopted this broader construction, when they concluded that "Section 15G(c)(1)(G) and section 15G(e) of the Exchange Act require the agencies to provide a total or partial exemption from the risk retention requirements for certain *types* of ABS or securitization *transactions*." 78 Fed. Reg. at 57969–70 (emphasis added).

Fourth, the initially suggested narrowing construction, both in limiting Section 15G(c)(1)(G)(i) to a process to be implemented later and doing so only with respect to individual transactions, renders redundant other provisions of the statute. The statute distinguishes between mandatory exemptions required in the rules themselves, *see* §15G(c)(1)(G)(i) ("The regulations prescribed under subsection (b) shall ... provide for" an exemption in the public interest), and discretionary exemptions the agencies are authorized to provide both when and after the rules go into effect, *see* §15G(e) (agencies "may jointly adopt or issue exemptions, exceptions, or adjustments *to the rules* issued under this section") (emphasis added). That is, Congress separately set forth in Section 15G(e) the standard and process for exemptions to be granted after the rules are issued. Under the agencies' construction, Section 15G(c)(1)(G)(i) would provide a superfluous, identical process for this same post-rule exemption function. That the initially suggested construction uses a different, inconsistent standard for such a post-rule exemption – an exemption "in the public interest and for the protection of investors," §15G(c)(1)(G)(i), rather than one that "help[s] ensure high quality underwriting standards" and "encourage[s] appropriate risk management practices," "improve[s] the access of consumers and businesses to credit on reasonable terms," or is "otherwise … in the public interest and for the protection of investors," §15G(e) – only compounds the error.[37]

The mandatory exemption authority in Section 15G(c)(1)(G)(i) therefore readily authorizes the agencies to adopt the proposed partial exemption for qualified Open Market CLOs. For the reasons set out above, *supra* Part II.C & Part III.A, the agencies' adoption of a final rule implementing this proposal would be fully authorized by the mandate that their "regulations prescribed under subsection (b) shall … provide … a … partial exemption" that is "appropriate in the public interest and for the protection of investors." §15G(c)(1)(G)(i).

C. <u>Construction of the Statutory Term "Credit Risk."</u>

Apart from the broad exemption powers described above, the agencies have ample authority to implement the proposal as a reasonable – indeed, the most reasonable – construction of the statutory requirement that a "securitizer … retain … not less than 5 percent of the credit risk for any asset." §15G(c)(1)(B). As the LSTA has previously demonstrated, this statutory phrase requires the retention of credit risk as understood in common economic terms by both Congress and the relevant credit market participants. The term "credit risk" means the risk presented by the non-payment of the obligation, and a percentage of that risk is a percentage of that risk of loss – not a percentage of the face value of the asset.[38]

By acquiring five percent of the equity interest in the CLO, and by bearing the deeply subordinated risk of non-payment embedded in the compensation structure demanded by investors, the CLO manager retains far more than five percent of the credit risk associated with the CLO's assets.[39] Indeed, each component – the purchase of five percent of the equity and the deferred, subordinated compensation – independently comprises nearly five percent of the credit risk.[40] This reality accords with the agencies' own understanding of credit risk, as reflected in their acknowledgment that credit risk is concentrated in the subordinated tranches of an ABS, and is thus not equivalent to the face value of the ABS assets.[41]

The agencies can, of course, avoid having to address this issue of statutory construction in this context by adopting the proposal under any of their sources of exemption authority. As

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[37] In addition, in light of the procedural protections and scrutiny surrounding the notice and comment rulemaking process, it makes sense that Congress would impose a "public interest" standard for exemptions embodied in the statute but require a higher, more constrained standard for the agencies' grant of waivers or adjustments in derogation of their rules.

[38] *See* LSTA Letter Comment (Oct. 30, 2013) at 7–9.

[39] *See id.*; LSTA Letter Comment (Apr. 1, 2013) at 8–10; *id.*, app. A (Prof. Ivashina's analysis).

[40] *See* LSTA Letter Comment (Apr. 1, 2013), app. A at 5–6 (Prof. Ivashina).

[41] *See, e.g.*, Credit Risk Retention, 76 Fed. Reg. at 24151.

explained above, these sources each provide more than an adequate basis to implement the proposal and offer a straightforward solution to addressing Open Market CLO risk retention.

IV. The Agencies May Adopt the Proposal Without Republication of the Proposed Rule for Further Comment.

If the agencies wish to proceed expeditiously, a rule implementing the approach outlined above may be adopted without republication of the rule for further comment.

"[I]t is well established that a final rule need not be identical to the proposed rule." *Select Specialty Hosp.-Akron, LLC v. Sebelius,* 820 F. Supp. 2d 13, 23 (D.D.C. 2011) (citing *Small Refiner Lead Phase–Down Task Force v. EPA,* 705 F.2d 506, 546 (D.C. Cir. 1983)). Republication for further comment is not required if – as would be the case if the agencies issued a final rule implementing the proposal – the final rule is the "logical outgrowth" of potential rules or proposals previously subject to comment in the rulemaking process. *First Am. Disc. Corp. v. Commodity Futures Trading Comm'n,* 222 F.3d 1008, 1015 (D.C. Cir. 2000).

The proposal set out above builds on previous proposals on which the agencies specifically requested comment and thus readily meets the "logical outgrowth" test. In April 2013, the LSTA proposed that Open Market CLO managers be allowed to satisfy the risk retention requirement by purchasing five percent of the CLO's equity securities and by retaining unfunded notes issued by the CLO based on the managers' existing subordinated compensation structure.[42] The LSTA noted that the agencies could limit eligibility for this alternative method of risk retention to CLOs "holding at least 90 percent of their assets in senior, secured syndicated loans and exclude those investing in asset backed securities (including CDOs of ABS, CDOs-squared, and other types of resecuritizations)."[43]

In the FNPRM, the agencies expressly requested comments on the LSTA's April 2013 proposal. 78 Fed. Reg. at 57964. In particular, the agencies asked interested parties to comment on whether the proposal would be a reasonable alternative to the agencies' proposed approach to CLO risk retention and how it would "meet the requirements and purposes of section 15G of the Exchange Act." *Id.* The agencies thereby provided notice that they were considering this particular alternative to CLO risk retention and that they might adopt some or all of its features, and they directly requested comment on that proposed approach. The notice and comment process is designed to provide just that notice and opportunity for comment, so publication and request for additional comment on a substantially similar proposal would not advance the objectives of the Administrative Procedure Act.

The current proposal builds directly on the April 2013 proposal, on which the agencies sought further comment, and incorporates at its core the two principal features of that proposal.

[42] *See* LSTA Comment Letter (Apr. 1, 2013).

[43] *Id.* at 10, n.9.

The current proposal retains the April 2013 proposal's approach of allowing managers of certain CLOs to satisfy the risk retention requirement by purchasing five percent of the equity securities. It also focuses on aligning the incentives between managers and investors, and satisfying Section 941's objectives of doing so through credit risk retention, by requiring managers to retain substantial credit risk through compensation reflecting a deeply subordinated position dependent on the performance of the superior classes of CLO securities. Apart from replicating these two central features, it also adopts the limitations on qualifying CLOs suggested in the April 2013 proposal (90 percent senior secured loans, no resecuritizations) and adds similar, additional limitations to increase investor protections to "meet the requirements and purposes of section 15G of the exchange Act," 78 Fed. Reg. at 57964. In light of the clear link between the current proposal and the April 2013 proposal and the ample notice provided by the FNPRM's request for further comment, the agencies may adopt a final rule implementing the proposal without again providing notice that they might pursue that approach and again seeking comment on the central elements of the proposal.

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The LSTA, SFIG, and SIFMA appreciate the agencies' consideration of these comments and would be pleased to provide additional information that might assist the agencies' decision-making. Please contact Meredith Coffey at (212) 880-3019 or Elliot Ganz at (212) 880-3003 if you have questions regarding these comments and the proposed approach to rulemaking that they set out.

Sincerely,

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