February 10, 2012

By Email

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: Prohibition Against Conflicts of Interest in Certain Securitizations; Proposed Rule (Release No. 34–65355; File No. S7–38–11; RIN 3235-AL04)

Dear Ms. Murphy:

The Loan Syndications and Trading Association ("LSTA")[1] is pleased to submit this comment letter in response to the Notice of Proposed Rulemaking ("NPR")[2] issued by the Securities and Exchange Commission (the "Commission") pursuant to Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[3] The NPR sets forth proposed Rule 127B (the "Rule 127B") under the Securities Act of 1933 (the "Securities Act"). Rule 127B prohibits certain conflicts of interest in asset-backed securities ("ABS") transactions.

I. Introduction

A. Scope of this Comment Letter

This comment letter focuses exclusively on certain aspects of the NPR that should be clarified in order to avoid impairing the issuance of open market collateralized loan obligations

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[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 LSTA is available on its Web site at www.lsta.org. This comment letter was prepared in consultation with the LSTA's CLO Committee, which includes representatives of institutions active in the CLO market as investors, asset managers, and underwriters.

[2] Prohibition Against Conflicts of Interest in Certain Securitizations; Proposed Rule, 76 Fed. Reg. 60320 (Sept. 28, 2011).

[3] Pub. L. No. 111-203, 124 Stat. 1376 (2010). Under Section 621 of the Dodd-Frank Act, the SEC is required to issue rules for the purpose of implementing the prohibitions of certain conflicts of interest under that section.

("Open Market CLOs"). The characteristics of Open Market CLOs are described more fully below.[4] *This comment letter does not address synthetic CLOs or balance sheet CLOs*.

Open Market CLOs are critical to the U.S. economy. Syndicated loans in the United States provide $2.5 *trillion* of financing to U.S. companies[5] and Open Market CLOs are a major purchaser of loans in the syndicated loan market. Therefore, it is imperative that the final conflicts of interest rule not impede the normal functioning of Open Market CLOs and the syndicated loan market.[6] Unless clarified, the ambiguities of the conflicts of interest rule could seriously diminish the flow of much needed credit to U.S. businesses that is provided through the purchase of syndicated loans by Open Market CLOs.

B. Purpose of Section 621 of the Dodd-Frank Act

A key mission of the LSTA is to promote a fair, orderly, efficient and growing corporate loan market. The LSTA therefore agrees with the fundamental principle that a market participant should not be permitted to create and sell an ABS that is intentionally designed to fail and to profit from the failure of that security.

The LSTA recognizes the difficulty in crafting a conflicts of interest rule that serves the underlying policy purpose of Section 621 without inadvertently prohibiting normal and legitimate transactions that are fully consistent with a fair, orderly and efficient securitization market. The LSTA believes that the Commission is correct in identifying the following governing principles for achieving the right balance when defining "material conflict of interest":

1. "If the phrase [material conflict of interest] is construed too narrowly, the proposed rule could potentially permit certain securitization participants to *take undue advantage of their role in the securitization process*, in which case the proposed rule might fail to enhance the integrity of securitization practices as fully as intended.[7] On the other hand, however, … an overly broad interpretation may curtail the willingness of securitization participants to engage in securitization transactions, which ultimately could limit, increase the costs of, or

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[4] For a detailed description of Open Market CLOs, see the LSTA's comment letters on the proposed credit risk retention rules, dated August 1, 2011 (available at: http://www.sec.gov/comments/s7-14-11/s71411-223.pdf) and September 2, 2011 (available at: http://www.sec.gov/comments/s7-14-11/s71411-309.pdf) (collectively, the "LSTA Risk Retention Comment Letters").

[5] *See* Shared National Credit Review, August 2011 (available at: http://www.occ.treas.gov/news-issuances/news-releases/2011/2011-112a.pdf).

[6] The Commission's economic analysis as set forth in the NPR does not address the impact of the Rule 127B on Open Market CLOs or the syndicated loan market. The LSTA urges the Commission to more closely consider the effects of Rule 127B on efficiency, competition and capital formation pursuant to the requirements of Section 2(b) of the Securities Act, taking into account the impact of Rule 127B on Open Market CLOs and the syndicated loan market generally.

[7] *See* NPR, at 60329 (emphasis supplied).

effectively prohibit, transactions that might benefit investors, efficiently redistribute risk, and support important segments of the economy."[8]

2. "[The Commission is] not aware of any basis in the legislative history of Section 621 to conclude that this provision was expected to alter or curtail the legitimate functioning of the securitization markets, as opposed to targeting and eliminating specific types of *improper conduct*."[9]

3. "[A]ctivities associated with the typical structuring of a non-synthetic ABS would not be prohibited by the proposed rule."[10]

4. "[M]ost activities undertaken in connection with the securitization process would not be prohibited by the proposed rule[.]"[11]

Unfortunately, it is not clear from the text of the Rule 127B and the accompanying interpretive guidance that the typical structuring and other activities undertaken in Open Market CLO transactions would be permissible. The LSTA therefore urges the Commission to provide clarification that the typical structuring and related activities associated with Open Market CLOs as described below would not be prohibited by the conflicts of interest rule.

II. Description of Open Market CLOs

As noted above, this comment letter does not address synthetic CLOs or balance sheet CLOs. Rather, like the LSTA Risk Retention Comment Letters, this comment letter addresses Open Market CLOs with the following typical characteristics:

- the assets of such Open Market CLO are comprised solely of:
  - (i) senior, secured syndicated loans acquired by the Open Market CLO directly from the sellers thereof in open market transactions[12] or from other Open Market CLOs and (ii) temporary investments (together accounting for at least 90% of the aggregate outstanding principal amount of the assets purchased by the Open Market CLO);

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8 *Id.* (summarizing the comments of industry participants).

9 *Id*. (emphasis supplied).

10 *Id*. at 60340.

11 *Id*.

12 The term "open market transaction" means (i) either an initial loan syndication transaction or a secondary market transaction in which a seller offers senior, secured syndicated loans to prospective purchasers in the loan market on market terms on an arm's length basis, which prospective purchasers include, but are not limited to, entities that are not affiliated with the seller, or (ii) a reverse inquiry from a prospective purchaser of a senior, secured syndicated loan through a dealer in the loan market to purchase a senior, secured syndicated loan to be sourced by the dealer in the loan market.

  - other corporate credit obligations;

  - government obligations used to credit enhance ABS issued by an Open Market CLO;

  - hedge transactions;[13] and

  - workout interests;[14]

- the Open Market CLO is managed by a collateral manager that is registered as an investment adviser under the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act"), or is an affiliate of a registered investment adviser and itself is in practice subjected to the Investment Advisers Act (such a collateral manager, a "Regulated Collateral Manager"); and

- the Open Market CLO is not a balance sheet CLO[15] or a synthetic CLO.

An Open Market CLO may obtain a credit facility from a third party to finance the acquisition of its assets prior to the issuance of its ABS in a securitization transaction (such credit facility, a "Warehouse Facility"). The structuring bank is often the lender under the Warehouse Facility[16] and, in its capacity as a lender under the Warehouse Facility, may enter into hedge transactions to protect it from currency, credit, interest rate and other related market risks.

III. Comments

A. The Application of Rule 127B to Structuring Banks Should be Limited

1. The Role of Structuring Banks

Structuring banks facilitate the selection by a third party collateral manager of an eligible portfolio of underlying syndicated leveraged and other corporate loans to be included in an Open

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13 The term "hedge transactions" means interest rate swaps, currency swaps, timing swaps, basis swaps, caps, floors and collars and similar transactions for the purpose of hedging related exposures and not for the purpose of obtaining exposure to a corporate credit obligation.

14 The term "workout interests" means equity interests and corporate credit obligations obtained as a result of a workout, restructuring, bankruptcy, or similar transaction or proceeding in connection with an asset held by an Open Market CLO.

15 The term "balance sheet CLO" means a CLO whose assets consist predominantly of loans originated and transferred to the CLO by one or more of its affiliates other than in (i) open market transactions or (ii) from another Open Market CLO, and the assets and liabilities of such CLO are, immediately after issuance of its ABS in a securitization transaction, included under generally accepted accounting principles in the consolidated balance sheet of one or more of its affiliates.

16 Under a Warehouse Facilities with multiple lenders, the structuring bank often acts as the agent of the lenders.

Market CLO. Those loans must satisfy the applicable rating agency criteria and permit the issuance of rated securities to be sold to third-party investors. As noted above, the structuring bank will often provide or arrange the Warehouse Facility to the Open Market CLO or the collateral manager for the purpose of financing this portfolio, since (due to the requirements for diversification by issuer and industry) it can take several months for an eligible portfolio to be assembled. Structuring banks also arrange for the preparation and negotiation of the legal documentation for the Open Market CLO transaction, model the Open Market CLO transaction and engage with the rating agencies and investors. Structuring banks are often involved as the initial purchaser or placement agent in distributing the ABS issued by the Open Market CLO.

2. Rule 127B Should Not Apply to the Structuring of Open Market CLOs by Structuring Banks

In the context of the typical Open Market CLOs described above, Rule 127B may inadvertently prohibit the typical structuring activities of the structuring bank, including the lending and related hedging activities of the structuring bank as the lender under the Warehouse Facility. As noted by the Commission, Rule 127B is not intended to prohibit "activities associated with the typical structuring of a non-synthetic ABS."[17] Therefore, the Commission should make clear that the structuring bank's activities in structuring an Open Market CLO, including its activities in connection with the related Warehouse Facility, should be exempt from Rule 127B.

Moreover, the Regulated Collateral Manager, not the structuring bank, is the entity responsible for selecting the loans to be included in an Open Market CLO.[18] Therefore, a structuring bank will simply not have a meaningful opportunity to engage in the sort of improper conduct that Section 621 of the Dodd-Frank Act is intended to prohibit.[19] As a result, the application of Rule 127B to the structuring activities of the structuring bank cannot achieve the balancing of interests described above because such application of Rule 127B would upset the normal operation of Open Market CLOs without serving the interest of preventing improper conduct.

3. Rule 127B Should Not Prohibit a Structuring Bank or its Affiliates from Entering Into a Short Position with Respect to the Loans Included in an Open Market CLO

Rule 127B should not prohibit a structuring bank or its affiliates from entering into short

[17] *Id*. at 60340 (containing a list of typical structuring activities in connection with non-synthetic ABS, including providing financing to a securitization participant.

[18] In the application of its credit underwriting criteria, the structuring bank, as lender under the Warehouse Facility, has the right to reject any loan for financing under the Warehouse Facility, thus effectively preventing such loan from being included in an Open Market CLO transaction.

[19] Unlike some synthetic or "hybrid" CLOs, Open Market CLOs do not enter into short positions with respect to a reference pool of loan assets. In other words, Open Market CLOs have only long positions with respect to the loan assets included in them. Generally, the eligibility criteria for a CLO would not permit the CLO to enter into short positions.

positions with respect to loans included in an Open Market CLO. As explained below, not only would such a rule be impractical or impossible to implement, it is also completely unnecessary in light of the purposes of Section 621 of the Dodd-Frank Act.

Such a rule would be impractical, and in many cases, impossible to effectively implement. There are more than 1,000 outstanding institutional loans, and a single Open Market CLO often contains 100 or more different loan assets. In addition to structuring CLOs, the structuring bank and its affiliates engage in myriad other investment and banking activities relating to the institutional loan market that are completely unrelated to any particular Open Market CLO transaction. It is simply impractical for a structuring bank to put into place internal controls to ensure that the bank and all of its affiliates do not enter into a short position with respect to any of the loans in the Open Market CLO. Indeed, information barriers within the consolidated bank group that have been established for various purposes[20] may make it impossible to effectively implement such controls because those information barriers may prevent the structuring bank from knowing about a short position taken by one of its affiliates. In addition, structuring banks are often dealers in loans and play a role in the syndication market and in that role may have sound commercial reasons for entering into short positions.

More fundamentally, the intent of Section 621 is to prohibit improper conduct by a securitization participant that constitutes taking undue advantage of that securitization participant's role in the securitization process.[21] As the Commission noted, Rule 127B is intended to prohibit a securitization participant from promoting an ABS "as a good investment when the securitization participant has either structured the transaction in a manner that is designed to fail or takes other actions (i.e., entering into a short transaction) through which it will profit from such failure."[22] A prohibition on the short sale of an underlying loan by the structuring bank or its affiliates does not serve this policy purpose because there is no potential for the economic outcome of that short sale to be influenced by the structuring bank's role in the Open Market CLO.

For example, if an affiliate of the structuring bank enters into a short transaction with respect to a loan included in an Open Market CLO, the economic outcome of that short position is independent of the manner in which the Open Market CLO is structured. In other words, the bank's role in the securitization process has no bearing on the economic outcome of that unrelated short transaction. Indeed, the very existence of the Open Market CLO that contains the shorted loan is completely irrelevant to the economic outcome of the affiliate's unrelated short transaction involving that loan. Thus, unlike the inherent conflict present in designing a security to fail so that it can be shorted profitably, the structuring bank is in no way able to take

[20] For example, informational barriers are often established in order to prevent the unpermitted use of material nonpublic information.

[21] *Id*. at 60329.

[22] *Id.* at 60330.

advantage of its role in the securitization process to create an opportunity for its affiliate to profitably short an underlying loan.[23]

B. Rule 127B Should Not Apply to Collateral Managers

1. Role of the Collateral Manager

An Open Market CLO does not originate loans. Rather, an Open Market CLO is itself a third-party purchaser that seeks to purchase loans in the open loan market for its portfolio based on the Regulated Collateral Manager's due diligence.

The Regulated Collateral Manager is the entity that manages the Open Market CLO. As discussed below, Regulated Collateral Managers are registered investment advisers who often manage loans included in business development companies, mutual funds, limited partnerships and separate accounts as well as CLOs.

The business mandate of the Regulated Collateral Manager is to select loans that will perform well for the Open Market CLO. After the acquisition of the loan, the Regulated Collateral Manager actively manages the Open Market CLO's loan portfolio through purchases and sales in accordance with the CLO transaction documents. As discussed below, the Regulated Collateral Manager's remuneration is tied directly to the performance of the underlying loan portfolio.

2. Collateral Managers are Not "Sponsors" of Open Market CLOs

Section 621 of the Dodd-Frank Act and Rule 127B prohibit certain conflicts of interest between securitization participants and investors. The term "securitization participant" is defined as an underwriter, placement agent, initial purchaser, or *sponsor*, or any affiliate or subsidiary of any such entity, of an ABS.[24]

In the NPR, the Commission states that it preliminarily believes that a collateral manager should be subject to Rule 127B as a sponsor based on its role in structuring the transaction and selecting assets.[25] The Commission seeks comment on whether the term "sponsor" should be defined to include a collateral manager.[26]

The LSTA strongly believes that it is inappropriate to characterize a Regulated Collateral Manager as the sponsor of an Open Market CLO. Regulated Collateral Managers are hired professional investment managers for Open Market CLOs. As explained in the LSTA Risk

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[23] The LSTA does not object to a rule prohibiting a structuring bank or its affiliates from entering into a proprietary short position with respect to the securities issued by the Open Market CLO itself.

[24] *See* NPR at 60320.

[25] *See* NPR at 60325.

[26] *Id.* (request for comment #12).

Retention Comment Letters, Regulated Collateral Managers do not organize and initiate an Open Market CLO transaction by transferring the loan assets, directly or indirectly, to the issuing entity because Regulated Collateral Managers do not own the assets held by the seller or transferor and thus cannot, and do not, sell or transfer assets either directly or indirectly to the Open Market CLO. As a result, collateral managers are not sponsors as that term is used in the regulatory regime for ABS transactions. [27]

3. *The Investment Advisers Act Provides a Robust Regulatory Regime for Regulated Collateral Managers*

Regulated Collateral Managers are registered as investment advisers under the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act"), or are affiliates of registered investment advisers and themselves are in practice subjected to the Investment Advisers Act. The Investment Advisers Act provides a robust regulatory regime for Regulated Collateral Managers. Therefore, even if the Commission believes that Regulated Collateral Managers are sponsors of Open Market CLOs for the purpose of Rule 127B, Rule 127B should not apply to Regulated Collateral Managers.

The existing regulatory regime under the Investment Advisers Act is more than adequate to address the concerns underlying Section 621 of the Dodd-Frank Act. For example:

- All investment advisers, as defined under the Investment Advisers Act, whether registered or not, have a fiduciary duty to their advisory clients. This has been described as an affirmative duty of utmost good faith to act solely in the best interests of the advisory client and to make full and fair disclosure of all material facts, particularly where the adviser's interests may conflict with those of the client.[28] This duty requires investment advisers to at all times act in the advisory client's best interests.

- The Investment Advisers Act prohibits investment advisers, directly or indirectly, from defrauding advisory clients, engaging in fraudulent, deceptive or manipulative practices with respect to an advisory client.[29]

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[27] *See, e.g.*, the definition of "sponsor" in Item 1101(l) of Regulation AB ("the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through and affiliate, to the issuing entity") (note that the definition of "sponsor" in the proposed credit risk retention rules is nearly identical to the Regulation AB definition of that term). *See, also*, the definition of "securitizer" added by the Dodd-Frank Act to Section 15G of the Securities Exchange Act of 1934 ("the term 'securitizer' means (A) an issuer of an asset-backed security or (B) a person who organizes and initiates and asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer").

[28] *See, e.g.*, U.S. Supreme Court case *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180 (1963).

[29] *See* Section 206 of the Investment Advisers Act.

- The Investment Advisers Act embodies a comprehensive disclosure and informed consent regime for all investment advisers, relative to conflicts of interest and other matters. In addition, disclosures to advisory clients regarding conflicts of interest and other matters are required through Form ADV for all registered investment advisers.

- Registered investment advisers are required to establish, maintain, and enforce written insider trading policies and procedures, which are to apply not only to the adviser and its personnel, but also to affiliates that control or are controlled by the adviser.[30]

- Registered investment advisers must establish, maintain and enforce a written code of ethics that, at a minimum: includes a standard (or standards) of business conduct for personnel, which reflects the adviser's fiduciary obligations (and those of its personnel) to advisory clients; requires the adviser's personnel to comply with applicable federal securities laws; requires certain personnel of the adviser to report their personal securities transactions and holding to the adviser; and requires personnel to report any violations of the code of ethics to the chief compliance officer or other designated persons.[31]

- Registered investment advisers also must adopt and implement written policies and procedures reasonably designed to prevent violation, by the adviser and its personnel of the Investment Advisers Act and the rules thereunder; and must designate a chief compliance officer to administer these policies and procedures and review them at least annually.[32]

- The Investment Advisers Act prohibits any investment adviser to a pooled investment vehicle[33] from:

    - making any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or

    - otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.[34]

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30 *See* Section 204A of the Investment Advisers Act.

31 *See* Rule 204A-1 under the Investment Advisers Act.

32 *See* Rule 206(4)-7 under the Investment Advisers Act.

33 A "pooled investment vehicle" for this purposes is any investment company (as defined in the Investment Company Act) or any company that would be such an investment company but for the exclusion in Section 3(c)(1) or 3(c)(7) of the Investment Company Act.

34 *See* Rule 206(4)-8 under the Investment Advisers Act.

- The Commission and its staff have provided investment advisers with extensive guidance, in the form of exemptive applications, "no-action" letters and administrative proceedings and other enforcement actions, which inform the manner in which advisers conduct their advisory businesses, make disclosures to advisory clients and otherwise address or manage conflicts of interest and other matters.

4. The Compensation Structure for Collateral Managers Provides a Strong Economic Disincentive to Create Open Market CLOs that are Designed to Fail

The management fee structure in Open Market CLOs creates a strong incentive for the collateral manager to prudently select and manage the Open Market CLO's loan portfolio, thereby aligning the collateral manager's interests with those of the Open Market CLO investors. As the Federal Reserve's Securitization Study describes the performance-based fee structure typically used to align incentives for CLO managers: "Management fees are often split into three parts: a base fee (senior to all noteholders), a subordinate fee (subordinate to all noteholders but senior to equity), and an incentive fee (gain sharing after equity has achieved a target rate of return)."[35]

The collateral manager of an Open Market CLO is not paid gain on sale (since it does not sell assets to the Open Market CLO) and is generally not paid any upfront fee, but rather is generally paid through a three-tier fee structure during the life of the Open Market CLO. The base fee (usually 10-20 basis points ("bps") per annum, generally based on the notional value of the assets in the Open Market CLO) is paid prior to payments of interest to noteholders. This fee allows the collateral manager to cover certain of its costs associated with managing the Open Market CLO. The subordinated fee, which is the bulk of the "running" fee (usually 30-40 bps per annum), is paid only after interest is paid on all rated ABS issued by the Open Market CLO notes. If the Open Market CLO is not performing well and interest is not being paid on the CLO's rated notes, the collateral manager will have the bulk of its fees deferred. Finally, the majority of Open Market CLOs also have an incentive fee, which is paid near the end of the life of the Open Market CLO. This fee is paid only if all of the Open Market CLO's rated ABS have received all payments of principal and interest required to be made by such time and the Open Market CLO equity has achieved a certain pre-negotiated rate of return. Thus, the majority of the collateral manager's compensation is tied to the performance of the Open Market CLO.

This compensation structure ensures that the collateral manager's incentives are aligned with those of the Open Market CLO investors throughout the life of the Open Market CLO. In addition, collateral managers rely on their reputations for prudence and performance to develop new business, and this reputational incentive provides an additional safeguard for investors' interests. Simply put, the collateral manager's compensation structure, as well as its reputational interests and regulated status as an investment adviser, provide a strong disincentive for the collateral manager to create Open Market CLOs that are designed to fail.

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[35] Report to the Congress on Risk Retention, The Board of Governors of the Federal Reserve (Oct. 9, 2010), available at http://federalreserve.gov/boarddocs/rptccongress/seeuritization/risk retention.pdf (at 47).

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We sincerely appreciate your consideration of our comments. Please feel free to contact Elliot Ganz at (212) 880-3003 or Meredith Coffey at (212) 880-3019 if you have any questions regarding our comments.

Sincerely,

R. Bram Smith
Executive Director
Loan Syndications and Trading Association