The Clearing House
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October 30, 2013

**By Electronic Submission**

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Re: **Notice of Proposed Rulemaking: Credit Risk Retention**
OCC (Docket No. OCC-2013-0010); FRB (Docket No. R-1411);
FDIC (RIN 3064-AD70); FHFA (RIN 2590-AA43);
SEC (Release No. 34-70277; File No. S7-14-11); HUD (RIN 2501-AD53)

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("**The Clearing House**")[1] appreciates the opportunity to comment on the Joint Notice of Proposed Rulemaking (the "**Revised Proposal**"), issued by the Office of

[1] Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers –
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the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Board of Governors of the Federal Reserve System (the "**Board**"), the Federal Housing Finance Agency and the Department of Housing and Urban Development (collectively, the "**Agencies**") to implement the risk retention requirements of Section 941 ("**Section 941**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**").[2] In the Revised Proposal, the Agencies re-propose with certain modifications rules originally proposed to implement Section 941 in 2011[3] (the "**Original Proposal**").

The Clearing House's members historically have arranged a large portion of the commercial loans that are purchased by open market collateralized loan obligations ("**CLOs**"),[4] and, accordingly, they are deeply interested in the rules implementing Section 941. Although we are interested in all aspects of the rules implementing Section 941, in this letter we focus only on the Revised Proposal's treatment of CLOs because of the unique role our members play in arranging commercial loans, for which CLOs are significant credit providers. The Clearing House did not comment publicly on the Original Proposal because the Loan Syndication and Trading Association (the "**LSTA**") and other industry associations with overlapping memberships have been actively engaged in the rulemaking process. We are commenting on the Revised Proposal now because The Clearing House believes that the Revised Proposal's shift of risk retention requirements, for a newly-defined category of "**open market CLOs**", to the lead arrangers of eligible commercial loans[5] (the "**Arranger Option**"), if adopted as proposed, would be neither workable nor actually used in practice, and could result in a contraction of credit available to non-investment grade commercial borrowers that in turn would cause considerable economic harm that Section 941 was crafted to avoid. Most importantly:

- The Arranger Option would be inconsistent with sound risk management, would expose arrangers to potential liability to CLO investors and other holders of the CLO eligible tranches for real or alleged breaches of representations and warranties that banks cannot realistically accept, and would be economically unworkable from the arrangers' perspective because of the

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the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated clearing-house, funds transfer, and check-image payments made in the U.S. *See* The Clearing House's web page at www.theclearinghouse.org.

[2] 78 Fed. Reg. 57928 (Sept. 20, 2013). Section 941 added Section 15G ("**Section 15G**") to the Securities Exchange Act of 1934, as amended.

[3] 76 Fed. Reg. 24090 (April 29, 2011).

[4] According to the LSTA, CLOs provide $285 billion of financing to U.S. companies. Based on data reported by Standard & Poor's as of October 23, 2013 on institutional term loan transactions, so far this year members of The Clearing House have been responsible for arranging approximately 58.5% of the term loans purchased by open market CLOs in the United States.

[5] *See* Revised Proposal at §___.9.

increase in capital costs and FDIC assessment charges that arrangers would incur by making any tranche of a syndicated loan to a commercial borrower consistent with the Arranger Option.

- If the Agencies believe that open market CLOs have a "securitizer" and that Section 941's risk retention rules apply to open market CLOs,[6] an approach to open market CLOs that recognizes (and where appropriate, builds on) the existing alignment of interests between the CLO managers and CLOs investors would better achieve Congress' objective in enacting Section 941.

- We endorse, as supplements to risk retention arrangements for open market CLOs that focus on the CLO manager's fees, the approaches that we understand the LSTA and the Structured Finance Industry Group (the "**SFIG**") are developing (the "**Alternative Approaches**") – namely (i) the LSTA's proposed criteria for qualifying assets held by open market CLOs that would be eligible for reduced risk retention (the "**Reduced Risk Retention Criteria**") and (ii) the SFIG's proposal that credit be given for the retention of credit risk by persons other than the CLO manager ("**Third Party Risk Retention**"), each described in their own comment letters on the Revised Proposal.

Part I of this letter addresses our concerns with the Arranger Option; Part II addresses further our views concerning the alignment of interests CLO managers and investors and our related proposals for risk retention; and Part III comments further on the Alternative Approaches.

## I. The Clearing House strongly believes that the Arranger Option is unworkable and will not benefit commercial borrowers.

The Arranger Option contemplated in the Revised Proposal would exempt from the risk retention requirements "open market CLOs" (as defined in the re-proposed rule) that satisfy a number of conditions. Those conditions generally require that the governing documents of an open market CLO provide that, at all times, the CLO's assets consist solely of senior, secured syndicated loans that are "CLO-eligible loan tranches" and servicing assets.

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[6] The Clearing House agrees with the view advanced by other commenters on the Original Proposal that an open market CLO does not have a "securitizer" within the meaning of Section 941, and, accordingly, that the Agencies do not have the authority under Section 941 to impose a risk retention requirement on them. While the manager of an open market CLO organizes and initiates an asset-backed securities transaction, it does not do so "by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer" as contemplated by Section 15G(1)(3)(B). We do not agree with the Agencies' position that the this language is ambiguous or that it must be read to include managers of open market CLOs, who play an entirely different role, to avoid making the statute inoperative for the structures it was intended to cover. The reference in the statute to "directly or indirectly, including through an affiliate" provides sufficient scope to prevent evasions by entities that continue to originate assets for distribution through securitizations by shifting activities to agents without being construed so broadly as to capture managers, whose function is to advise CLOs on the selection of assets for purchase and not themselves to sell or transfer assets to CLOs. *See* Revised Proposal at 57962.

Under the Arranger Option, a term loan tranche of a syndicated credit facility must have specified features in order to qualify as a "CLO-eligible loan tranche", which include (i) that a minimum of 5 percent of the face amount of the term loan tranche be retained by the "lead arranger" thereof until the earliest of the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of such tranche, and (ii) that the "lead arranger" of the term loan must comply with the rule's limitations on hedging, transferring and pledging with respect to its retained interest. To be a "lead arranger", an institution must, among other things, be identified as the "lead arranger" in the applicable agreements governing the term loan tranche, represent to the holders of such tranche that such arranger and such tranche satisfy the rule's applicable requirements and covenant to such holders that it will fulfill the risk retention requirement and observe certain prohibitions on hedging, transferring and pledging the retained interest. The term loan tranche must be a "senior, secured syndicated loan", which requires among other things that (i) the loan be secured by a valid first priority security interest on collateral having a value that, together with other attributes of the obligor, is adequate in the commercially reasonable judgment of the CLO manager exercised at the time of the investment to repay the loan in accordance with its terms and to repay all other indebtedness of equal seniority secured by such first priority security interest, and (ii) the CLO manager certify as to the adequacy of the collateral and the attributes of the borrower in regular periodic disclosures to investors.

We strongly believe that the criteria contemplated by the Arranger Option are unworkable for three principal reasons:

- First, the requirement to retain at least 5 percent of the tranche, when combined with the prohibition on hedging, transferring and pledging the retained interest, is inconsistent with sound risk management practices. Bank supervisory authorities, which include certain of the Agencies, strongly encourage banks to maintain the flexibility to actively manage their risk exposures and respond to changed circumstances.[7] Moreover, in light of regulatory and prudential lending limits, any requirement to retain term loan exposure would limit lead arrangers' capacity to provide other forms of credit to borrowers – such as revolving credit – that, as depository institutions, they are uniquely qualified to provide. The restriction on hedging is particularly onerous since it extends to affiliates of the lead arranger over which the lead arranger may not have operational control.

- Second, the requirement that a lead arranger represent to the holders of the CLO-eligible loan tranche that the loans meet the rule's criteria would expose the arranger to potential liability to CLO investors and other holders of loans within CLO-eligible loan tranches for real

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[7] *See, e.g.,* Comptroller of the Currency, Leveraged Lending, Controller's Handbook (Feb. 2008) at 5, 9 (identifying "liquidity risk" as one of the primary risks associated with leveraged lending), *available at* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/_pdf/leveragedlending.pdf; *id*. at 16-17 (ongoing loan review with management and disposition planning for troubled loans); Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766, 17773-74 (Mar. 22, 2013) (encouraging development of sound hedging policies, active assessment and management of portfolios, and disposition path for problem credit).

or alleged breaches of representations and warranties that banks cannot realistically accept. These criteria call for subjective determinations as to the creditworthiness of borrowers and the quality and sufficiency of collateral[8] and may be easy to question in hindsight. A lead arranger, by making such a representation, would make itself potentially liable for credit losses on loan tranches eligible for sale to open market CLOs whether or not they are actually sold to CLOs, and at the very least such a representation would expose the lead arranger to potential litigation with respect to any nonperforming assets and the potential costs of defense.[9]

- Third, since making any tranche of a syndicated loan to a commercial borrower eligible for the Arranger Option requires the lead arranger to take an allocation of at least 20 percent of the aggregate principal balance at origination[10] and retain at least 5 percent of the tranche on its balance sheet, use of the Arranger Option would increase the capital and FDIC assessment charges that lead arrangers would suffer, requiring them to increase the pricing of CLO-eligible tranches. Such increased pricing would have an adverse impact on commercial borrowers who today rely on them for arranging and providing credit.

The Clearing House believes it is highly unlikely that the Arranger Option will meaningfully ameliorate the adverse impact on open market CLO formation that the Agencies have previously acknowledged the proposed rule will have.[11] For instance, if any lead arrangers were willing to entertain making a tranche of a term loan eligible under the Arranger Option, compliance with the Arranger Option's requirements could result in increased compliance costs that would be passed along to borrowers. And by reducing the liquidity of tranches that are not eligible for purchase by open market CLOs, it would increase the cost of those tranches as well. As a result, the Arranger Option would not serve its intended purpose to "avoid having the general risk retention requirements create unnecessary barriers to potential open market CLO managers sponsoring CLO securitizations"[12] by providing a viable alternative to standard risk retention under the proposed rule.

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[8] Since it is generally not possible to obtain priority opinions with respect to security interests, a lead arranger certifying that a loan meets the rule's eligibility criteria would be assuming a risk, namely that the security interest or lien in or on the collateral does not meet the priority requirements of the rule, that it could not fully mitigate by obtaining an opinion of counsel when arranging the loan.

[9] Indeed, as a purely technical matter, as currently drafted, the Revised Proposal would require a lead arranger to represent as to the *CLO manager's* reasonable judgment as to the adequacy of the collateral and the *CLO manager's* compliance with the Arranger Option's ongoing certification requirements. We assume this to be a drafting error.

[10] This requirement, in particular, would limit the universe of potential lead arrangers to a very small number of banks.

[11] Revised Proposal at 57962.

[12] *Id*.

**II. We strongly believe the Agencies should address Section 941's risk retention requirements for open market CLOs, if applicable at all to such transactions,[13] by (i) recognizing that the CLO manager is the decision-maker whose interests are already aligned with CLO investors, and (ii) exercising their authority under Section 941 to treat the CLO manager's customary at-risk fees as acceptable risk retention, subject to appropriate standards.**

The principal purpose of Section 941 was to address the risk to investors arising from lax underwriting standards that were considered in significant part to be responsible for the financial crisis by aligning the incentives of sponsors of securitizations with those of investors.[14] The Report of the Senate Committee on Banking, Housing, and Urban Affairs in its discussion of Section 941 cited two problems that emerged in the crisis. "First, 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. . . . Second, it proved impossible for investors in asset-backed securities to assess the risks of the underlying assets, particularly when those assets were resecuritized into complex instruments like collateralized debt obligations (CDOs) and CDO-squared."[15]

Section 941 grants the Agencies broad authority "to adopt or issue exemptions, exceptions, or adjustments to the rules issued under [such] section, including exemptions, exceptions, or adjustments for classes of institutions or assets relating to the risk retention requirement . . . ."[16] Such exemptions, exceptions and adjustments must meet a two-part test. First, they must "[h]elp insure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization."[17] Second, they must "[e]ncourage 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."[18] The Senate Report stated specifically that "[t]he Committee expects that [the Section 941] regulations will recognize differences in the assets securitized, in existing risk management practices, and in the structure of asset-backed securities, and that regulators will make appropriate adjustments to the amount of risk retention required."[19]

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13 *See footnote 6.*

14 "The provision intends to create incentives that will prevent a recurrence of the excesses and abuses that preceded the crisis, restore investor confidence in asset-backed finance, and permit securitization markets to resume their important role as sources of credit for households and businesses." Senate Report 111-176 (April 30, 2010) at 128 (the "**Senate Report**").

15 *Id*.

16 Section 15G(e)(1).

17 Section 15G(e)(2)(A).

18 Section 15G(e)(2)(B).

19 *Id*. at 130. The Senate Report went on to state that "regulators should have flexibility in setting risk retention levels, to encourage recovery of securitization markets and to accommodate future market developments

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Treating the CLO manager's customary "**at-risk**"[20] fees as acceptable risk retention, subject to appropriate standards, satisfies the standards set forth in Section 941 for the Agencies to exercise their authority to fashion a test that is different from the standard risk retention prescribed by the Revised Proposal. These at-risk fees make up the predominant portion of the manager's compensation and, accordingly, highly incentivize them to select for the CLOs they manage high quality assets that they believe appropriately balance risk and return in order allow the CLO to perform (*i.e.*, make all current payments on the CLO debt, repay the CLO debt principal at maturity and make ongoing distributions to the CLO equity). CLO managers find syndicated term loans attractive, in part, because of the discipline inherent in the review of the credit facility by multiple members of the lending syndicate. At the same time, in contrast to the Arranger Option, treating the CLO manager's customary at-risk fees as acceptable risk retention, subject to the standards described below, would maintain the access of businesses to credit on reasonable terms since it would not have the adverse effects on term loan pricing and availability that the Arranger Option would have. Nor would it have the adverse effects on open market CLO formation that the application of standard risk retention under the Revised Proposal would have. The approach we propose is particularly appropriate for the protection of investors because it would strongly align managers' interests with those of the investors, thus discouraging excessive risk taking.

The structural features of open market CLOs as defined in the Revised Proposal incentivize and facilitate the exercise of independent judgment by their managers in the selection of assets, and thus already go a long way towards satisfying Section 941's concerns, to the extent relevant in the context of CLOs, about the perceived lax underwriting standards and the alignment of incentives of securitizers and investors even without imposition of the Arranger Option:

- First, an open market CLO must hold less than 50% of its assets in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates of the CLO.[21]

- Second, a manager of an open market CLO must be a registered investment adviser or affiliated with and managed by a registered investment advisor, and would thus have fiduciary obligations to the CLOs it manages and be subject to a robust enforcement scheme. This requirement thus serves to reinforce the manager's independence from

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and innovations, but that in all cases the amount of risk retained should be material, in order to create meaningful incentives for sound and sustainable securitization practices."

[20] When we refer to a CLO manager's "**at-risk**" fees, we mean that portion of its compensation that is not paid as fixed compensation for basic operating expenses but rather depends on the performance of the CLO's assets.

[21] We assume the intent of the provision is to limit loans syndicated by lead arrangers or originate by originators that are affiliates of the CLO *manager.*

the originators of the assets that these CLOs securitize and influences its standard of care when selecting assets, thus ensuring sound underwriting and selection.

- Third, a manager of an open market CLO may not earn a spread or other commission on the open market CLO's purchase of the securitized assets.

- Fourth, a manager of an open market CLO may not receive any management fee or gain on sale at the time the open market CLO issues its ABS interests.[22]

Moreover, as noted by the Board, since unlike securitizations of other asset classes CLOs are actively managed, investors must determine how to align the interests of the CLO manager.[23] As a result, under current market practice, a substantial majority of managers' potential compensation is already derived from fees that are either subordinated to ABS interests or entirely contingent on the success of the transaction. We believe that in light of these requirements, it is entirely appropriate to treat the CLO manager's customary at-risk fees as acceptable risk retention for open market CLOs for purposes of the Section 941 regulations.[24]

As the Agencies have acknowledged in the Revised Proposal, in light of the economics of open market CLOs, standard risk retention as proposed would impose prohibitive costs on managers of open market CLOs.[25] CLO managers do not have the capital or access to credit necessary to retain five percent of the interests issued by open market CLOs on a funded basis. According to a July 2013 LSTA survey of managers running the vast majority of CLOs, the Original Proposal would cause CLO formation to decline by 75%. Since managers of open market CLOs do not earn any spread on the sale of assets to the CLO and thus rely entirely on management and incentive fees for their compensation, it is

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22 We note that this requirement would prohibit the management fees that some managers earn during the warehouse period. We believe this prohibition is not necessary to achieve Section 941's objectives since these fees do not undermine the incentives created by the manager's at-risk compensation.

23 Risk Retention Report at 46.

24 It should also be noted that under current market practice, the typical open market CLO includes loans to 100 to 150 obligors and managers of open market CLOs have extensive access to information on the obligors' credit and the nature of the collateral provided when selecting loans for purchase and making ongoing portfolio management decisions. Selection criteria, including credit quality and concentration requirements, are developed by managers together with equity investors to satisfy investors' objectives. Since there are far fewer assets and considerably greater transparency than in most other securitization structures, open market CLOs do not raise the concerns identified in the Senate Report with regard to investors' inability to assess the risk of the underlying assets. Senate Report at 128. Adding an information access condition for an open market CLO to be permitted to treat the CLO manager's at risk fees as acceptable risk retention would be consistent with existing practice in the loan syndication market and would further support the argument that this approach is consistent with sound underwriting and risk management practices.

25 "The agencies also recognize that the standard forms of risk retention in the original proposal could, if applied to open market CLO managers, result in fewer CLO issuances and less competition in this sector." Revised Proposal at 57962.

economically not practical for them to meet the standard risk retention requirement by holding fully-funded eligible horizontal residual interests that satisfy the rule's cash flow criteria.

Standard risk retention as now proposed is not viable for open market CLOs because equity interests in these CLOs under current market practice would not qualify as eligible horizontal residual interests and could not as a practical matter be restructured to qualify. Today, equity interests in open market CLOs provide for current distributions of interest notwithstanding the reinvestment of principal during their initial phase,[26] subject to a requirement, often referred to as "cash flow diversion", to divert cash flow to amortize senior debt or reinvest in new assets if specified over-collateralization ratio tests are not met.[27] Likewise, cash flow derived from principal payments on the CLO's portfolio cannot be distributed to the CLO equity until the CLO debt has been repaid, and no payments of principal are payable on the CLO debt until after a reinvestment period. Cash flow diversion further incentivizes managers because, apart from the senior component of the fee that is designed to cover their basic operating expenses, they are only paid while the CLO is performing. A flat prohibition on current distributions during the reinvestment phase would drastically reduce the return on equity and make the equity interests unattractive to investors. We therefore do not believe it is practical to design an open market CLO such that the equity interests comply with the cash flow limitations in the Revised Proposal, and, in fact, no existing CLO today would meet the requirements of the Revised Proposal.

Accordingly, The Clearing House believes that the at-risk component of the manager's compensation in an open market CLO meeting the structural conditions set forth in the Revised Proposal[28] should be treated as acceptable risk retention. We would define the at-risk component to include incentive fees and any fees that are subordinated to all ABS interests other than equity interests in the open market CLO, but not the senior component of the fee, provided that at least 65% of the manager's expected total compensation is payable only to the extent the CLO's debt is being been paid on a current basis and the CLO's portfolio is not suffering from losses or credit deterioration in excess of specified triggers set forth in its governing documents. In light of the structural features of open market CLOs that themselves strongly encourage CLO managers to select high quality loans, as well as the more limited resources of the managers of open market CLOs, we also believe the Agencies should use their discretionary authority under Section 941 to permit a lower percentage of risk retention than the five

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[26] CLOs are designed with a reinvestment period (typically four years) to protect investors from scheduled principal payments during such period and early repayments that would result from the prepayment rights granted to borrowers in the syndicated loan market in response to their commercial requirements.

[27] *See* the SFIG letter to the Agencies dated October 30, 2013 for a more detailed description of the waterfall provisions that are typical of open market CLOs.

[28] To make this approach practical, however, the definition of "open market CLO" would have to be modified to permit such entities to hold some senior, syndicated loans that are not secured by a first priority security interest or lien. We believe that since a significant fraction of high quality senior syndicated loans is not so secured, excluding them from open market CLOs qualifying for this form of risk retention would adversely impact the availability of credit to a significant group of borrowers without any corresponding benefit to the public or to investors in securitizations.

percent that is required for other securitization structures. We believe further that it is not necessary for the protection of investors that the retained risk be funded or that it meet the cash flow test applicable to eligible horizontal residual interests under standard risk retention given the structural features of open market CLOs and more limited resources of these managers. Imposing these requirements on managers of open market CLOs would reduce the access of businesses to credit on reasonable terms and do nothing to enhance the protection of investors that would not be accomplished by our proposal.

The Clearing House notes that nothing in the text or legislative history of Section 941 requires that in the open market CLO context a sponsor purchase subordinated interests for an amount equal to at least five percent of the value of the assets or that it retain such interests until all other investors are repaid.[29] The statute states only that a securitizer must retain "not less than 5% of the credit risk for any asset that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer."[30] In the context of open market CLOs, where managers are entirely dependent on their incentive compensation and their reputations to remain in business, there is no reason for the Agencies to interpret the statute as mandating that the entire retained interest be funded and serve as credit enhancement. Indeed, the Agencies' acceptance of vertical risk retention as part of standard risk retention itself makes clear that retained interests need not absorb losses to serve Section 941's purpose of aligning the interests of securitizers and investors.

The LSTA's proposal for expanded manager risk retention set forth in its April 1, 2013 letter to the Agencies is a more structured and elaborate approach to providing credit for the at-risk component of manager's compensation and also responds to the purposes of Section 941 while recognizing the realities of the CLO market. Under this approach, a manager of an open market CLO could satisfy the rule's risk retention requirements by holding, at least until the end of the CLO's reinvestment period, a combination of unfunded "vertical" and "incentive" notes issued by the CLO that are modeled to reflect the risks currently assumed by managers through the performance based compensation structure that is now common in the industry and by purchasing equity securities issued by the CLO alongside other investors. To the extent the Agencies believe that recasting managers' compensation as unfunded notes issued by the CLO makes it easier to value them and thus easier to ascertain whether they satisfy some numerical standard, the Clearing House would find the LSTA's proposal an acceptable alternative to our own proposal. While we do not believe that either the text of Section 941 or its legislative history requires any party, in the context of an open market CLO meeting the other criteria set forth in the Revised Proposal, to purchase and retain an equity interest alongside other investors as contemplated by the LSTA proposal, to the extent that managers are financially able to do so without an adverse impact on the formation of open market CLOs, we would not object to such a requirement. Such a

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[29] Moreover, as discussed in *footnote 6*, we believe that the better view is that Section 941's risk retention requirements do not apply to open market CLOs because such CLOs do not have a "securitizer" as defined in Section 941.

[30] Section 15G(c)(1)((B)(i)(I).

requirement would, however, not be viable for the reasons set forth above if such interest were made subject to the cash flow limitations otherwise applicable to standard risk retention.

Managers of open market CLOs exercise independent judgment in the selection of assets and must establish a successful track record in order to remain in business. The strong performance of open market CLOs during the financial crisis is itself compelling evidence of managers' independence and diligence in the selection of assets for securitization. In applying Section 941 to open market CLOs, the Agencies must recognize these fundamental differences between open market CLOs and other securitization structures. The Clearing House believes that so long as open market CLO managers are subject to the requirements of the Investment Advisers Act, are incentivized by appropriate fee structures and are required to purchase and retain some portion of the open market CLO's equity as would be required by our proposal or the LSTA's expanded manager risk retention approach, they will have sufficient "skin in the game" to assure that their interests are aligned with those of investors and that these securitizations will not encourage lax underwriting on the part of commercial loan arrangers.

## III. Either Alternative Approach would further the objectives of Section 941 without adversely affecting the availability of credit or the safety and soundness of the arrangers of syndicated loan facilities.

### A. Reduced Risk Retention Criteria

While The Clearing House believes that its proposal for treating the at-risk component of managers' compensation as sufficient risk retention would be the best approach for implementing Section 941 with respect to open market CLOs, we note that the LSTA's proposed Reduced Risk Retention Criteria are also consistent with Section 941 and would similarly ameliorate to some extent the adverse impact that we believe the Revised Proposal would otherwise have on the syndicated term loan market by reducing the amount of retained risk required to the extent the open market CLO holds loans satisfying these criteria.

Few, if any, loans that are currently held by open market CLOs would satisfy the underwriting and product standards that are included in the Revised Proposal's definition of "qualifying commercial loan",[31] and open market CLOs as currently structured would not meet the Revised Proposal's requirement that a securitization not permit reinvestment periods in order to be eligible for zero or reduced risk retention because some or all of the securitized assets are qualifying commercial loans.[32] Borrowers of loans that satisfy the proposed underwriting standards in the Revised Proposal generally have access to the investment grade credit facility and corporate bond markets. These borrowers would not normally have any reason to borrow on the terms required by product standards in the Revised Proposal. Accordingly, the qualifying commercial loan exemption as currently proposed has no relevance for the syndicated term loan market.

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[31] *See* §___.16.

[32] *See* §___.15(a)(3).

We believe the Reduced Risk Retention Criteria are justified in light of Section 15G(c)(2)(B)'s requirement that the credit risk retention regulations include underwriting standards that "specify the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan." Open market CLOs have had a *de minimis* impairment rate and the CLO market performed well during the financial crisis and continues to do so today.[33] The Board itself has acknowledged that defaults in the collateral underlying CLOs during the financial crisis were limited.[34] The Agencies have not thus far seriously attempted to consider the historical performance of the relevant asset class and the structural features of open market CLOs in defining qualifying commercial loans for purposes of open market CLOs.

The Clearing House believes that the LSTA's Reduced Risk Retention Criteria reflect high underwriting standards and are consistent with the practicalities of the loan syndication market. The flexibility embodied in these criteria reflects the diversity of the commercial loan market without compromising the quality of the assets. Accordingly, in light of the greater alignment of interest between managers of and investors in open market CLOs and the greater transparency, we believe that syndicated term loans satisfying these criteria should not be subject to risk retention when held by an open market CLO.

### B. Third Party Risk Retention

Section 941 contemplates third party risk retention for commercial mortgage backed securities.[35] Like "B-piece buyers" of commercial mortgage backed securities ("**CMBS**"), CLO equity investors exercise considerable control over portfolio quality and parameters of the asset pool. In the case of CLOs, the investors negotiate the portfolio constraints the manager will work within while managing the CLO's portfolio, or in the case of CMBS, the investors negotiate the specific assets to be included in the CMBS' asset pool.

The Clearing House believes that the SFIG's Third Party Risk Retention proposal also has merit and that the Agencies have the authority under Section 941 to adopt it. Under this proposal, a sponsor would be permitted to satisfy some or all of its risk retention requirements if not more than two third-party purchasers purchase and hold an eligible horizontal residual interest.[36] For the same reasons as discussed in connection with the LSTA's expanded manager risk retention proposal, this approach would not be practical unless the cash flow limitations that are now proposed for eligible horizontal residual interests that are part of standard risk retention were made inapplicable to open market CLOs. As noted

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[33] *See* "Losses on US Cash Flow CLO Tranches are Infrequent" in CLO Interest (July 2012) published by Moody's Investors Service.

[34] Board of Governors of the Federal Reserve System, Report to the Congress on Risk Retention (October 2010) at 62 (the "**Risk Retention Report**").

[35] Section 15G(c)(1)(E).

[36] *See* the SFIG Letter to the Agencies dated October 30, 2013 for a more detailed description of the SFIG proposal.

above, nothing in Section 941 requires that a retained interest (regardless of which party holds it) be a first loss provision, and The Clearing House believes that in light of the other structural protections present in open market CLOs, the cash flow limitations otherwise applicable to eligible horizontal residual interests are not necessary to align the interests of the holders of the required retained interests with those of other CLO investors.

The Clearing House believes that the greater transparency and alignment of interests between managers of and investors in open market CLOs support giving credit for Third Party Risk Retention in this context. The Agencies clearly have the authority to adopt such an option under the public interest and protection of investors standard set forth in Section 15G(e).

* * *

The Clearing House believes strongly that that the Revised Proposal's requirement that managers of open market CLOs be subject to the same risk retention provisions as sponsors of securitizations of other asset classes using other structures is not supported by the language or legislative intent of Section 941. Moreover, the adoption of the credit risk retention regulations in their current form is likely to have a severe and adverse impact on the formation of open market CLOs and thus on the availability of credit for commercial borrowers in the United States, which the Arranger Option would not meaningfully mitigate. The Clearing House encourages the Agencies instead to treat the CLO managers' at-risk fees as a form of risk retention along the lines discussed above and to give serious consideration to the Alternative Proposals put forth by the LSTA and the SFIG.

If you have any questions or need further information, please contact John Court of The Clearing House (e-mail – john.court@theclearinghouse.org; telephone number – 202-649-4628).

Respectfully submitted,

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