MEMORANDUM

TO: File No. S7-14-11

FROM: Arthur Sandel
Special Counsel
Office of Structured Finance
Division of Corporation Finance
U.S. Securities and Exchange Commission

RE: Meeting with representatives of the Loan Syndications and Trading Association

DATE: December 12, 2013

On December 11, 2013, Katherine Hsu, Arthur Sandel, David Beaning and Lulu Cheng of the Division of Corporation Finance and Sean Wilkoff and Igor Kozhanov of the Division of Economic and Risk Analysis participated in a meeting with the following representatives of the Loan Syndications and Trading Association ("LSTA"): Meredith Coffey and Elliot Ganz of the LSTA; John Clements of Citigroup, Inc.; Ross Smead of Halcyon Asset Management LLC; Goran Puljic of Oak Hill Advisors, L.P.; and Cynthia Williams of Dechert LLP (by telephone).

The participants discussed topics related to the Commission's August 28, 2013 joint proposed rules regarding credit risk retention. Handouts are attached to this memo.

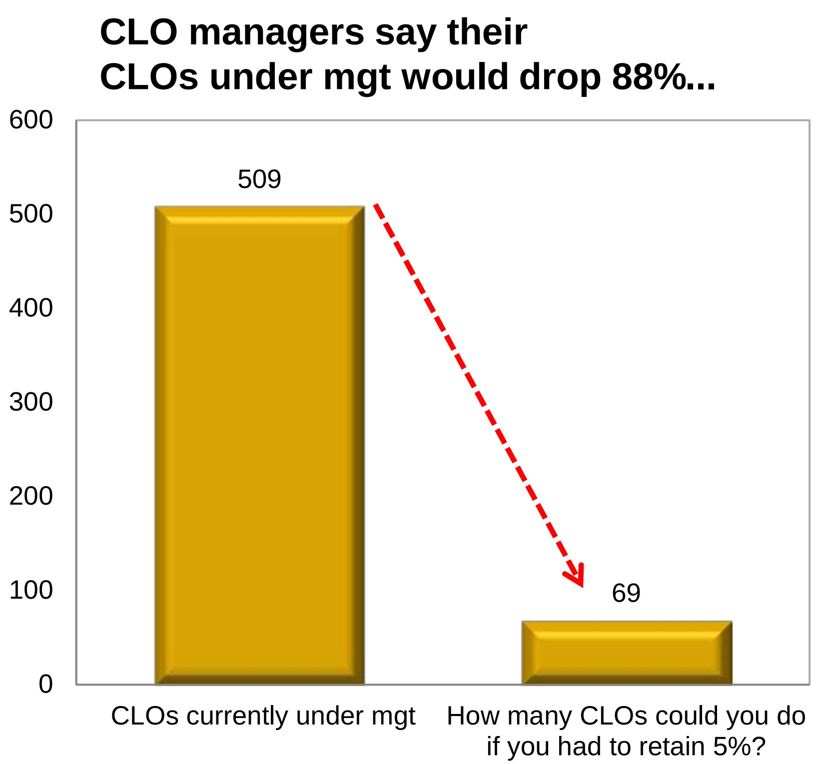
Attachment

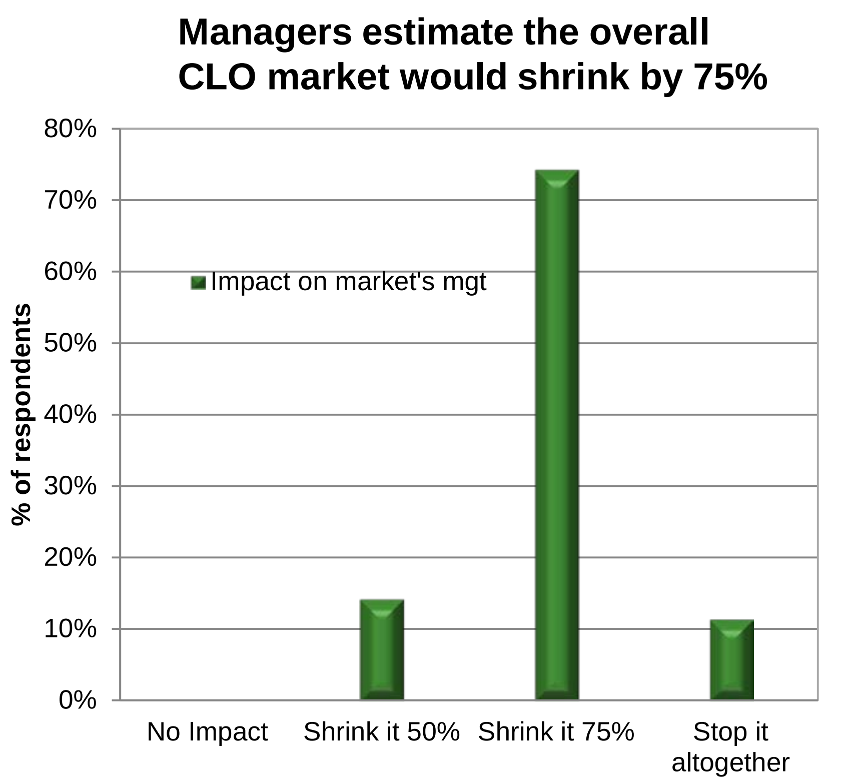
Risk Retention and CLOs

CLOs are different from most securitizations… And they cannot tolerate proposed retention

- Open market CLOs are distinct forms of securitization
- They are actively managed securitizations,
- Their purpose is asset management, *not origination for distribution or funding*
- *And, critically, the proposed risk retention options still do not work for Open Market CLOs*

Risk Retention Shutters CLOs: According to an LSTA survey, market shrinks by more than 75%





- The LSTA asked managers running 70% of U.S. CLOs whether they could manage CLOs if they were required to retain 5% of the fair value of any new CLOs
- According to the LSTA Survey, managers, who currently manage more than 500 CLOs, said they would only run approximately 70 CLOs – in total – if the risk retention rules went into effect as originally written (*left*)
- They estimated it would reduce the CLO market by 75% (*right*) …and this is before the disruptive horizontal retention cash flow diversion language

Source: LSTA Manager Survey, July 2013

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In Their Reproposal, the Agencies Have Acknowledged That…

- The CLO manager is not in a position to retain
  - "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." (FNPRM at 78 Fed. Reg. 57962)

- The horizontal first loss retention is a larger share of the credit risk than the vertical retention option
  - "The agencies observe that horizontal risk retention, as first-loss residual position, generally would impose the most economic risk on a sponsor. Should a sponsor be required to hold a higher percentage of risk retention if the sponsor retains only an eligible vertical interest under this option or very little horizontal risk retention?" (FNPRM at 78 Fed. Reg. 57940)

The LSTA's Latest Comment Letter: Reiteration of Prior Positions

- Reiteration of Prior Positions
  - The Agencies do not have the statutory authority to require managers to retain risk under Section 941
    - Managers initiate CLOs by selecting (i.e., purchasing) assets, not by selling assets (directly or indirectly)
  - A horizontal slice of equity in the amount of 5% of the notional amount of a CLO far exceeds 5% of the credit risk
    - 5% of the equity and the risk inherent in the deferred fees earned by managers equals twice the statutory requirement
  - The costs of imposing risk retention on managers far exceeds the non-existent benefits and the Agencies have not conducted an adequate cost/benefit analysis

The LSTA's Latest Comment Letter: Responses and Recommendations

- Qualified Corporate Loans should not attract retention
  - Agencies should expand the definition of loans that do not attract risk retention to include high quality leveraged loans that have a very low expected loss
- The "Arranger Option" will not work
  - Lead Arrangers will not create CLO-eligible loan tranches
    - The costs of holding 5% of institutional Term Loan B tranches is prohibitive
    - Lead Arrangers will rightly not agree to hold loan exposure without any ability to hedge or sell for the life of the loan
- Third Party Retention
  - Third party equity investors that commit to purchase and not sell or hedge a significant portion of the equity of a CLO and are involved in developing the asset selection criteria for the CLO should be permitted to retain the risk
  - The Limitation on the Payment of Cash to Holders of Eligible Horizontal First Loss Positions is Unworkable
    - It would dramatically reduce IRR and render sponsor equity retention uneconomic

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A New Approach to Consider: The Qualified CLO

- A Qualified Open Market CLO that Meets Strict Criteria Would Require the Manager to Retain 5% of the Equity of the CLO
  - Requires a very significant cash investment by the manager
  - Does not require the agencies to grant an outright exemption, but rather the exercise of modest exemptive relief to a very tightly defined category of ABS
  - Does not require the agencies to contest the definition of credit risk
  - Codifies “best practices” for the CLO market
  - Allows the CLO market to continue to function through a consensual arrangement
  - Avoids a major disruption to the credit markets

Qualified Open Market CLO

- **Manager and CLO regulated**
  - Manager must be a registered investment adviser
  - All purchases and sales must be on an arm's-length basis and in compliance with the Investment Adviser's Act
  - All US holders of CLO notes must be qualified purchasers
- **Manager's incentives aligned with investors**
  - Manager may be removed by majority of senior note holders
  - At least 60% of Manager's fees must be subordinated to note holders
  - Discretionary sales limited to 25% per annum of the principal amount of the CLO (other than defaulted, deteriorated or credit-improved assets)
- **Asset Quality: Constrained by tests, including**
  - Assets must be at least 90% first lien senior secured loans
  - Assets may not include derivatives (other than permissible hedges), CDOs of ABS, CDOs-squared, synthetic CDOs and other types of ABS
- **CLO Portfolio Performance: Facilitated by constraints, including**
  - No more than 3% of assets may relate to any single borrower
  - No more than 15% of assets may relate to any single industry

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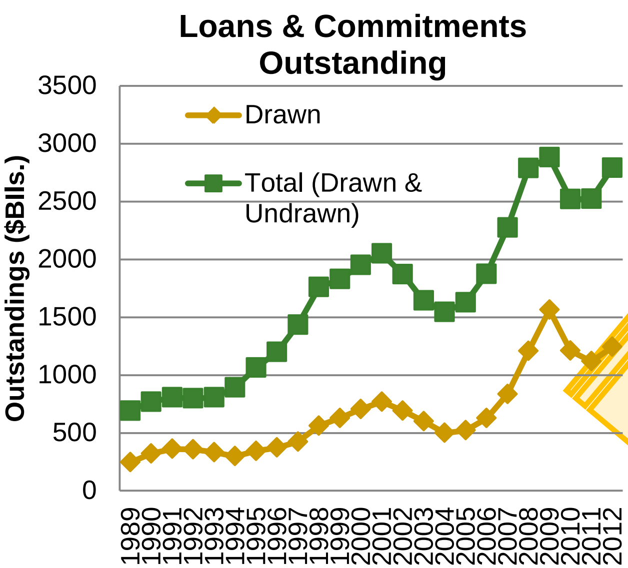
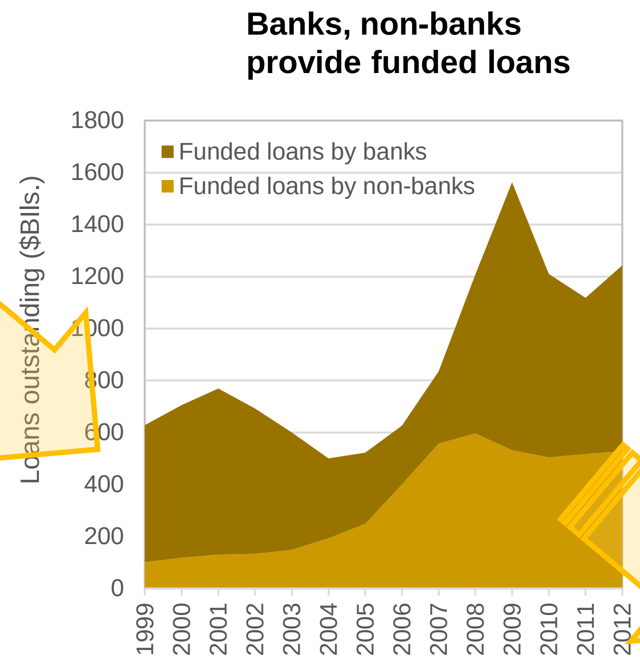
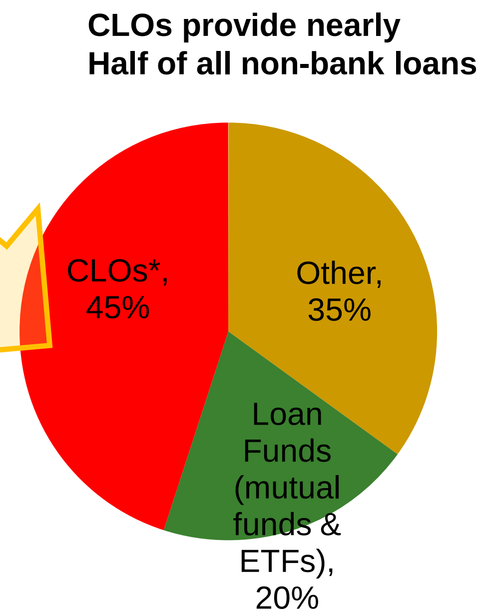
Appendix: Loan and CLO Market Statistics

Syndicated loans provide nearly $2.8 trillion in financing to U.S. companies; CLOs a big component







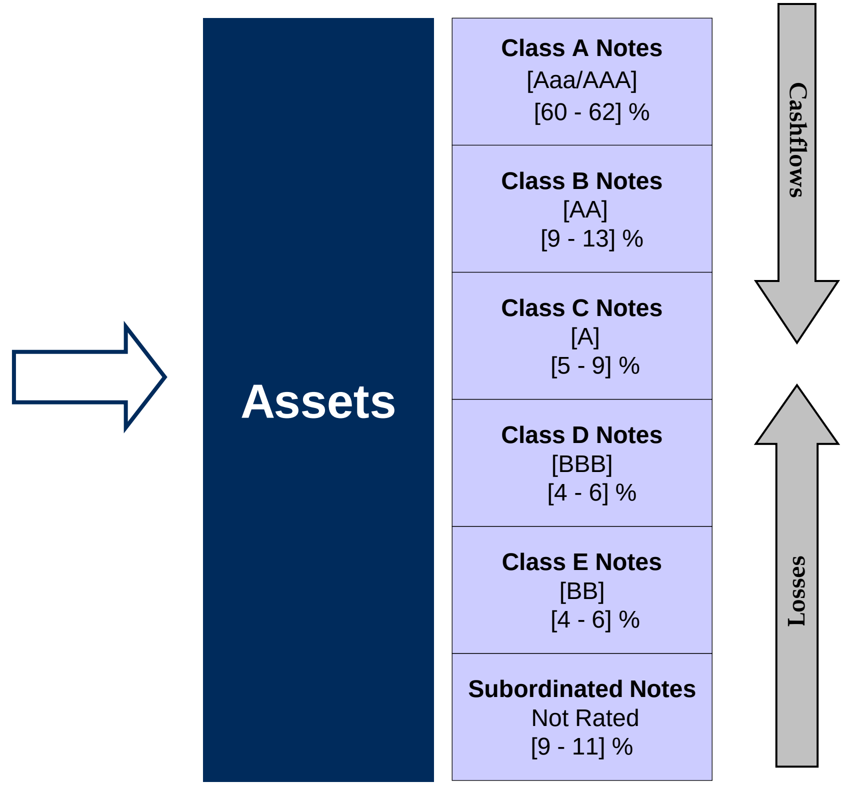
- There are $3 trillion of SNC loans; these are shared loans $20 million and higher
- There are $1.2 trillion of drawn loans
- CLOs provide nearly half the funded non-bank loans, and 25% of ALL SNC term loans

Source: Shared National Credit Review, Fed, OCC, FDIC

CLOs participate in real loans to real companies

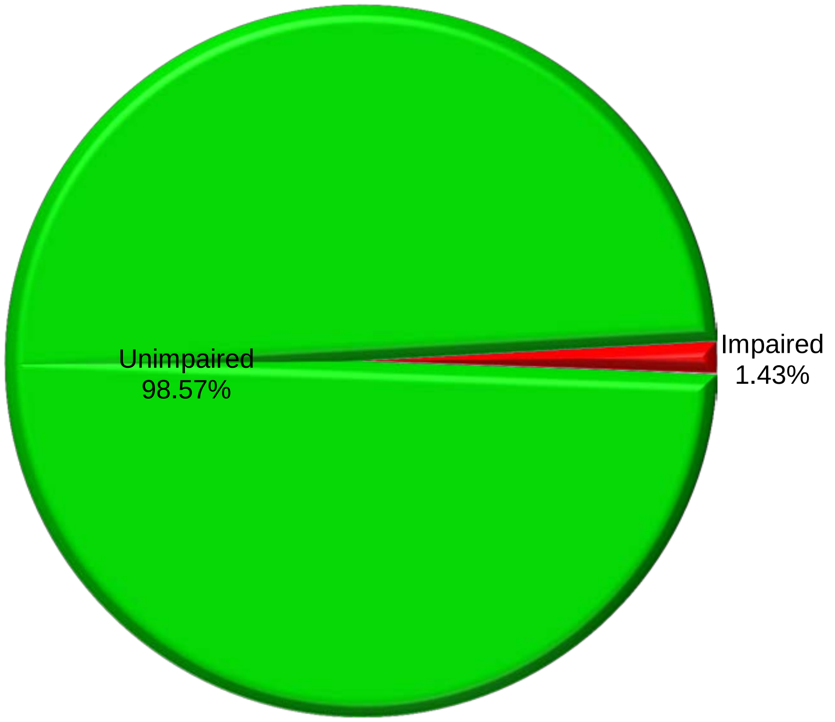
CLO Structure

Illustrative Underlying Credit Assets	Illustrative CLO Balance Sheet



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

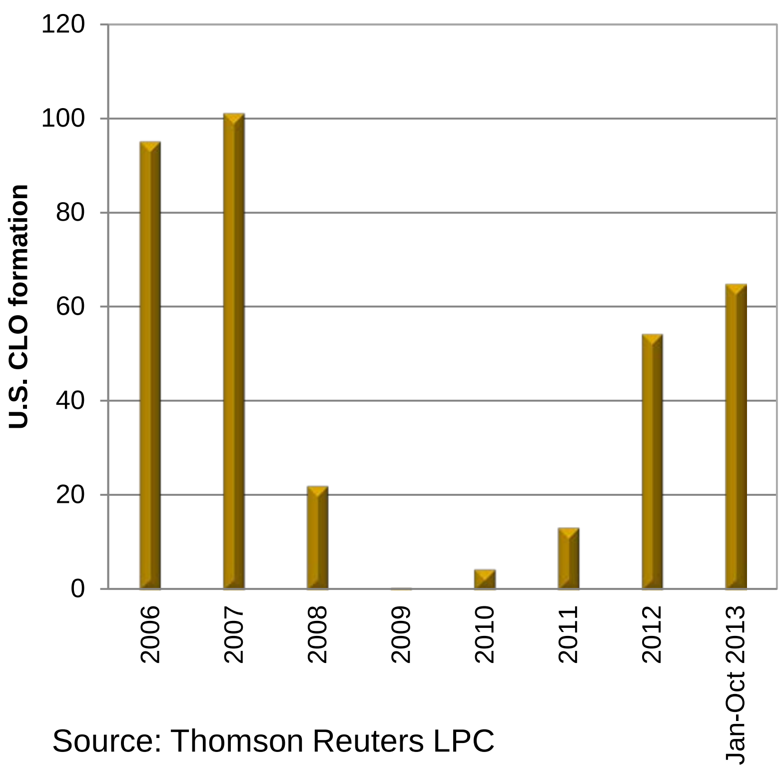
Cumulative **impairment rate from Jan 1996 to May 2012**



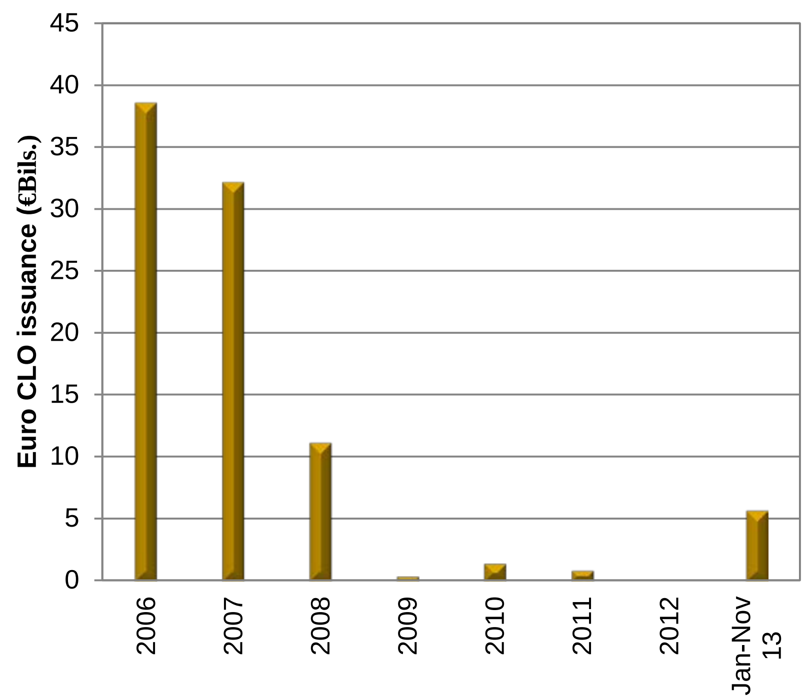
- Over the course of 17 years, the cumulative impairment rate of CLOs has been de minimus – less than 1.5% in that entire time span
- Losses will be lower than impairments, because impairments can include market value EOD, distressed exchanges, etc., in addition to realized losses

Source: Moody's Investors Service

Without risk retention (yet), U.S. CLO formation has recovered; European CLO formation has collapsed



Source: Thomson Reuters LPC



Source: S&P/Capital IQ/LCD

- U.S. CLO formation has recovered, bringing capital to U.S. companies
- European CLO formation collapsed, due in large part to risk retention rules