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October 30, 2013

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549
File Number S7-14-11
RIN 3235-AK96

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Docket Number R-1411
RIN 7100-AD70

Mr. Alfred M. Pollard
General Counsel
Attention: Comments/RIN 2590-AA43
Constitution Center
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Federal Housing Finance Agency
1700 G Street, N.W., Fourth Floor
Washington, D.C. 20552

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, S.W., Suite 3E-218, Mail Stop
Washington, D.C. 20219
Docket Number OCC 2013-0010
RIN 1557-AD40

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RIN 3064-AD74

Regulations Division
Office of General Counsel
Department of Housing and Urban Development
451 7th Street, S.W., Room 10276
Washington, D.C. 20410-0500
RIN 2501-AD53

Re: Credit Risk Retention

Ladies and Gentlemen:

The Investment Company Institute[1] is pleased to have the opportunity to comment on the re-proposed rules ("Proposed Rules") jointly issued by the Securities and Exchange Commission ("SEC"

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical

or "Commission"), Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, and Department of Housing and Urban Development (together, the "Agencies") to implement the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934 ("Exchange Act"), as added by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2] We appreciate that the Agencies have considered the comments raised by ICI and others in response to the Agencies' 2011 proposal on credit risk retention.[3] We remain concerned, however, that the Proposed Rules still do not adequately reflect the unique characteristics of certain classes of asset-backed securities ("ABS") in which registered investment companies ("funds") invest.

In particular, we continue to believe that the proposed standards for risk retention may not be necessary or appropriate for notes issued by asset-backed commercial paper ("ABCP") programs and securities issued by municipal tender option bond ("TOB") programs. Although we appreciate that the Agencies have attempted to better tailor the Proposed Rules to the operation of these programs, we do not believe that the Proposed Rules sufficiently reflect how ABCP and TOB programs are structured. We also remain concerned that the Proposed Rules on commercial mortgage-backed securities ("CMBS") do not adequately reflect market practice. Our concerns are discussed further below.

I. Asset-Backed Commercial Paper Programs

The original proposal included an alternative risk retention option for sponsors of ABCP conduits, or would have permitted ABCP sponsors to rely on one of the standard risk retention options described in the original proposal. ICI recommended that certain bank-sponsored ABCP programs should be exempt from further risk retention requirements, on the basis that, unlike those segments of asset-backed finance that serve longer term investors, the structural elements of these programs ensure that the great preponderance of risk is retained by the bank and ABCP originators, resulting in a cash-like risk profile.[4] These characteristics result in an alignment of interests between investors and ABCP originators, consistent with the Agencies' regulatory objectives. ICI suggested that if, however, the Agencies concluded that imposing further risk retention requirements was appropriate, the parameters for the ABCP option should be redefined to better reflect current market practice. Although we are

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standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $15.2 trillion and serve over 90 million shareholders.

[2] *Credit Risk Retention*, 78 Fed. Reg. 57928 (Sept. 20, 2013) ("Release").

[3] *Credit Risk Retention*, 76 Fed. Reg. 24090 (Apr. 29, 2011) ("original proposal"). *See, e.g.,* Letter to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, et al., from Karrie McMillan, General Counsel, Investment Company Institute, dated July 29, 2011 ("ICI 2011 Letter"); Letter to Office of the Comptroller of the Currency, et al., from Ashurst LLP, Citibank, N.A., Deutsche Bank AG, New York Branch, Société Générale, New York Branch, Wells Fargo Bank, N.A., Investment Company Institute, dated August 31, 2012 ("ICI 2012 Letter").

[4] *See* ICI 2011 Letter, *supra* note 3.

disappointed that the Agencies did not exempt bank-sponsored ABCP programs under the Proposed Rules, we appreciate the extensive refinements the Agencies have made to the ABCP risk retention option in the Proposed Rules.[5] Unfortunately, further refinements to the Proposed Rules are necessary.

A. Revise Liquidity Coverage Definition to Permit Partially-Supported ABCP Programs

Specifically, we are concerned that the proposed "100 percent liquidity coverage" definition would make it impossible for many sponsors of ABCP programs to meet the conditions of the Proposed Rules. Under the Proposed Rules, an "eligible ABCP conduit" is defined as an ABCP conduit that meets four enumerated conditions, including that:

> A regulated liquidity provider has entered into a legally binding commitment to provide 100 percent liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or other similar arrangement) to all the ABCP issued by the ABCP conduit by lending to, purchasing ABCP issued by, or purchasing assets from, the ABCP conduit in the event that funds are required to repay maturing ABCP issued by the ABCP conduit. . . .[6]

The Proposed Rules define "100 percent liquidity coverage" as "an amount equal to the outstanding balance of all ABCP issued by the conduit plus any accrued and unpaid interest without regard to the performance of the ABS interests held by the ABCP conduit and without regard to any credit enhancement."[7] We are concerned that the Agencies may have misunderstood our prior suggestion of 100 percent liquidity coverage as a condition of exempting certain ABCP programs as meaning 100 percent support of ABCP for all credit losses.[8] That was not our intent.

As discussed in the ICI 2011 Letter, ABCP programs typically are supported by credit enhancement and committed liquidity facilities.[9] For the latter, the amount of liquidity support for an ABCP program typically equals 100 percent of the face amount of ABCP outstanding, and is available to protect investors in case of a market interruption or any timing differences with respect to repayment.[10] For ABCP programs referred to as "fully supported," the full amount of liquidity support

[5] Release, *supra* note 2, at 57949.

[6] Proposed Rule §_.6.

[7] *Id.*

[8] *See* ICI 2011 Letter, *supra* note 3.

[9] *Id.*

[10] In the event that maturing ABCP cannot be refunded in the money markets, the administrator of the program (which is often the financial institution sponsoring the program) will draw upon the liquidity facilities in an amount sufficient to redeem all maturing ABCP.

can be drawn to fund all of the receivables held by the program, even if some of those receivables are deemed to be "defaulted." For "partially supported" ABCP programs, the liquidity facilities will fund only "performing" receivables, *i.e.*, those not deemed to be in default. For each of these two program types, however, investors typically expect 100 percent liquidity coverage.

The ABCP market has a high degree of comfort with partially-supported ABCP programs, which remain the market's standard format. According to data compiled by a major rating agency, seventeen of the largest 25 bank-sponsored multi-seller ABCP conduits are partially-supported and all of these programs enjoy 100 percent liquidity coverage of ABCP outstanding. Generally, investors undertake a holistic analysis of ABCP that heavily weighs the strength of the ABCP program sponsor, the programs' credit and liquidity arrangements and the quality of monthly pool reports, in addition to the credit quality of receivables being financed.

The proposed definition of "eligible ABCP conduit" includes a limitation that "(amounts due pursuant to the required liquidity coverage may not be subject to credit performance of the ABS held by the ABCP conduit or reduced by the amount of credit support provided to the ABCP conduit and liquidity support that only funds performing receivables or performing ABS interests does not meet the requirements of this section)."[11] This limitation is unnecessary to ensure 100 percent liquidity coverage and, as noted above, would cause a significant portion of the ABCP market to be ineligible for the ABCP risk retention option. Furthermore, not making the ABCP risk retention option available to ABCP programs that permit partially-supported ABCP is unnecessary to achieve the Agencies' regulatory objectives.

ICI therefore recommends that the definition of "100 percent liquidity coverage" be revised only to consider liquidity coverage, and not credit enhancement, which is a separate element of these programs, so that the final definition would state that: "100 percent liquidity coverage means an amount equal to the outstanding balance of all ABCP issued by the conduit plus any accrued and unpaid interest." We further recommend that the definition of "eligible ABCP conduit" be revised to omit the parenthetical language above. Although we acknowledge that this revised definition would permit partially-supported ABCP conduits, it would only permit such conduits if they have 100 percent liquidity coverage of ABCP outstanding.

We recognize that the Agencies have a legitimate interest in requiring an "eligible ABCP conduit," as defined under the Proposed Rules, to be subject to a minimum level of credit enhancement. We believe, however, that such credit enhancement should be clearly distinguished from liquidity support, for the reasons described above. We therefore recommend that the definition of "eligible ABCP conduit" be revised to add a condition (5), as follows:

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[11] Proposed Rule §_.6.

"(5) at least five percent program-wide, first loss credit enhancement is provided by the sponsoring institution of any partially-supported ABCP conduit in the form of a letter of credit, cash collateral, guarantee, or other similar facility, or none is required for any fully-supported ABCP conduit.

Partially-supported ABCP conduit means an ABCP conduit in which the liquidity coverage will fund only performing receivables (*i.e.*, those not deemed to be in default).

Fully-supported ABCP conduit means an ABCP conduit in which the full amount of liquidity coverage can be drawn to fund all of the receivables held by the ABCP conduit, even if some of those receivables are deemed to be defaulted."

B. Exempt Fully-Supported Bank-Sponsored ABCP Programs

We continue to believe that bank-sponsored ABCP programs that meet certain characteristics should be exempt, pursuant to Section 15G of the Exchange Act, from the risk retention requirements.[12] We believe the alignment of interest that exists in bank-sponsored ABCP programs makes an exemption from the Proposed Rule's risk retention requirements for these ABCP programs appropriate, subject to the conditions described below. Therefore, we recommend that the Agencies exempt from the risk retention requirements those ABCP programs in which:

(i) The sponsoring institution is a regulated banking institution;

(ii) The issuing entity is bankruptcy remote;

(iii) Regulated liquidity providers have entered into a legally binding commitment to provide 100 percent liquidity coverage for all issued ABCP;

(iv) The ABCP conduit is fully supported, and the liquidity providers do not deduct for non-performing ABCP interests; and

(v) Monthly investor performance reports are provided on a timely basis.

We believe that exempting fully-supported bank-sponsored ABCP programs with these characteristics would align the interests of sponsors with those of investors, consistent with the policy objectives of Section 15G of the Exchange Act, such that imposing additional risk retention requirements would be unnecessary under these circumstances. Under these criteria, bank-sponsored

[12] Section 15G of the Exchange Act states that the risk retention rules adopted 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 . . ." Section 15G(c)(1)(G)(i). *See* ICI 2011 Letter, *supra* note 3.

programs in which 100 percent of the credit risk related to the underlying assets is explicitly retained by the bank sponsor of the ABCP program would be exempt, and the only risk to investors would be the risk of the sponsoring institution itself. These criteria would align the incentives of the sponsor and investors by ensuring that the risk of the ABCP program remains with the bank sponsor.[13]

II. Municipal Tender Option Bond Programs

The original proposal did not address the applicability of the risk retention requirements to TOB programs. In our comment letters responding to the original proposal, ICI requested that the Agencies expressly exempt TOB programs from the risk retention requirements.[14] In the Proposed Rules, the Agencies do not propose to exempt TOB programs, but instead provide two additional risk retention options for TOB programs. Specifically, the Proposed Rules provide that a sponsor with respect to an issuance of "tender option bonds"[15] by a "qualified tender option bond entity"[16] may satisfy its risk retention obligation by complying with the standard risk retention methods (*i.e*., vertical, horizontal, or a combination thereof), or may choose to rely on one of two additional risk retention options tailored for TOBs.

A. TOB Program Sponsors Should be Exempt From the Risk Retention Requirements

Although we appreciate that the Agencies have proposed specific risk retention options for TOB programs, we continue to believe that sponsors of TOB programs should be exempted, pursuant to Section 15G of the Exchange Act, from the risk retention requirements under the Proposed Rules.[17] As discussed in more detail in our prior letters,[18] although TOBs have certain features that are similar to those of ABS, market participants generally do not perceive TOBs to be ABS. Nor do we believe that TOBs raise the concerns that Congress intended to address when it enacted Section 15G of the Exchange Act.[19] Furthermore, if TOB sponsors were forced to restructure their programs significantly

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[13] The criteria also would exclude SIVs, as well as those securities arbitrage programs that are not sponsored by a regulated banking institution and do not have available liquidity equal to at least the amount of ABCP outstanding.

[14] *See* ICI 2011 Letter, *supra* note 3; ICI 2012 Letter, *supra* note 3.

[15] *See* Proposed Rule §_.10.

[16] *Id.*

[17] *See supra* note 12.

[18] *See* ICI 2011 Letter, *supra* note 3, ICI 2012 Letter, *supra* note 3.

[19] For example: (i) TOB programs are almost uniformly used to finance municipal securities, not to transfer risk; (ii) the TOB program structure (A) ensures that the interests of the securitizer are closely aligned with those of the holders of TOB floating rate certificates; and (B) provides all participants with transparency regarding the TOB program assets; and (iii) TOB program assets are high quality and are typically publicly issued, rated debt securities that are subject to the anti-fraud provisions of the federal securities laws. ICI 2012 Letter, *supra* note 3.

to comply with the risk retention options provided by the Proposed Rules, the increase in the cost of TOB program sponsorship could adversely affect the state and local governments that indirectly receive funding through these programs.

B. Further Modifications are Needed if TOB Program Sponsors are Subject to the Proposed Rules

If the Agencies do not accept our argument that TOB program sponsors should be exempt from the Proposed Rules, we request that the Agencies consider several modifications to the Proposed Rules to better reflect how TOB programs are structured. We describe these issues below, along with our recommended modifications.

We believe that if these modifications are not adopted, third-party TOB programs could be eliminated, thereby reducing liquidity currently available to the municipal bond market. Moreover, because the underlying municipal bonds are typically traded in the secondary market, any impact on their market values will affect all holders of municipal bonds, from individuals to institutional investors.

Fund Residual Holders Should be Deemed Third-Party Purchasers

As discussed above, the Proposed Rules provide two additional risk retention options for sponsors of TOB programs. Under the Proposed Rules, as under the original proposal, "sponsor" means "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."[20] We request confirmation that, for purposes of the Proposed Rules, the sponsor is the bank that creates the TOB program. We further request that the Proposed Rules be revised to reflect that, consistent with market practice, funds or other institutional investors in municipal bonds that purchase residuals in the trust may satisfy the risk retention obligations of the sponsor as third-party purchasers.[21] We believe this treatment is fully consistent with Congressional intent underlying the risk retention requirements,[22] as

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[20] Proposed Rule §_.2.

[21] We acknowledge that the Agencies stated, in the context of discussing CMBS, that " . . . the agencies believe there is insufficient benefit to market liquidity to justify an expansion of third-party risk retention to other asset classes, and propose to maintain the more direct alignment of incentives achieved by requiring the sponsor to retain risk for the other asset classes not covered by section 15G(c)(1)(E)(ii)." We believe the TOB context is distinguishable, however, because, as discussed further below, the TOB risk retention options would achieve the alignment of interests sought by the Proposed Rules while being fully consistent with *current* market practice for residual interest holders in the TOB market.

[22] As Congress stated in the legislative history for Section 15G of the Exchange Act, "a 'one size fits all' approach to risk retention may adversely affect certain securitization markets . . . . Accordingly, the bill requires that the initial joint rulemaking include separate components addressing individual asset classes -- home mortgages, commercial mortgages, commercial loans, auto loans, and any other asset class that the regulators deem appropriate. The Committee expects that these regulations will recognize differences in the assets securitized, in existing risk management practices, and in the

well as the Agencies' intent in proposing these additional risk retention options to "reflect and incorporate the risk retention mechanisms currently implemented by the market . . ."[23] Confirming that fund residual holders may serve as third-party purchasers would be consistent with the fact that they bear the burden of risk associated with the residual interest. Furthermore, deeming these residual holders to be sponsors is unnecessary for purposes of the Proposed Rules, and could potentially result in adverse and unforeseen implications under other Dodd-Frank Act rules, as well as other provisions of the federal securities laws and rules.

As explained in the ICI 2011 Letter, a TOB program is created by a bank that deposits one or more high-quality municipal bonds into a trust that issues two classes of tax-exempt securities: a short-term security (the "floater") that is supported by a liquidity facility and an inverse floating rate security (the "residual"). The floater is a variable-rate demand security that bears interest at a rate adjusted at specified intervals (daily, weekly, or other intervals up to one year) according to a specific index or through a remarketing process. The liquidity facility provides a "put" or demand feature, allowing the floater holder to tender the security and receive, with specified notice, face value plus accrued interest, either from remarketing proceeds or a draw on the liquidity facility.[24] Floater holders bear limited and well-defined insolvency and default risks associated with the underlying bonds, and rely upon their largely unfettered put right to manage these risks. Tax-exempt money market funds are the principal holders of the floaters.

Holders of residuals are typically long-term investors, such as the TOB program sponsor bank or an affiliate, in a bank proprietary program, or tax-exempt bond funds, closed-end funds, or other institutional investors in municipal bonds, in a third-party TOB program. Residual holders receive all interest payments from the underlying bonds that are not needed to pay interest on the floaters and expenses of the trust. Given the presence of the liquidity facility, the primary short-term credit risk to the holders of the floaters is that of the liquidity provider, while the residual holder bears all of the market risk associated with the underlying municipal bonds (except upon the occurrence of a TOTE).

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structure of asset-backed securities, and that regulators will make appropriate adjustments to the amount of risk retention required." S. Rep. No. 111-176, at 130 (2010).

[23] Release, *supra* note 2, at 57965.

[24] The liquidity facility is subject to termination upon certain major credit events, known as "tender option termination events" ("TOTEs") affecting the issuer of the underlying municipal bonds. TOTEs, which are very limited and remote, include: a default on the underlying municipal securities and credit enhancement where applicable; a credit rating downgrade below investment grade; the bankruptcy of the issuer, and when applicable, the credit enhancer; or the determination that the municipal securities are taxable. Upon the occurrence of a TOTE, the TOB trust would be collapsed and the floater and residual holders would be paid on a *pari passu* basis after the payment of any outstanding trust fees. If the collateral's value were sufficient to pay the trust fees and to return par plus accrued interest to both the floater and residual holders on a *pari passu* basis, then the collateral would be sold and the payments would be made. If the value were insufficient, then the collateral would be delivered on a proportionate basis to the floater and residual holders.

Accordingly, the credit quality of the underlying municipal bonds is of paramount concern to the residual holder.

Although residual holders such as tax-exempt bond funds and closed-end funds may identify the underlying municipal bonds they would like to finance through a TOB program, a bank will perform the traditional functions of a sponsor for that TOB program. The bank will, for example, establish the TOB trust, hire counsel to draft the trust documents, hire a trustee and remarketing agent for the trust, approve of any bond identified by the residual holder to be deposited into the trust, purchase the bond from the residual holder or on the open market and deposit the bond into the trust (and take a fee on each side of the transaction), and may arrange for credit enhancement on the underlying bonds, as discussed further below. The bank also may serve as the underwriter of a new issuance of municipal securities, some of which may be deposited into a TOB trust.

Deeming funds to be sponsors under the Proposed Rules could have serious adverse implications under other rules proposed under the Dodd-Frank Act, as well as potentially other provisions of the federal securities laws and rules. For example, the proposed amendments to rule 2a-7 under the Investment Company Act of 1940 would require a money market fund to treat the sponsor of a special purpose entity that issues an ABS as a guarantor of the ABS subject to rule 2a-7's ten percent diversification limitations applicable to guarantors and demand feature providers.[25] As a result, if a residual holder in a TOB trust were deemed a sponsor for purposes of proposed rule 2a-7, a money market fund would be subject to the rule's ten percent diversification limit with respect to that residual holder. Such a result makes no sense, and does not further the purpose of this proposed amendment to rule 2a-7, which is intended to "provide that, subject to an exception, money market funds investing in ABSs, including ABCP, rely on the ABSs sponsors' financial strength or their ability or willingness to provide liquidity, credit, or other support to the ABSs."[26] As discussed above, however, it is the bank that organizes the TOB trust, and provides, or may arrange for, the liquidity and credit support for the trust. Accordingly, when money market funds conduct credit analysis on an ABS, it is the bank whose credit and liquidity support they assess. A money market fund would have no credit exposure to a fund residual holder.

As another example, if funds were deemed to be sponsors, they could be subject to the conflict of interest prohibitions under section 621 of the Dodd-Frank Act, as intended to be implemented by proposed rule 127B, which applies to, among others, a sponsor of an ABS.[27] ICI has argued that actions

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[25] *See* Proposed Rule 2a-7(a)(16)(ii) (definition of guarantee). Proposed rule 2a-7 provides an exception to the requirement if the money market fund's board (or its delegate) determines that the fund is not relying on the sponsor's financial strength or its ability or willingness to provide liquidity, credit, or other support to determine the ABS's quality or liquidity.

[26] *Money Market Fund Reform; Amendments to Form PF*, 76 Fed. Reg. 36834, 36959 (June 19, 2013).

[27] Section 621 of the Dodd-Frank Act, which added new Section 27B to the Securities Act of 1933, prohibits material conflicts of interest in connection with certain securitizations. In September 2011, the SEC proposed rule 127B to implement the prohibition.

taken by a fund in connection with investing in ABS, through its investment adviser acting in a fiduciary capacity, do not raise the conflicts of interest proposed rule 127B was intended to address.[28] If funds were deemed to be sponsors, however, they would be much more likely to be captured by proposed rule 127B, which we do not believe was intended.

These are only two examples of the potential, unintended consequences of deeming fund residual holders to be sponsors of TOB trusts. We are also concerned that there could be additional negative consequences of this designation under other provisions of the federal securities laws and rules.

Permit Multiple Fund Residual Holders

The Proposed Rules limit a "qualified tender option bond entity" to issuing only "*a single residual equity interest* that is entitled to all remaining income of the TOB issuing entity."[29] This requirement is inconsistent with current market practice.

Several funds in a fund complex that are managed by the same, or an affiliated, investment adviser often purchase residuals issued by a single TOB trust. One reason for this practice is that the TOB trust must be of sufficient size to be marketable to potential floater holders because purchasers of floaters generally have minimum purchase requirements to reduce costs and administrative burdens. A single smaller fund would not be able to purchase all of the residuals issued by such a trust without breaching issuer concentration limits. We therefore recommend the Agencies broaden the definition of "qualified tender option bond entity" to permit a sponsor of a TOB trust to satisfy its risk retention obligation by allowing more than one fund in a fund complex to hold residuals in the trust, as is common practice in the TOB market. Doing so would allow multiple funds to invest in the residuals issued by a single trust, thus enabling smaller funds to have access to securities that otherwise would be unavailable to them. We strongly believe that permitting multiple funds in a fund complex that are managed by the same investment adviser (or an affiliate) to hold residuals in a TOB trust is fully consistent with the regulatory objectives of the Proposed Rules, as fund residual holders would still hold interests in a single class of securities, and having several fund holders would not change the alignment of interests of trust holders.

Recommended Revisions to TOB Risk Retention Options

If the Agencies determine to subject TOB programs to the risk retention requirements, we agree that the Proposed Rules should include risk retention options tailored to TOB programs. We appreciate the Agencies' efforts to do so, although we believe that one of the options under the

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[28] Letter to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, from Karrie McMillan, General Counsel, Investment Company Institute, dated Feb. 13, 2012.

[29] Proposed Rule §_.10.

Proposed Rules is inconsistent with the manner in which TOB programs are structured. We recommend that this option be modified to better reflect the manner in which TOB programs are structured, and that two additional risk retention options be permitted for TOB program sponsors or third-party residual holders to reflect market practice.

The Proposed Rules provide that a sponsor with respect to tender option bonds issued by a "qualified tender option bond entity"[30] may satisfy its risk retention obligation by complying with the standard risk retention methods (*i.e.*, vertical, horizontal, or a combination thereof), or may choose to rely on one of two additional risk retention options particular to TOBs:

- The sponsor may retain an interest that upon issuance meets the requirements of an eligible horizontal residual interest but that upon the occurrence of a "tender option termination event" as defined in Section 4.01(5) of IRS Revenue Procedure 2003-84, as amended or supplemented from time to time will meet requirements of an eligible vertical interest.

- The sponsor may satisfy its risk retention requirements by holding municipal securities from the same issuance of municipal securities deposited in the qualified tender option bond entity, the face value of which retained municipal securities is equal to 5 percent of the face value of the municipal securities deposited in the qualified tender option bond entity.[31]

We request, consistent with our recommendation above that fund residual holders be deemed third-party purchasers for purposes of the TOB risk retention options generally, that the five percent face value risk retention option for TOB sponsors be modified to clarify that this option could be satisfied either directly by the sponsor or by a third-party purchaser.

The first TOB risk retention option, as drafted, is technically inconsistent with the manner in which TOB trusts are structured. Because TOB trusts are designed to ensure that the tax-free nature of the income of the underlying municipal securities passes through to the floater holders and the residual holders, it is not clear that upon issuance, a residual would technically meet the definition of an "eligible horizontal residual interest,"[32] or that upon the occurrence of a TOTE, a residual would technically

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[30] Proposed Rule §_.10.

[31] *Id.*

[32] Under the Proposed Rules, an "eligible horizontal residual interest" means, with respect to any securitization transaction, an ABS interest in the issuing entity: (1) that is an interest in a single class or multiple classes in the issuing entity, provided that each interest meets, individually or in the aggregate, all of the requirements of this definition; (2) with respect to which, on any payment date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts paid to the eligible horizontal residual interest prior to any reduction in the amounts paid to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision (until the amount of such ABS interest is reduced to zero); and (3) that has the most subordinated claim to payments of both principal and interest by the issuing entity.

meet the definition of an "eligible vertical interest."[33] While during the trust's normal operations, the floater holders receive income from the trust prior to the residual holders, at the time a TOTE occurs, the floater and residual holders are paid on a *pari passu* basis after the payment of any outstanding trust fees. If the collateral's value is sufficient to pay the trust fees and to return par plus accrued interest to both the floater and residual holders on a *pari passu* basis, then the collateral is sold and the payments are made. If the value is insufficient, then the collateral is delivered on a proportionate basis to the floater and residual holders.

We understand the Agencies' regulatory purpose in proposing the first TOB risk retention option, and believe that this purpose could be achieved through technical modifications to this option. We therefore recommend that the Agencies modify this option to permit a sponsor or residual holder to satisfy the risk retention requirement by purchasing and retaining a residual interest having an up-front cash investment value equal to five percent of the initial market value of the municipal securities in the TOB program.[34] As discussed in our prior letter, holding the residual in a TOB program is substantially equivalent to holding horizontal risk prior to the occurrence of a TOTE and a vertical interest after a TOTE because: (i) prior to the occurrence of a TOTE, the residual holder bears all market risk,[35] and (ii) after the occurrence of a TOTE, any credit losses are shared pro rata between the floaters and the residuals.[36] For this reason, among others detailed in our prior letter, we believe this option would be fully consistent with the Agencies' regulatory objectives.

In addition to this risk retention option, and the five percent face value option included in the Proposed Rule, we recommend, as we have previously, that the Agencies deem a sponsor's risk retention requirement to be satisfied in a TOB program transaction in which the residual interest holder is either (i) the same as, or an affiliate of, the entity that provides a liquidity facility, or (ii) an unaffiliated entity, such as a fund residual holder serving as a third-party purchaser, that either (a) agrees to subordinate its right to payment to the floater holders and the liquidity provider until the occurrence of a TOTE; or (b) agrees to reimburse the liquidity facility provider for any losses, in recognition of the fact that all of the market risk associated with the underlying assets is already borne by the residual interest holder.[37]

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[33] Under the Proposed Rules, an "eligible vertical interest" means with respect to any securitization transaction, a single vertical security or an interest in each class of ABS interests in the issuing entity issued as part of the securitization transaction that constitutes the same portion of the fair value of each such class.

[34] We recommended this option previously. *See* ICI 2012 Letter, *supra* note 3.

[35] This is because, when the residual holder is an entity that is not related to the liquidity provider, the residual holder may be subject to a full recourse obligation to reimburse the liquidity provider for any losses with respect to the liquidity facility, may have posted cash or cash equivalent collateral at the time of closing to secure the liquidity provider for any losses, or may have subordinated its right to payment to the floater holders and the liquidity provider until the occurrence of a TOTE. *See* ICI 2012 Letter, *supra* note 3, at notes 12, 14.

[36] *Id.*

[37] ICI 2012 Letter, *supra* note 3.

As discussed in our prior letter, we believe that 100 percent market risk, along with the pro rata credit risk in the event of a TOTE, is a more than adequate (and arguably more stringent) substitute for a five percent credit risk under the proposed standard risk retention options.[38]

Offering all three of these risk retention options would accomplish the Agencies' regulatory objectives, while providing sponsors and third-party holders with the flexibility necessary to accommodate current market practices for issuers, sponsors, and investors in TOB programs.[39]

III. Commercial Mortgage-Backed Securities

In the original proposal, the Agencies proposed to permit a sponsor of CMBS to meet its risk retention requirements if a third-party purchaser acquired an eligible horizontal residual interest in the issuing entity.[40] The CMBS risk retention option was only available for securitization transactions where commercial real estate loans constituted at least 95% of the unpaid principal balance of the assets being securitized and six proposed requirements were met. These requirements included, among others, that any third-party purchaser acquiring an eligible horizontal residual interest under the CMBS option complied with the hedging, transfer, and other restrictions applicable to such interest under the original proposal as if the third-party purchaser were a sponsor that had acquired the interest under the horizontal risk retention option.

The Agencies have significantly revised the risk retention standards applicable to sponsors and third-party purchasers of CMBS. Although we appreciate that the Agencies have attempted to better align these standards with market practice, we believe they still fall short in several key respects. We provide below several recommended modifications to the Proposed Rules that we believe are consistent with the Agencies' regulatory objectives, and maintain the important role of funds as third-party purchasers, or "B-piece buyers," in the CMBS market.

A. Limit Transfer Restrictions

Although the Proposed Rules have eliminated the requirement for the third-party purchaser to retain its interest for the life of the transaction, they still contain significant transfer restrictions. A third-party purchaser may transfer the retained interest to another third-party purchaser at any time after five years after the date of the closing of the securitization transaction, but the transferee must satisfy the conditions applicable to the initial third-party purchaser under the CMBS option.[41] We

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[38] *Id.*

[39] *Id.*

[40] Such interest would have had to take the same form, amount, and manner as the sponsor would have been required to retain under the horizontal risk retention option.

[41] Proposed Rule §_.7.

believe these transfer restrictions, while less restrictive than those in the original proposal, would significantly impair the liquidity of CMBS and discourage funds from purchasing these interests as B-piece buyers.

To address the Agencies' concern that a transfer restriction is necessary to ensure high quality underwriting standards,[42] we reiterate our recommendation that Agencies adopt a tiered approach to transfer.[43] Under our recommended approach, a third-party purchaser would be required to retain its interest for a one-year period. For the following four years, the third-party purchaser could transfer its interest to a "qualified transferee" that must meet the same criteria as the third-party purchaser, and for the remainder of the transaction, no restrictions would be imposed on transfer or hedging.

B. Permit Multiple Fund B-Piece Buyers

Under the Proposed Rules, two (but no more than two) third-party purchasers may satisfy a sponsor's risk retention obligation under the CMBS option.[44] The Agencies state that they do not believe it would be appropriate to allow more than two third-party purchasers to satisfy the risk retention requirement for a single transaction, because "it could dilute too much the incentives generated by the risk retention requirement to monitor the credit quality of the commercial mortgages in the pool."[45] Similar to the practice described above in the context of TOB trusts, it is common for several funds in a fund complex that are managed by the same, or an affiliated, investment adviser to purchase B-piece interests in a single CMBS transaction. We believe this practice does not dilute incentives to monitor the credit quality of the mortgages in the pool. Instead, each fund, through its investment adviser, has an independent incentive to monitor the credit quality of its investment to maximize its investment return for shareholders.[46] The restriction in the Proposed Rules, however, would prevent an investment adviser with investment discretion over multiple funds in a fund complex from allocating a beneficial investment opportunity among multiple funds it manages. We therefore request that the definition of "third-party purchaser" be expanded, consistent with current market practice, to permit multiple funds that are managed by the same, or an affiliated, investment adviser to serve as third-party purchasers.

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[42] Release, *supra* note 2, at 57978.

[43] *See* ICI 2011 Letter, *supra* note 3.

[44] Proposed Rule §_.7.

[45] Release, *supra* note 2, at 57953.

[46] An investment adviser to a fund is a fiduciary and must act in a manner consistent with the interests of each fund that it manages. *See, e.g., Tannenbaum v. Zeller,* 552 F.2d 402 (2d Cir. 1977).

IV. Risk Retention Requirements Should Only Apply Prospectively

As discussed in our earlier letter, we believe any risk retention requirements the Agencies may adopt should apply only on a prospective basis, and request confirmation that the rules will operate in this manner.[47] The Agencies have stated that "[c]onsistent with section 15G of the Exchange Act, the risk retention requirements would become effective, for securitization transactions collateralized by residential mortgages, one year after the date on which final rules are published in the Federal Register, and two years after that date for any other securitization transaction."[48] We request confirmation that the final risk retention rules will *not* apply retroactively to ABS structures in existence on the effective date of those rules, as such application would result in significant adverse operational and tax consequences. Instead, the final rules should apply prospectively only to ABS structures created after the effective date of the final rules.

V. Avoid Conflicts with the Volcker Rule

Given the complexities of the Proposed Rules, and their potential implications for other provisions of the federal securities laws and rules, and rules proposed under the Dodd-Frank Act,[49] we recommend that the Agencies ensure that the final rules do not raise conflicts with any final rules adopted under the proposal that has been issued to implement Section 619 of the Dodd-Frank Act, commonly known as the "Volcker Rule."[50] Funds and other market participants will be required to consider the compliance implications of all of the Dodd-Frank rules, and thus it is critical to avoid conflicts among these rules, as well as other existing or proposed federal securities laws and rules.

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We commend the Agencies for seeking to better tailor the risk retention requirements to reflect the diversity that exists across the ABS markets and recognize the challenge in coordinating this undertaking jointly across six federal agencies. We reiterate our concern that, because of the joint nature of this rulemaking, the Agencies must develop workable standards for risk retention *prior* to the rules' adoption. We do not believe the statements in the Release concerning subsequent interpretations or similar guidance suggest that an adequate process has yet been developed by the Agencies to achieve

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[47] ICI 2012 Letter, *supra* note 3.

[48] Release, *supra* note 2, at 57931.

[49] *See* text accompanying *supra* notes 28-31.

[50] *Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships with, Hedge Funds and Private Equity Funds,* 76 Fed. Reg. 68846 (Nov. 7, 2011).

the necessary and timely coordination in the event post-issuance clarifications are necessary, and urge the Agencies to do so promptly.[51] If there is any way we may further assist the Agencies, please feel free to contact me directly at (202) 326-5815, Sarah Bessin at (202) 326-5835, or Jennifer Choi at (202) 326-5876.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: The Honorable Mary Jo White
The Honorable Luis A. Aguilar
The Honorable Daniel M. Gallagher
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar

[51] In the original proposal, the Agencies stated their intent to jointly approve any written interpretations, written responses to requests for no-action letters and general counsel opinions, or other written interpretive guidance concerning the scope or terms of Section 15G of the Exchange Act and the final rules issued thereunder that are intended to be relied on by the public. The Agencies also stated that they intended for the appropriate Agencies to jointly approve any exemptions, exceptions, or adjustments to the final rules. In response to comments expressing concerns about the practicality and uncertainty of this process, the Agencies state that they "continue to view the consistent application of the final rule as a benefit and intend to consult with each other when adopting staff interpretations or guidance on the final rule that would be shared with the public generally." They state, however, that they are "considering whether to require that such staff interpretations and guidance be jointly issued by the agencies with rule writing authority and invite comment."