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The International Comparative Legal Guide to:

Securitisation 2013

6th Edition

A practical cross-border insight into securitisation work

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The International Comparative Legal Guide to: Securitisation 2013

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Penny Smale

Group Consulting Editor
Alan Falach

Group Publisher
Richard Firth

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EDITORIAL

Welcome to the sixth edition of *The International Comparative Legal Guide to: Securitisation*.

This guide provides the international practitioner and in-house counsel with a comprehensive worldwide legal analysis of the laws and regulations of securitisation.

It is divided into two main sections:

Five general chapters. These are designed to provide readers with a comprehensive overview of key securitisation issues, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in securitisation laws and regulations in 36 jurisdictions.

All chapters are written by leading securitisation lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor, Mark Nicolaides of Latham & Watkins LLP, for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The International Comparative Legal Guide series is also available online at www.iclg.co.uk.

Alan Falach LL.M.
Group Consulting Editor
Global Legal Group
Alan.Falach@glgroup.co.uk

CLOs: An Expanding Platform

Schulte Roth & Zabel LLP

Craig Stein

Paul N. Watterson, Jr.

At the beginning of 2011, the collateralised loan obligation ("CLO") market was poised to make a comeback. In *The International Comparative Legal Guide to: Securitisation 2011* chapter we authored entitled "On the CLO Horizon – Regulations Expected to Impact CLOs" (the "CLO Regulations Chapter") we discussed the new or proposed regulations that might affect the growth of the CLO market. Moreover in 2011, we did, in fact, see a modest revival of CLOs. New issuance for the year totaled approximately $12.3 billion. In *The International Comparative Legal Guide to: Securitisation 2012* we authored a chapter entitled "New Structural Features for Collateralised Loan Obligations" which discussed the structural changes being made to the governing documents for a post-financial crisis CLO, which has become known as CLO 2.0. Those changes helped foster the growth in the CLO market last year, when new issuance reached approximately $55 billion. Industry participants are predicting that new issuance in 2013 will exceed that level and reach $65 billion to $75 billion and, in fact, issuance so far in 2013 is on a pace that would exceed that amount. 2013 will also see an expansion of the CLO market into new asset classes and new markets, and a return of the European CLO. However, there continue to be regulatory and market challenges for CLOs.

Return of the European CLO

Unlike the United States, where the recovery in the leveraged loan market continues and the pace of new CLO issuances continues to increase, Europe has seen no significant CLO activity since the credit crisis. However, the European market appears to be slowly picking up, with one transaction successfully pricing in February 2013 and others in the pipeline. If these offerings are successful, industry participants estimate that in 2013 we could see from €3 billion to €5 billion of new CLO issuance, increasing to €5 billion to €7 billion in 2014.

The European CLO market faces significant hurdles on the way to recovery. The relative scarcity of leveraged loans in the European primary market has made it more difficult for prospective CLO managers to assemble marketable portfolios of loans. The European institutional loan market has fallen from pre-credit crisis levels to a 2012 low of €150 billion in new issuances, and pre-credit crisis European CLOs are reaching the end of their reinvestment periods. As these CLOs begin to unwind, and pre-credit crisis loans begin to come due (between now and 2015), the conditions are in place for strong demand for new financing.

A second hurdle is Article 122a of the European Union's Capital Requirements Directive ("Article 122a"). Article 122a's five per cent risk retention requirement (discussed below) is a potentially impossible burden for less-well-capitalised managers. The first European CLO to price in 2013 is reported to have complied with this risk retention requirement by arranging for a structured credit fund to hold the equity.

Unlike in the U.S. market, where 2013 CLOs have employed leverage equal to as much as ten times the equity tranche, the new wave of European CLOs are expected to be significantly less leveraged. Concentration limitations and portfolio criteria are expected to be broadly in line with current CLO 2.0 standards in the United States, except that collateral obligations must be Euro-denominated.

Emerging Market CLOs

Issuance of CLOs that invest in emerging market ("EM") leveraged loans and debt securities came to a halt in 2008. 2012 saw the successful offering of the first post-credit crisis CLO that invests primarily in leveraged loans and debt issued by EM borrowers. The notes issued by this CLO generally had higher spreads than comparable CLOs issued to invest in U.S. leveraged loans, and the leverage was lower.

The portfolio requirements for this new EM CLO and for others that are following in its wake are similar to the current CLO 2.0 criteria for U.S. CLOs as a result of rating agency methodology and investor preferences. Obligations are U.S. Dollar-denominated, and most of the portfolio is required to be first-priority senior secured loans. Unlike in earlier EM CLOs, the amount of EM sovereign obligations that new EM CLOs can buy is more limited (ten per cent in a recent CLO) and hedging is limited to interest rate hedges and short credit default swaps on obligations owned by the CLO. The concentration limitations are structured to provide significant flexibility to invest in most of the major EM markets. There are also substantial non-EM buckets to permit the CLO to acquire collateral if suitable EM collateral is not available.

Other CLOs focused on EM debt markets are appearing in the market, but there remain significant obstacles. *Bloomberg* recently reported that prices for non-investment-grade EM debt are at their highest level in seven years. The demand for quality EM debt may make assembling CLO portfolios more challenging. If these CLOs will make extensive investments in loans and debt securities that are not denominated in U.S. Dollars, it will be necessary to issue liabilities in other currencies or confront the hedging issues discussed below.

High-Yield CBOs

One of the early structured credit products, known as a collateralised bond obligation ("CBO"), invested primarily in high-

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yield bonds, and pre-credit crisis CLOs often had the capacity to invest a large portion of the portfolio in high-yield bonds. However, CLO 2.0 transactions have limited high-yield bonds to five per cent to ten per cent of the portfolio. Recently, managers have begun early-stage marketing of hybrid CLO/CBOs which would have the capacity to invest a majority of the portfolio in high-yield bonds. A few recent CLOs have permitted a larger portion (e.g., 40 per cent) of the portfolio to be invested in high-yield bonds than the typical five per cent to ten per cent limit.

The challenges to a revival of CBOs include the losses that investors experienced on some pre-credit crisis CBOs, and the differences in terms (interest rate, maturity, covenants, security and seniority) between a typical senior secured loan and a typical high-yield bond. CLOs that invest in high-yield bonds are unlikely to qualify for the exemption from the U.S. risk retention requirements (discussed below), and are more likely to need to enter into hedging instruments (also discussed below). The revival of CLOs that invest in high-yield bonds is being facilitated by the increasing use of floating rates on high-yield bonds, the increased issuance of senior secured bonds and the greater acceptance by CLO investors of covenant lite ("cov lite") terms (which are often found in high-yield bond indentures).

CRE CDOs

Pre-credit crisis Commercial Real Estate CDOs (known as "CRE CDOs") invested in many different kinds of assets, including CMBS, commercial mortgages of varying quality and seniority, B notes, loan participations, and even tranches of other CRE CDOs. Beginning in 2012 and continuing in 2013, established players in the commercial mortgage market have begun to remake the CRE CDO as a specialty commercial real estate product focusing on proven, but sometimes more risky, segments of the CRE market.

Sponsors of "CRE CDO 2.0" transactions prefer to call their offerings a "CRE resecuritisation" or a "mortgage CLO". These transactions also have been structured to more closely resemble CLO transactions, rather than pre-credit crisis CRE CDOs.

In 2012, the first of the CRE CDO 2.0 transactions (marketed as a "mortgage collateralised loan obligation") was offered by a subsidiary of a real estate investment trust. Others have followed, and still more are in marketing. The terms have generally been more conservative than in pre-credit crisis CRE CDOs. For example, one transaction was fully ramped at closing, and the portfolio criteria limited its assets solely to whole loans and senior participations secured by multi-family properties. Another CRE CDO consisted of a static portfolio primarily consisting of mezzanine and B-note positions.

CRE CDOs can play an important role if they remain focused on sectors of the commercial mortgage market that are not currently well-served by CMBS.

Challenges for CLOs in 2013

Sourcing Collateral

Although market insiders predict a robust market for CLO offerings, even CLOs that primarily invest in senior secured loans to U.S. borrowers face challenges. One of the main challenges this year is sourcing collateral with a yield sufficient for the equity investors in a CLO to receive an attractive return after interest is paid on the senior notes.[1] Due to the growth in the CLO market and other market trends (such as the growth of retail investor-oriented loan funds), spreads on leveraged loans in the United States have declined. Unless the spread on senior CLO notes continues to tighten, the equity returns may not be high enough to attract investors. In addition, maintenance covenants in new credit agreements have fallen by the wayside, forcing CLOs to invest more in cov lite loans. This has resulted in increases in the concentration limit on cov lite loans in CLO indentures and redefinition of what is a cov lite loan to more closely reflect current loan market practices.

Risk Retention

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") mandated the U.S. Securities and Exchange Commission ("SEC") and Federal banking agencies (the "Agencies" and, together with the SEC, the "Joint Regulators") to adopt regulations requiring the sponsor of a securitisation to retain not less than five per cent of the aggregate credit risk. In March 2011, the Joint Regulators issued proposed rules (the "CRR Proposal") to implement the risk retention requirement. The Agencies proposed that CLOs would be subject to the risk retention requirement and concluded that the collateral manager should be viewed as the "sponsor" which must retain at least five per cent of the risk. (Alternatively, lenders which originated a significant percentage of the loans could retain the risk.) The only CLOs that the Agencies proposed to exempt from this requirement would be ones that invested only in commercial loans that met very strict underwriting standards and satisfied other conditions summarised in our CLO Regulations Chapter.

Several industry organisations, including the American Securitization Forum ("ASF") and the Loan Syndications and Trading Association ("LSTA") submitted comments to the regulators, asking them to reconsider whether CLOs should be subject to risk retention. The LSTA asserted that, as a matter of statutory interpretation, managers of CLOs that purchase syndicated commercial loans in the open market are not subject to risk retention requirements because their activities do not meet the definition of "securitiser" in section 941 of the Dodd-Frank Act. The ASF argued that risk retention was not needed in the CLO market to avoid the "originate to distribute" problem that afflicted other types of pre-credit crisis securitisations, because the manager of a CLO rarely originates the loans purchased by a CLO; moreover, the management fee structure used in most CLOs aligns the interests of the CLO manager with the interests of investors, because the manager subordinates part of its fee to payments on the senior notes and receives a private equity-style incentive fee only after the equity investors have achieved a specified return on their investments. Both the LSTA and the ASF asked that, if the regulators conclude that risk retention applies to CLOs, they should exempt from risk retention any CLO that meets specified criteria; however, they pointed out that no CLO could meet the criteria for an exempt CLO set forth in the CRR Proposal. The LSTA's suggested criteria included the following: the portfolio must be limited to corporate credit obligations, cash and temporary liquidity investments, 90 per cent of which must be senior secured syndicated loans; purchases in an initial commercial loan syndication transaction would be limited to circumstances where multiple financial institutions can acquire loans through the syndication process; underlying obligors must be commercial borrowers; no asset-backed securities; no synthetic assets; managers must be registered investment advisers; and compensation to the manager must be structured to align its interest with the CLO investors.

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As of the date of this writing, the proposed rule has not been finalised. The recent adoption of a rule defining a "qualified mortgage" by the Consumer Financial Protection Bureau was expected to lead to regulatory action on the CRR Proposal. However, this is now in doubt because the director of the Bureau, Richard Cordray, was appointed by President Barack Obama without U.S. Senate confirmation during the Senate's recess, and a federal appeals court ruled that the president's recess appointments to the National Labor Relations Board — which were made at the same time as Mr. Cordray's appointment — were unconstitutional.

Article 122a applies to new securitisations, including CLOs, which issued securities after 31 December 2010.[2] Article 122a imposes a significant capital charge on securitisation securities acquired by a European Economic Area ("EEA") regulated credit institution, unless the originator, sponsor or original lender of the securitisation has disclosed to the EEA-regulated credit institution that it will retain, for the life of the transaction, a net economic interest of not less than five per cent of specified credit risk tranches. As of the date of this writing, most CLOs have not complied with Article 122a. However, a few CLOs that invest in U.S. loans have complied with Article 122a, and as discussed above new European CLOs in the market are planning to comply. Article 122A permits a third-party equity investor in the CLO to retain the risk if it is involved in structuring the transaction and selecting the assets, as well as being involved in any material changes to the transaction. The equity investor may be a fund, provided that it is not a fund which is controlled by, or managed by, the investment manager of the CLO.

Foreign Account Tax Compliance Act

On 17 January 2013, the U.S. Treasury issued final regulations that provide guidance on Sections 1471 through 1474 of the U.S. Internal Revenue Code of 1986, as amended (commonly referred to as the "FATCA"). FATCA generally requires foreign financial institutions ("FFIs"), including CLOs, to enter into information sharing agreements with the U.S. Internal Revenue Service (the "IRS") and report certain information about their U.S. accounts to the IRS on an annual basis in order to avoid a 30 per cent withholding on certain U.S.-connected payments (including U.S. source interests and gross sale proceeds from the disposition of U.S. debt obligations). The final regulations provide that FATCA withholdings will not apply to any U.S. debt obligations outstanding on 1 January 2014, unless such obligations are materially modified after that date, and treat certain entities in existence on 31 December 2011 as deemed-compliant FFIs through 31 December 2016 if, among other things, the organisational documents do not permit amendments without the agreement of all of such entity's holders. However, because most CLOs require only a two-third majority for consent, among other reasons, this temporary relief is unlikely to provide much respite to pre-FATCA CLOs, absent further guidance from the IRS. The U.S. Treasury is developing an alternative approach for FFIs resident in a country that has entered into an intergovernmental agreement ("IGA") with the United States. The United States and the Cayman Islands are working together on an IGA, but it is unclear whether, and when, a United States and Cayman Islands IGA will be put in place and how such an IGA would impact CLOs.

Volcker Rule

Section 619 of the Dodd-Frank Act (commonly referred to as the "Volcker Rule") prohibits a "banking entity" from acquiring or retaining an equity, partnership, or other ownership interest in, or sponsoring, any hedge fund or private equity fund. The terms "hedge fund" and "private equity fund" include any issuer that does not register with the SEC as an investment company under the U.S. Investment Company Act of 1940 (the "Investment Company Act") based on the exceptions in Section 3(c)(1) or Section 3(c)(7) thereof, and any "similar fund". Most (but not all) CLOs have been structured as "3(c)(7)" vehicles, which limit investors (or, in the case of CLOs domiciled outside of the United States, U.S. investors) to "qualified purchasers" (as defined in Section 2(51)(A) of the Investment Company Act). Therefore, most managed or "arbitrage" CLOs will fall under the purview of the Volcker Rule as currently drafted, despite the fact that CLOs are not regarded by market participants as either hedge funds or private equity funds. "Balance sheet" CLOs, which banks use for regulatory capital efficiency by transferring loans (or the credit risk of the loans) from its balance sheet to the CLO and then holding the equity in the CLO, can also be structured as Section 3(c)(7) vehicles, in which event the prohibitions on banking entity sponsorship and ownership contained in the Volcker Rule would apply. In addition, the Volcker Rule may restrict the warehouse arrangements used to accumulate loans for a CLO if the placement agent is a banking entity and is regarded as the sponsor or adviser to the CLO, because the warehouse facility could constitute a prohibited covered transaction under Section 23A of the U.S. Federal Reserve Act. These problems can be avoided if the regulations implementing the Volcker Rule do not treat CLOs as hedge funds or private equity funds. Alternatively, CLOs can escape the Volcker Rule if they are offered without relying on Section 3(c)(1) or Section 3(c)(7) and escape characterisation as a "similar fund". Many balance sheet CLOs and some managed or arbitrage CLOs have been structured to qualify for the SEC's Rule 3a-7 exemption for issuers of ABS. However, Rule 3a-7 imposes many restrictions and is best suited for static or very lightly managed CLOs that do not invest in credit default swaps.

Industry participants have argued that the Volcker Rule should not apply to CLOs, because the Volcker Rule includes a provision that "nothing in the rule limit or restrict the sale or securitization of loans" and a CLO is essentially a loan securitisation.

As of the date of this writing, no further action has been taken on the Volcker Rule by the federal regulators.

CFTC CPO Registration for CLOs

Any securitisation vehicle, including a CLO, which enters into a swap (including an interest rate or currency swap and some types of credit default swaps) is considered by the U.S. Commodity Futures Trading Commission ("CFTC") to be a "commodity pool" under Section 1a(10) of the U.S. Commodity Exchange Act and under the CFTC's Regulation 4.10(d). As a result, the collateral manager of the CLO is required to register with the CFTC as a CPO ("commodity pool operator") or CTA ("commodity trading adviser") unless there is an applicable exemption. Most CLOs qualified for an exemption under the CFTC's Regulation 4.13(a)(4) because they required all U.S. investors to be "qualified purchasers". However, that exemption was revoked by the CFTC in 2012.

Few, if any, post-credit crisis CLOs have entered into swaps. Nonetheless, most of these CLOs are authorised to enter into swaps and they may need to hedge as they invest more in fixed rate assets or in assets denominated in a different currency than their liabilities. In any event, pre-credit crisis CLOs which entered into swaps are subject to these new requirements.

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The CFTC staff recognised that securitisations, including CLOs, would become subject to these registration requirements for the first time and issued an interpretation letter on 11 October 2012, excluding securitisation vehicles that met certain conditions from the definition of "commodity pool". Most CLOs could not meet these conditions because their investment activities are much more active than contemplated by this interpretation letter. In a subsequent interpretation and no-action letter issued by the CFTC staff on 7 December 2012, the staff provided further exclusions from commodity pool regulation for securitisation vehicles. In CFTC Letter No. 12-45, one example of a securitisation vehicle that would not be a commodity pool is a traditional CLO or CDO that (i) owns only financial assets consisting of corporate loans, corporate bonds, or investment-grade, fixed-income mortgage-backed securities, asset-backed securities or CDO tranches issued by vehicles that are not commodity pools, (ii) is permitted to trade up to 20 per cent of the aggregate principal balance of all financial assets owned by the issuer per year for three years, and (iii) uses interest rate swaps to convert fixed rate financial assets to floating and foreign exchange swaps to convert Euro-denominated assets to Dollars, and none of these swaps may be terminated before the related hedged asset has been liquidated. However, this letter stated that if a CLO used swaps to create investment exposure, then the securitisation vehicle may be a commodity pool.

CFTC Letter No. 12-45 also provided no-action relief for securitisation vehicles, including CLOs, formed prior to 12 October 2012 if specified criteria were met. The CLO must not issue securities on, or after, 12 October 2012 and its securities must be backed by payments on, or proceeds received in respect of, and their creditworthiness must primarily depend upon, cash or synthetic assets owned by the CLO. Note that legacy securitisation vehicles, unlike new CLOs that rely on the exclusions described in the prior paragraph, are permitted to hold synthetic assets.

CFTC Letter No. 12-45 also granted temporary no-action relief for securitisation vehicles unable to rely upon CFTC Letter No. 12-14 or CFTC Letter No. 12-45 until 31 March 2013.

Hedging

As CLOs expand beyond funding investments in U.S. Dollar-denominated floating rate loans with U.S. Dollar-denominated floating rate liabilities to CLOs which also invest in fixed rate bonds or in assets denominated in multiple currencies and fund with fixed and floating rate liabilities and multi-currency liabilities, the need to enter into hedging arrangements will increase. In addition to the CFTC regulatory framework discussed above, these new CLOs will face other issues. Since the financial crisis, rating agency requirements for hedge counterparties have become more stringent, and the credit ratings of many of the dealers which traditionally provided swaps to CLOs have been reduced. This combination of heightened agency requirements with reduced dealer credit ratings makes hedging currency or interest rate risks challenging for these new types of CLOs. For example, this concern is evident in emerging market and European CLOs.

Rating agencies have consistently required ratings triggers for hedge counterparties that enter into hedge agreements in CLO transactions so that the issuer can de-link the counterparty risk of the hedge counterparty from the credit risk of the CLO. For a CLO which issues notes rated by Moody's, the counterparty must have a specified minimum rating and, if the counterparty gets downgraded below a specified ratings trigger, then the hedge counterparty must obtain a guarantee, replace itself or post collateral. If the hedge counterparty is further downgraded below a lower specified ratings trigger then the hedge counterparty must obtain a guarantee or replace itself and post additional collateral in the interim. Moody's new rating agency framework has additional requirements, including requiring execution of all ISDA documentation at close, including a credit support annex that incorporates specific collateral amounts and valuation percentages and requiring amendments to standard ISDA provisions and clarifying certain events of default and termination events. Standard & Poor's takes a similar approach — the underpinning of its counterparty criteria is the replacement of a counterparty when its creditworthiness deteriorates. Their criteria combine minimum eligible counterparty ratings, collateral amounts and remedy periods to support a maximum potential rating on the securities. The basis for the criteria is that similar credit quality may be achieved through balancing the minimum eligible counterparty rating and the collateral amount, where lower minimum eligible counterparty ratings result in higher collateral amounts. If the counterparty gets downgraded below a certain level it must replace itself or obtain a guarantee from an appropriately rated guarantor.

* * *

The CLO market in the United States made a triumphant return in 2012 and CLO issuance is on a pace this year to surpass last year's strong numbers. This market is expanding to include other similar financial products — the European CLO, the emerging market CLO and an expansion into asset classes such as high-yield bonds and commercial mortgage related assets.

Endnotes

1. The most junior tranche in a CLO often consists of subordinated notes which do not bear an interest rate, but also may be preferred shares, limited liability company or limited partnership interests or certificates. For convenience, we refer to all of these CLO securities as "equity".
2. Directive 2009/111/EC of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management. Article 122a applies to new CLO transactions issued on, or after, 1 January 2011, and existing CLO transactions where new underlying exposures are added or substituted after 31 December 2014.

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Craig Stein

Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
USA

Tel: +1 212 756 2390
Fax: +1 212 593 5955
Email: craig.stein@srz.com
URL: www.srz.com

Craig Stein is a partner and co-head of the Structured Products & Derivatives Group at Schulte Roth & Zabel LLP. His practice focuses on structured finance and asset-backed transactions, swaps and other derivative products, including credit- and fund-linked derivatives, prime brokerage and customer trading agreements. He represents issuers, underwriters, collateral managers and portfolio purchasers in public and private structured financings, including collateralised loan obligations. Mr. Stein has been recognised by leading peer-review publications as a leader in the industry and he speaks and writes widely on advanced financial products. He earned his undergraduate degree, *cum laude*, from Colgate University and his J.D., *cum laude*, from the University of Pennsylvania Law School. He is a member of the ISDA Credit Derivatives Market Practice Committee, the American Bar Association and the New York State Bar Association.

Paul N. Watterson, Jr.

Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
USA

Tel: +1 212 756 2563
Fax: +1 212 593 5955
Email: paul.watterson@srz.com
URL: www.srz.com

Paul N. Watterson, Jr. is a partner and co-head of the Structured Products & Derivatives Group at Schulte Roth & Zabel LLP. He concentrates on structured product and derivative transactions, formation and representation of credit funds and capital markets regulation, and is counsel to many participants in the securitisation, credit and derivatives markets. He represents underwriters, issuers and managers in structured financings, including CLOs, and is involved in structured finance transactions that use credit derivatives, including regulatory capital transactions and repackagings. He advises funds and other alternative investment vehicles on their transactions in derivatives, loans, asset-backed securities and CDOs. Mr. Watterson has also been active in the creation of derivative products that reference hedge funds. He is a regular speaker at major industry events and is widely published and recognised by peer-reviewed publications. He earned his A.B., *cum laude*, from Princeton University, and his J.D., *magna cum laude*, from Harvard Law School.

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59 Tanner Street, London SE1 3PL, United Kingdom
Tel: +44 20 7367 0720 / Fax: +44 20 7407 5255
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