FEINGOLD
O'KEEFFE
CAPITAL

October 30, 2013

By Electronic Submission

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Regulations Division
Office of General Counsel
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451 7th Street, S.W., Room 10276
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Re: **Notice of Proposed Rulemaking, Credit Risk Retention**
SEC (Release No. 34-64148; File No. S7-14-11); FDIC (RIN 3064-AD74);
OCC (Docket No. OCC-2011-0002); FRB (Docket No. 2011-1411);
FHFA (RIN 2590-AA43); HUD (RIN 2501-AD53)

Ladies and Gentlemen:

Feingold O'Keeffe Capital, LLC ("FOC") is pleased to submit these comments in response to the joint Further Notice of Proposed Rulemaking, 78 Fed. Reg. 57928 (Sept. 20, 2013; originally released Aug. 28, 2013) ("FNPRM"), concerning risk retention and the implementation of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").

I. Overview.

FOC is a sophisticated investor and an Open Market CLO manager. We submit these comments to address how the agencies' proposed regulations would adversely affect the US non-investment grade debt market and, more specifically, corporate borrowers, institutional lenders and investors by severely curtailing the formation of CLOs. CLOs provide a vital and not insignificant ongoing source of capital to hundreds of US businesses. We also seek to illustrate how existing features of CLOs already protect investors through extensive and adequate incentives that align CLO managers' interests with those of the CLO investors.

We are very concerned that the regulations proposed by the agencies would significantly and adversely affect the formation and continued operation of CLOs, together with the scope of investment opportunities they offer to investors. Open Market CLOs present none of the risks to investors presented by the originate-to-distribute model that Section 941 was designed to address, and a range of incentives ensure that their managers act consistently with investors' interests. CLO performance during the recent financial crisis confirms the robustness of these incentives and investor protections, as does the subsequent resurgence of the CLO market that demonstrates investors' confidence that their interests are fully protected. For these reasons, additional regulation requiring CLO managers to retain more credit risk would produce no benefits and would substantially harm competition and the public. This result would be especially unfortunate because various alternatives are available to the agencies that would far better advance the public interest.

II. The Proposed Rules Would Adversely Affect Open Market CLO Managers, Other CLO Investors, and US Businesses.

Our experience as an Open Market CLO manager leaves us with no doubt that the proposed rules would cause a dramatic decrease in the size and functioning of the CLO market as a whole. We are aware of a survey of CLO managers that indicated that the decrease in CLO offerings is anticipated to be in the order of 75 percent.[1] We agree with that assessment. We are also aware of the broad range of comments and record evidence that establish that the proposed rules would adversely affect the formation and continued operation of the CLO market.[2] We agree with the factors identified in those comments and assess that those factors will contribute to the magnitude of the decrease in CLO formation identified in the LSTA survey. Indeed, the agencies themselves anticipate these adverse effects on CLOs and competition.[3]

The requirement that Open Market CLO managers retain five percent of the face value of the CLO's assets would drastically reduce CLO formation. Many CLO managers, including ourselves, simply do not have the financial capability to devote funds of the order contemplated by the 5% risk retention threshold. Moreover, those managers that do have the financial capability to meet the risk retention requirement will undoubtedly need to re-examine the prospect of dedicating such capital within the broader context of how capital is deployed. In short, we believe the risk retention rule would drive CLO managers out of the CLO business, whether forcibly or voluntarily.

We would also suggest that a dramatic decrease in the formation and scope of CLOs would have negative implications for CLO investors as well as investors in products that compete with CLO securities. CLO offerings are an important part of the capital markets and benefit a broad range of investors. These CLO securities provide an attractive, transparent mechanism for securing yield and credit exposure with a tailored investment approach. CLO securities permit that exposure while providing a range of protections, modes of investment, and related services to investors. Since CLOs compete with other debt investment offerings (loan mutual funds, ETFs, hedge funds) their existence effectively applies downward pressure on the costs borne by investors in those competing products – while increasing the range of investor protections and service features that competitors must offer. A

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[1] *See* LSTA Letter Comment, July 29, 2013 at 3–6.

[2] *See* LSTA Letter Comment, Aug. 1, 2011 at 14–17; LSTA Letter Comment, Apr. 1, 2013 at 14–16; LSTA Letter Comment, July 29, 2013 at 3–9; SIFMA Letter Comment, June 10, 2011 at 70; American Securitization Forum Letter Comment, June 10, 2011 at 137; JP Morgan Chase & Co. Letter Comment, July 14, 2011 at 50; Financial Services Roundtable Letter Comment, Aug. 1, 2011 at 32; Bank of America, Letter Comment, Aug. 1, 2011 at 29-30; Wells Fargo Letter Comment, July 28, 2011 at 29; White & Case Letter Comment, June 10, 2011 at 2.

[3] *See* 78 Fed. Reg. 57962.

reduction in the size and scope of the CLO market would inevitably increase the cost to invest in this vital credit sector – corporate America.

III. Additional Regulation of Open Market CLOs Is Inappropriate and Unnecessary.

A. Commercial and Regulatory Factors Already Align the Interests of Open Market CLO Managers and CLO Investors.

The proposed credit risk retention rules fail to account for the significant factors that already ensure that Open Market CLO managers select and manage CLO assets prudently and in investors' interests. Open Market CLOs do not employ the "originate-to-distribute" model of securitization that contributed to the financial crisis and prompted Congress to enact Section 941. The nature of Open Market CLOs, and their role in the loan market and in the provision of securities to investors, ensures that they operate independently and that managers' interests are aligned with CLO investors' interests. This alignment of interests, and related lack of any need for risk retention regulation to further align those interests, arises from the following characteristics of Open Market CLOs.

First, Open Market CLO managers act independently of loan originators and exercise independent judgment in selecting among loans originated by unaffiliated entities. They are free from potential conflicts and disincentives related to the originate-to-distribute model and attract investors based in large measure on this independence and the resulting quality of asset selection. This provides a strong incentive for continued selection of higher-quality assets.

Second, CLO managers bear significant risk through their deferred, contingent compensation structure that has been shaped and ratified by the market. CLO managers receive their primary sources of compensation only if they deliver for their investors: they are compensated principally as the most subordinated CLO investors secure their returns. Moreover, a large component of the manager's compensation is to be received only if the CLO itself has achieved specific performance metrics that, in turn, require several years of satisfactory performance. CLO managers' compensation structure places a premium on careful selection and management of assets, aligning their interests with investors' interests, *for the life* of the CLO. Indeed, investors and the competitive process have shaped and ratified the compensation structure. In this fundamental sense, CLO managers already have skin in the game – and creating that interest, which already exists for CLOs, is the entire point of the proposed regulations. The agencies have recognized and acknowledged this alignment of investor and manager interests created by the compensation structure.[4]

Third, almost all Open Market CLO managers, including ourselves, are registered investment advisors, with associated fiduciary duties – and potential liabilities – to their investors. This status triggers a separate and quite effective regulatory and supervisory regime that also provides incentives for careful selection and management of assets.

Fourth, the assets selected by Open Market CLO managers have been evaluated through multiple layers of underwriting and market decisions. These include the loan arrangers' decisions in underwriting the loans, the market's evaluation in pricing and syndicating the loans, and the CLO manager's decisions in selecting the loans for the CLO to purchase. Often, the assessments reflected in secondary market pricing also contribute to the selection of high-quality assets.

Fifth, CLO managers actively manage their loan portfolios for much of the life of a CLO. This

[4] *See* 78 Fed. Reg. 57963.

active role is unlike that for many other ABSs, and further protects investors. CLO managers can limit losses and secure additional gains based on the additional performance information provided for the particular loans and by the secondary market. In this management role, the CLO manager exercises independent judgment and has every incentive to act only in the best interest of CLO investors.

Finally, CLO managers select – and CLO investors demand – commercial loans with features that protect investors. Prominently, CLO managers select senior secured loans. This often ensures complete or substantial recovery and loss protection even in the event of a specific loan default; it is an important reason why CLOs protected investors so well during the recent financial crisis.

B. CLO Performance Confirms the Adequacy of Existing Incentives and Investor Protections.

The historically strong performance of CLOs demonstrates the concrete and practical results of these unique features of CLOs. Despite the massive financial crisis that resulted in widespread losses among other asset classes, CLOs performed exceptionally well. Although CLOs experienced ratings downgrades, the vast majority of CLO notes that were originally rated AAA retained ratings of AA or higher during the crisis.[5] And most significantly, CLOs experienced *de minimis* events of default and even lower rates of financial loss.[6] The Board of Governors of the Federal Reserve has acknowledged the low default rate among CLOs during the financial crisis, which it attributed in part to the incentive alignment mechanisms inherent to CLOs.[7]

We are aware of numerous comments submitted in this rulemaking that confirm the strong performance of CLOs during the financial crisis.[8] Our experience as direct participants in the industry accords with these views. We believe that this record of performance demonstrates that the existing safeguards and incentive alignments in the CLO industry more than adequately meet the goals of Section 941.

In particular, the ongoing investor demand for CLO securities reflects a market judgment, by the most informed and interested parties, that Open Market CLOs are structured in a manner that protects and advances investor interests while offering a valuable investment opportunity. CLOs were one of the first types of ABS to experience revived demand following the 2008 financial crisis, and demand for CLOs has been quite strong during the past few years. This resurgence indicates that the investor community has examined CLO performance during an extremely stressful financial period and has concluded that CLOs offered, and continue to offer, robust protections for investor interests.

C. In Light of These Incentives and Performance History, Additional Regulation Would Provide No Public Interest Benefits.

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[5] *See* LSTA Letter Comment, August 1, 2011 at 7.

[6] *Id*.

[7] *See* Board of Governors of the Federal Reserve, Report to Congress on Risk Retention 62, Oct. 2010.

[8] *See* LSTA Letter Comment, Aug. 1, 2011 at 7; LSTA Letter Comment, April 1, 2013 at 19; LSTA Letter Comment, July 29, 2013 at 2 and Appendix A; American Bar Association Business Law Section Letter Comment, July 20, 2011 at 90-93; American Securitization Forum Letter Comment, June 10, 2011 at 134-135; SIFMA Letter Comment, June 10, 2011 at 69; Morgan Stanley Letter Comment, July 27, 2011 at 18; Bank of America Letter Comment, Aug. 1, 2011 at 23; Wells Fargo Letter Comment, July 28, 2011 at 29; The Center for Capital Markets Competitiveness of the United States Chamber of Commerce Letter Comment, Aug. 1, 2011 at 4; Cong. Himes and other Members of Congress Letter Comment, July 29, 2011 at 2.

Because existing commercial and regulatory incentives fully align the interests of CLO managers and CLO investors, additional risk retention requirements would not redress any market failure or further align those interests. Because Open Market CLO managers select assets independently of loan originators, and do not operate as part of an "originate-to-distribute" model, the operations of Open Market CLOs present none of the risks to investors that Section 941 was designed to address. As set out above, the recent performance of CLOs and investor demand for CLO securities confirms that no additional risk retention requirements are needed.

We agree with other commenters that have analyzed the language and purpose of Section 941 and have shown that Congress did not intend to impose risk retention requirements on Open Market CLO managers.[9] Presumably, Congress did not intend to do so precisely because Open Market CLOs present none of the problems Section 941 was designed to fix. Because Open Market CLO managers facilitate the CLOs' purchase of assets, they do not directly or indirectly sell or transfer assets to the CLO – and are thus not within the scope of the statutory definition of "sponsor" as the agencies incorrectly assert.[10]

We also agree with commenters that, in light of the high costs and absence of benefits arising from imposing credit risk retention requirements on Open Market CLO managers, the agencies should exercise their statutory powers to exempt those managers from the credit risk retention requirements – assuming that those requirements even apply.[11]

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Feingold O'Keeffe Capital, LLC appreciates the agencies' consideration of these comments and would be pleased to provide additional information or assessments that might assist the agencies' decision-making. Please feel free to contact scott@focapital.com in the event you have questions regarding these observations and conclusions.

Sincerely,

Scott M. D'Orsi, CFA
Investment Principal

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[9] *See, e.g.*, LSTA Letter Comment, Aug. 1, 2011 at 7–14; LSTA Letter Comment, Apr. 1, 2013 at 17–19; LSTA Letter Comment, July 29, 2013 at 9–10; American Bar Association Business Law Section Letter Comment, July 20, 2011 at 93–95; SIFMA Letter Comment, June 10, 2011 at 68–69; American Securitization Forum, June 10, 2011 at 135–136; JP Morgan Chase & Co. Letter Comment, July 14, 2011 at 53–60; The Financial Services Roundtable Letter Comment, Aug. 1, 2011 at 31–32; Morgan Stanley Letter Comment, July 27, 2011 at 21; Bank of America Letter Comment, Aug. 1, 2011 at 23–30; Wells Fargo Letter Comment, July 28, 2011 at 26–29; White & Case Letter Comment, June 20, 2011 at 1–7; Cong. Himes and other Members of Congress Letter Comment, July 29, 2011 at 1–2.

[10] *Compare* 78 Fed. Reg. 57962.

[11] *See, e.g.*, LSTA Letter Comment, Aug. 1, 2011 at 17–19; LSTA Letter Comment, Mar. 9, 2012; LSTA Letter Comment, Apr. 1, 2013 at 23; American Bar Association Business Law Section Letter Comment, July 20, 2011 at 93–95; SIFMA Letter Comment, June 10, 2011 at 71–72; American Securitization Forum, June 10, 2011 at 138–139; The Financial Services Roundtable Letter Comment, Aug. 1, 2011 at 33; Bank of America Letter Comment, Aug. 1, 2011 at 30; Wells Fargo Letter Comment, July 28, 2011 at 29; Loan Market Association Letter Comment, Aug. 1, 2011 at 2.