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O A K H I L L

October 30, 2013

By Electronic Submission

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2–3
Washington, D.C. 20219

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551

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

Alfred M. Pollard, Esq.
General Counsel
Federal Housing Finance Agency
1700 G Street, N.W.
Washington, D.C. 20552

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

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

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:

Oak Hill Advisors, L.P. ("Oak Hill Advisors") respectfully submits 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").

Oak Hill Advisors is an investment management firm headquartered in New York City with $21 billion in capital under management. The firm invests in a diverse array of assets, including both broadly syndicated leveraged loans and securities issued by collateralized loan obligations ("CLOs"). Oak Hill Advisors is registered with the Unites States Securities and Exchange Commission as an Investment Adviser. More information about the firm and its activities is included below.

I. Overview.

Oak Hill Advisors submits these comments to address: 1) how the agencies' proposed regulations would adversely affect the CLO market, with significant and adverse "knock-on" effects to the US corporate loan market; 2) how existing features of CLOs provide extensive and adequate incentives that align CLO managers' interests with CLO investors' interests; and 3) how, if regulation is deemed necessary, alternative protections would achieve the same result without causing extensive harm to the CLO market, US corporate credit markets, competition, and ultimately, the public that we believe the proposed regulation causes.

In particular, Oak Hill Advisors is very concerned that the regulations proposed by the agencies would cause a materially adverse effect on the formation and continued operation of CLOs and the CLO market, along with the broader US corporate loan market. In our view, as both an investor in and an issuer of CLOs, we do not believe CLOs present risks similar to that of the "originate-to-distribute" securitized products that Section 941 was designed to address, and we believe that a range of incentives exist in the current structures to reasonably ensure that managers act consistent with investors' interests. In fact, CLOs have always operated different than the 2000's "originate-to-distribute" mortgage model that is widely credited as a major cause of the credit crisis. With CLOs, the manager is strongly incentivized to select assets that will perform well, and the manager has the ability to substitute assets over the life of the deal as market conditions change. In the "originate-to-distribute" mortgage model, there is no manager with a direct responsibility to investors, and there is no ability to actively manage the portfolio over time as conditions change. Indeed, one can argue that the "manager" is the originator of the mortgages and their interests are opposed to investors' interests from the very beginning.

The empirical data on CLOs is illuminating. During the worst credit crisis in the last 50 years, CLOs incurred *de minimis* principal loss in their debt tranches and no principal losses in the AAA-rated tranches – and that is over hundreds of deals done over a dozen years, in a market that is hundreds of billions in size.[1] (Please note that CLOs are defined as deals with >90% of loans as collateral). On the other hand, the problems in the mortgage market are well known. Many, if not most, debt tranches have been fully wiped out, and many, if not most, formally "AAA"- rated bonds have taken (or are expected to take) significant principal losses.

Additionally, capital markets activity since 2009 has been telling: the CLO market has enjoyed a resurgence and is functioning as it was prior to the crisis (in fact, 2013 will be the third

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

largest year of issuance on record). We believe this demonstrates investors' confidence in the structures and process and that the market is "working". On the other hand, very few new private-label mortgage deals are getting done – that market is for all intents and purposes "shut down".

It is no coincidence that the US Corporate High Yield and Leveraged Loan markets are fully functioning alongside the CLO market – these markets are intimately linked. Simply put, we believe the availability and cost of credit to many US companies will be adversely affected if the CLO risk retention rules are implemented as proposed.

For these reasons, we believe that additional regulation requiring CLO managers to retain more credit risk would produce few, if any, benefits and would substantially harm competition, the businesses that require fully functioning credit markets to survive and thrive, 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. Our Experience with CLOs and Commercial Loan Markets.

Oak Hill Advisors has been actively involved in the institutional leveraged loan market and the CLO market since their respective inceptions in the 1990s. Our firm's investment activities include not only these two assets classes, but also high yield bonds, distressed debt, mortgage securities and residential non-performing whole loans (distressed mortgages). We manage capital across CLOs, open and closed-end pooled investment vehicles and separately managed accounts. Our clients are predominantly large, global institutional investors, including state and government pension funds, sovereign wealth funds, family offices, and insurance and financial institutions. We are a partnership predominately owned by employees, and we employ approximately 160 people In New York, London, Fort Worth and Sydney.

We are a highly experienced manager of corporate leveraged loans, currently managing over $8 billion of capital in this space, with over $6 billion in CLOs. We managed some of the first "market-value" CLOs in the late 1990s and the first "cashflow" CLO we managed was issued in 2001. Our most recent CLO closed this month. In total, we have managed 16 "cashflow" CLOs (2 of these are European deals), 3 of which have been "called" or wound down and produced attractive returns for our investors. We currently actively manage 13 CLOs, 4 of which came to market in 2013.

Additionally, Oak Hill Advisors manages over $2 billion in CLO debt and equity capital in both specialized and multi-strategy funds and separate accounts. Collectively, we believe we are one of the largest global investors in and issuers of CLOs. We believe that our market roles (i.e., CLO manager and investor) and experience provides us with a clear understanding of the CLO market (before, during and since the recent financial crisis) and the likely adverse effects of the proposed regulations.

III. The Proposed Rules Would Adversely Affect Us, Other Open Market CLO Managers, Commercial Lending, Borrowers, and Investors.

Our experience in the CLO market leaves us with little doubt the proposed rules would have a material adverse effect on the formation of future CLOs and the size of the market.

The requirement that Open Market CLO managers retain five percent of the face value of the CLO's assets – in addition to the very significant credit risks already assumed through the CLO managers' compensation structure – would have a material adverse effect on CLO formation. Many CLO managers are too small to secure or devote funds of that magnitude for positions that cannot be risk managed or hedged – no matter what the competing business opportunities or demands. For other CLO managers that might have the financial capacity to hold such a significant position, including ourselves, doing so would require a capital commitment that could be made in other higher-returning opportunities.

Our market assessment is that the proposed rules would cause a dramatic decrease in the size and functioning of the CLO market. And as mentioned in the summary above, this would have very significant and negative "knock-on" effects to the availability and pricing of credit to a significant portion of US companies.

We are aware of the survey of CLO managers that indicated the decrease in CLO offerings is anticipated to be in the order of 75 percent[2], and we generally agree with that assessment. We are also aware of the broad range of comments and record evidence that establish the proposed rules would have a materially adverse effect on the formation and continued operation of the CLO market.[3] We agree with the factors identified in those comments, and we agree 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.[4]

Our experience also indicates the resulting decrease in the formation and scope of CLOs would have profoundly negative implications for the loan market. CLOs are vital to supporting the loan syndication process and to providing liquidity necessary to the efficient functioning of many of the most important sectors of the commercial loan market. If the proposed rules were implemented and adversely affected CLOs in the manner we anticipate, then borrower costs would increase, the secondary market would become considerably less liquid, and many investors would be denied a valuable and attractive set of investment opportunities. Competition in the provision of loans and investment product would decrease. Those adverse results pose broad risks to the efficient functioning of the loan market, and the adverse effects on borrowers could have further adverse effects on production efficiency, innovation, employment, and

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

[3] *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.

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

consumer prices.

IV. 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 protections currently in place that reasonably ensure Open Market CLO managers select and manage CLO assets prudently and in investors' interests. Open Market CLO managers 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 they operate independently and that managers' interests are aligned with CLO investors' interests. This alignment of interests, and corresponding 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 the substantial portion of compensation only if they deliver for their investors: they are compensated principally as the most subordinated CLO investors secure their returns, and a large component of their compensation is received only after the CLO has performed well over all of its life for all classes of investors, including those whose securities are most at risk. CLO managers' compensation structure places a premium on careful selection and management of assets, aligning their interests with investors' interests. Indeed, investors and the competitive process have shaped and ratified the compensation structure. In this very 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.[5]

Third, we understand the substantial majority of Open Market CLO managers 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

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

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 active role is unlike that for many other asset backed securitizations, 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. We believe this feature of CLOs was critical in allowing deals to survive and ultimately thrive through the deepest depths of the credit crisis.

Finally, CLO managers select – and CLO investors demand – commercial loans with features that protect investors. CLO managers are predominantly required to select senior secured loans. This often ensures complete or very substantial recovery and loss protection even in the event of default, and is another 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 strong historical 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.[6] And most significantly, CLOs experienced *de minimis* events of default and even lower rates of financial loss.[7] 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.[8]

We are aware of numerous comments submitted in this rulemaking that discuss the strong performance of CLOs during the financial crisis.[9] Our experience as direct participants in the

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

[7] *Id.*

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

[9] *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.

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.

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

Because existing commercial and regulatory incentives 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 independent of loan originators and do not operate as part of an "originate-to-distribute" model, the operations of Open Market CLOs do not present similar risks to investors of other securitized products that Section 941 was designed to address. As set forth above, the recent performance of CLOs serves as strong support 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 expressed why Congress did not intend to impose risk retention requirements on Open Market CLO managers.[10] Presumably, Congress did not intend to do so precisely because Open Market CLOs do not present 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.[11]

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 those requirements apply.[12] If the agencies believe certain types of CLOs pose a risk to investors or that further restrictions on which CLO managers can qualify for an exemption are appropriate, a commercially sensible set of "ring-fencing" qualifications has been proposed in the comments.[13]

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[10] *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.

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

[12] *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.

[13] *See* LSTA Letter Comment, Mar. 9, 2012 at Appendix A.

We note there have historically been certain types of financial instruments known as "balance-sheet CLOs" whereby banks selected already existing loan assets from their balance sheets for inclusion in a securitization and that the pool of loans was "static" or unmanaged throughout the life of the transaction. We believe these kinds of transactions more closely resemble the "originate-to-distribute" model that Section 941 was designed to fix.

V. Other Regulatory Alternatives Would Be Preferable to the Agencies' Proposed Approach.

Although we believe the intended scope of Section 941 and the facts surrounding the operation of CLOs indicate it would be a significant mistake to impose credit risk retention requirements on Open Market CLOs, alternative regulatory approaches would meet the agencies' objectives while causing far less harm to CLOs and the commercial loan market.

For example, the LSTA has proposed that CLO managers retain credit risk, consistent with the statutory requirements, by holding a set of securities that embody the compensation structure currently endorsed by the market and purchasing an interest in the CLO's equity.[14] Both the securities and the equity interest would align the interests of the CLO manager and the CLO investors. We believe the cash outlay for the proposed equity interest would be manageable for most CLO managers. We endorse that approach as far more preferable to the agencies' proposed regulations. We also believe the standard CLO compensation structure aligns our interests with those of our investors and the proposed purchase of an equity interest is workable and should remove any doubt about whether appropriate incentives apply to CLO managers' asset selection decisions.

Similarly, we endorse proposals that would reduce any risk retention requirement on a *pro rata* basis to the extent that a CLO's assets are comprised of higher-quality loans. A material portion of the loans that we and other CLO managers select are higher-quality loans under any commercially reasonable definition and present only moderate risks to investors. The quality of the CLO holdings should be taken into account in setting the amount of any credit risk that the CLO manager must retain.

In addition, we are aware that various commenters are proposing that parties associated with the CLO manager be able to retain credit risk in a manner that would satisfy Section 941's requirements. We endorse those proposals, should the agencies' deem the risk retention requirements as proposed necessary. Often, key investors or market participants work with a CLO manager to initiate the CLO and may play an advisory or other role in the selection of CLO assets. Having such parties, rather than the CLO manager, retain credit risk makes sense in terms of the agencies' objectives and the effect on the CLO market (the agencies' recently proposed alternative related to loan arrangers' holding risk similarly relies on a third party's retention of credit risk). Because parties coordinating with the CLO manager may contribute to the selection of assets, having them retain credit risk advances the agencies' goal of improving incentives related to asset selection. Such parties often have investment, rather than investment

[14] *See* LSTA Letter Comment, Apr. 1, 2013.

management, as their core business, making it more appropriate that they retain the requisite interest. In addition, they may do so without causing the disincentives and adverse impacts that arise when the CLO manager is required to retain a comparable economic interest.

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Oak Hill Advisors 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 Goran Puljic (212-326-1534, gpuljic@ohpny.com) in the event you have questions regarding these observations and conclusions.

Sincerely,

Goran Puljic

Goran Puljic
Managing Director
Oak Hill Advisors