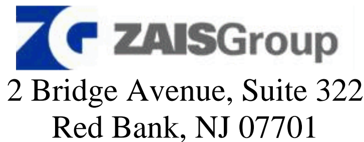

2 Bridge Avenue, Suite 322
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October 30, 2013

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.
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Alfred M. Pollard, Esq.
General Counsel
Federal Housing Finance Agency
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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:

ZAIS Group, LLC ("ZAIS") 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.

ZAIS is a sophisticated investor in the structured credit space and has, for the past fifteen years, actively invested in various tranches of CLO securities. We submit these comments to address how the agencies' proposed rules would adversely affect the credit markets by severely curtailing the formation of CLOs, and how certain structural features of CLOs already protect investors through extensive and adequate incentives that align CLO managers' interests with those of CLO investors, and how, if regulation is deemed necessary, other alternatives would protect investors without causing extensive harm to CLOs, credit markets, and competition.

In particular, ZAIS is 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 currently embedded in CLO structures ensure that their managers act in the best interests of the investors. 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 credit risk would produce no incremental additional benefit to investors and would substantially harm competition and ultimately cut off an important source of capital to the leveraged loan market. This result would be especially unfortunate because various alternatives to risk retention are available to the agencies that would far better advance the public interest.

II. Our Experience with CLO Securities and the Investor Protections Afforded by Open Market CLOs.

<u>Description of ZAIS</u>

ZAIS has been an active investor in this asset class since 1998, investing up and down the capital structure, from AAA rated debt securities to 1st loss equity positions. Our firm has developed proprietary analytical software to help us identify CLO securities that meet our investment criteria and we consider ourselves specialists in this asset class. Our firm's current AUM is approximately $5 billion and a majority of our assets are invested in debt and equity tranches of CLO's managed by U.S. managers.

ZAIS' market role and experience provides us with a clear understanding of the current CLO market, CLOs' performance 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 CLO Investors, Investors in Related Products, and Open Market CLO Managers.

Our experience as an investor in the CLO market leaves us with no doubt that the proposed rules would significantly and adversely affect the formation and scope of future CLOs, and thus would severely curtail CLOs' offerings to investors.

The requirement that Open Market CLO managers retain five percent of the face value of the CLO's assets – in addition to the significant credit risks already assumed through the CLO managers' compensation structure – would drastically reduce CLO formation. Many CLO managers are too small to secure or devote funds of that magnitude for positions that cannot be disposed or hedged and would simply exit the CLO business. And, even for CLO managers that might have the financial capacity to hold such a significant position, doing so would place such a substantial drag on anticipated returns, that these managers would have to restructure their current business models; making a once viable business much less profitable and forcing managers to instead devote their resources to other, more productive uses.

Our market assessment is 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 the survey of CLO managers that indicated that the decrease in CLO offerings is anticipated to be in the order of 75 percent.[1] We generally agree with that assessment, and are concerned that it may well be too optimistic. We are also aware of the broad range of comments and overwhelming evidence that support the position that the proposed rules would adversely affect the formation and continued operation of the CLO market,[2] and agree that the factors identified in those comments 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]

Our experience also indicates that a shrinking CLO market will have negative implications for us, other CLO investors, and investors in products that compete with CLO securities. CLO offerings are an important part of the ABS market that benefits all credit investors. CLO securities are an attractive, transparent mechanism for securing yield and exposure to an important credit sector. They offer various levels of exposure while providing a range of protections, modes of investment, and related services to investors. CLOs also compete with other, similar investment offerings, putting downward pressure on those competitors' margins and prices – while increasing the range of investor protections and service features that competitors must offer.

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 significant factors that

[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.

already ensure that Open Market CLO managers select and manage CLO assets prudently and in investors' best 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 as purchasers of loans and issuers of securities to investors, ensures that they operate independently from the originators and that managers' interests are aligned with CLO investors' interests. This alignment of 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 expect to receive their primary sources of compensation only if they deliver for their investors: their compensation is principally earned only upon the most subordinated CLO investors securing a certain return on their investment, and received only after the CLO has performed well over most 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 to achieve the desired alignment of interest between investors and managers.[4] In this fundamental sense, CLO managers already have "skin in the game" – which is the principal policy reason behind the proposed risk retention rules.

Third, almost all Open Market CLO managers are registered with the Securities and Exchange Commission as investment advisers, with associated fiduciary duties – and potential liabilities – to their investors. This creates 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 active role is unlike that for static pool ABS, and further protects investors. CLO managers can limit losses and secure additional gains based on the additional performance information available from underlying loan issuers and the secondary market. As an active trader of loans,

[4] Even the agencies have recognized and acknowledged this alignment of investor and manager interests created by the compensation structure. *See* 78 Fed. Reg. 57963.

the CLO manager has every incentive to act in the best interests of the CLO investors by maintaining a pool of collateral with, in its independent judgment, are the best performing credits.

Finally, CLO managers select – and CLO investors demand – commercial loans with features that protect investors. Prominently, CLO managers source senior secured loans. This often ensures complete or substantial recovery and loss protection even in the event of default, and 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 confirms the effectiveness of existing safeguards and incentive alignments inherent in 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 offer investors a valuable investment opportunity while structured in a manner to protect and advance their interests. CLOs were one of the first types of ABS to experience revived demand following the 2008

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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.

financial crisis, and demand for CLOs has been quite strong during the past few years. As mentioned above, we have been active investors in the CLO markets for the past fifteen years. We have naturally experienced several cycles of volatility, the most extreme cycle occurring in and after 2008. However, we continued to identify attractive CLO investment opportunities during this period and doing so has benefitted our investors greatly. This resurgence in investment returns 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.

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] If the agencies believe

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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,

that 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.[12]

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

Although we believe that the intended scope of Section 941 and the facts surrounding the operation and market evaluation of CLOs indicate that 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 investor interests.

For example, 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. Since a material portion of the loans that CLO managers select are senior secured loans, this reduced risk to investors 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 funds managed by the CLO manager be able to retain credit risk in a manner that would satisfy Section 941's requirements. We endorse those proposals. Often, key investors or market participants work with a CLO manager in launching a CLO. Having such parties, rather than the CLO manager, retain credit risk makes considerable 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 launch of the CLO, having them retain credit risk advances the agencies' goal of improving incentives related to asset selection. Such parties often have investment, rather than investment 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 would arise if the CLO manager is required to retain a comparable economic interest.

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ZAIS 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 me in the event you have questions regarding these observations and conclusions.

Aug. 1, 2011 at 30; Wells Fargo Letter Comment, July 28, 2011 at 29; Loan Market Association Letter Comment, Aug. 1, 2011 at 2.

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

Sincerely,

ZAIS GROUP, LLC

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Title: President