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By Electronic Submission

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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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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 (File No. S7-14-11); FDIC (RIN 3064-AD74);
OCC (Docket No. OCC-2013-0010); FRB (Docket No. R-1411);
FHFA (RIN 2590-AA43); HUD (RIN 2501-AD53)

Ladies and Gentlemen:

West Gate Horizons Advisors ("WGHA") is pleased to take this opportunity submit the following 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.

We would like to explain how we think that the agencies' proposed regulations with respect to Credit Risk Retention will significantly adversely affect the extension of credit to borrowers in the commercial loan market. This impact will certainly have a negative impact on the economy and the creation of jobs, the only question being the scope of the negative impact. Specifically, we will show how these rules will adversely affect the creation of CLOs, which provide much of the foundation for the commercial loan market. Further, we will show that, unlike many other securitized products, the features of CLOs have historically provided extensive and adequate incentives that align CLO managers' interests with those of CLO investors, much like other more traditional investment vehicles used by investors.

WGHA, as a CLO Investment Manager itself, is also convinced that smaller, independently owned investment managers like us would be completely forced out of the CLO Investment Management business despite our long and successful track record as a result of these proposed rules. Should the new rules be implemented, the CLO Investment Management business would be dominated by a few extremely large financial service giants only because they have more capital resources than smaller managers like us.

We do not believe that Open Market CLOs present any of the risks 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, as does the subsequent resurgence of the CLO market that demonstrates investors' confidence that their interests are fully protected.

II. WGHA's Experience, Discussion of the Current Economic Incentives of WGHA and a Review of the Current Leveraged Loan Market.

WGHA is boutique investment advisory firm registered under the Investment Advisers Act of 1940, with its primary location in Los Angeles, California. WGHA is owned by a combination of several independent investors and its executive officers. In addition to the executive team, WGHA employs five credit analysts and three administrators with tentative plans to hire more. WGHA commenced operations (through its predecessor firm) in 1995 and currently has approximately $1.4 billion in assets under management; all of WGHA's clients are open market CLOs. We believe that we have a strong reputation for competence and trustworthiness among those who invest in the securities of Open Market CLOs and other participants in the industry.

WGHA is currently the CLO Investment Manager for four Open Market CLOs.

As the CLO Investment Manager, WGHA earns a "Senior Management Fee" and a "Subordinated Management Fee" that are payable quarterly. In addition, upon meeting certain long range return objectives, WGHA potentially earns a "Performance Fee". The Subordinated Fees and the Performance Fee represent the lion's share of the total Fees paid by the CLO to WGHA. The Subordinated Fees are only payable, except in unusual circumstances, to the extent that CLO's debt-holders have received all of their scheduled interest in arrears and the CLO's equity holders have received some payment in that quarter. Performance Fees are not payable to the CLO Investment Manager unless the CLO equity-holders receive a predetermined cash on cash internal rate of return ("IRR"), which is typically 12%. It takes years of cash on cash returns to the CLO equity-holders to meet this hurdle, even under the best of circumstances. Once this cash on cash IRR hurdle is met, the CLO Investment Manager partially shares in future payments to the CLO equity-holders. WGHA does not receive a transactional fee or payment for structuring or closing the CLO itself. WGHA incentives for profit are the long term prudent and effective management of the CLO, not the origination or bundling of the CLO.

What does a CLO Investment Manager do in order to influence the investment performance of a CLO? It evaluates loans syndicated by large banks and creates a highly diversified pool of these loans. The CLO Investment Manager will sell some of these loans for gains and others because of concerns about the credit risk of the borrower. The CLO Investment Manager will re-invest the proceeds from repayment of loans and sales of loans for a certain period of time. If the CLO suffers too many defaults, credit losses, and downgrades of its investments to CCC by the ratings agencies, then the CLO's overcollateralization tests will be breached, which will eliminate or reduce quarterly distributions to the CLO's equity-holders. The CLO Manager's Subordinated Fees will be cut off as well until the overcollateralization tests are once again passing. The Senior Management fees for a CLO are not enough to cover a CLO Investment Manager's operating costs, so it is clear that a CLO Investment Manager is highly incentivized to select creditworthy loans.

WGHA was appointed CLO Investment Manager of three traditional CLOs from the period May of 2006 through June of 2007. These three CLOs have generated to date cash on cash IRR returns to equity-holders ranging from 13.3% to 16.1%. To put this in another way, the equity investors in these CLOs have thus far received a return of between 162% to 176% of their original investment. The most recent quarterly payment to the equity-holders on each of these CLOs ranged between 7.2 to 7.7% of the initial investment, so the final IRR returns for these CLO equity investors will only grow over time. All three of these CLOs have been profitable for WGHA *only because the performance was good.* We hope these returns demonstrate to you that CLOs performed well as a group during the financial crisis of 2008, unlike many other asset classes and other structured products.

As we have shown, a CLO Investment Manager's profitability is based upon its ability to evaluate credit. CLO debt and equity-holders, which are typically sophisticated institutions, do not require out-sized investments by the CLO Investment Manager. For example, in the most recent CLO WGHA was appointed investment manager of in the summer of 2013, WGHA's individual owners made a $5 million investment. In the three CLOs from 2006 and 2007, WGHA made much smaller investments. If a rule is enacted that requires a CLO Investment Manager to make extremely large investments in the CLO it manages, (i.e. 5% of a

$400 million CLO would equate to a $20 million investment), *then many CLO Investment Managers, like WGHA, would decide or be forced to exit the market.* Under such proposed rules, CLO Managers would be judged more on their financial heft than their historical performance.

Let's take a closer look at why a smaller CLO Manager would not be able to meet the risk retention proposed guideline. Although we manage CLOs with total assets of $1.4 billion, the total assets for WGHA are significantly less than $10 million. The only way WGHA could come up with $20 million in order to meet the risk retention requirements for a new $400 million CLO, would be to either borrow more than our current total assets or raise some very expensive additional equity at the cost of greatly diluting our existing equity investors. Neither is an attractive option. If we borrowed the money, this would be to invest in the equity of a new CLO, and within the CLO there is already approximately 10:1 leverage. Adding leverage on top of leverage is a sure fire way to make a business fail, and we are quite certain that most CLO Investment managers would avoid taking this risk.

At this point, we would like to turn to the commercial loan market as a whole. The Open Market CLOs that WGHA manages primarily invest in leveraged loans. The par amount of outstanding leveraged loans was over $600 billion at September 2013. A leveraged loan is a commercial loan that is structured and arranged by a commercial or investment bank and then is sold to other banks and institutional investors. These leveraged loans are used, among other things, to pay for capital expenditures, for general corporate purposes or to finance mergers. The borrowers that utilize leveraged loans are typically rated below investment grade and contain such household names as Goodyear Tire, Delta Air Lines and Hertz. Other borrowers are less known. In any case, these borrowers cannot meet all of their financing needs through the bond markets. CLOs compose a significant portion of the leveraged loan market. For example, according to S&P, CLOs purchased approximately 47% of leveraged loans during the first three quarters of 2013 while mutual funds, hedge funds and high yield funds purchased, on a combined basis, 33% of leveraged loans over the same period. During the first three quarters of 2013, over $57 billion of CLOs were issued. Leveraged loans are an important source of financing, and CLOs are an important source of the funding of the leveraged loan market.

III. The Proposed Rules Would Probably Eliminate Many CLO Investment Managers, Significantly Reduce the Issuance of CLOs and Squeeze Needed Investment in U.S. Commercial Businesses Resulting in Negative Consequences for the General Economy

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 very adversely affect CLO formation. Many CLO managers, including WGHA, are too small to secure or devote funds of that magnitude for positions that cannot be disposed or hedged – no matter what the competing business opportunities or demands. We are a boutique investment manager who depends upon its historical track record, the competence of its staff, and the loyalty of our long standing clients to compete in this space. All the capital we have invested in the business, including any investments WGHA has made in the equity of the CLO it manages, comes from the resources of the individual owners of WGHA. We will be unable to compete for investment management contracts of CLOs in the future if the requirement to manage CLOs is based upon the ability of the CLO Manager to commit $20 million to each transaction rather than our professional qualifications.

We believe that the proposed rules would cause a dramatic decrease in the size and functioning of the CLO market as a whole. Clearly, smaller boutique CLO Investment Managers such as us would be at a huge disadvantage. Since the CLO Investment Management business is generally steady and reasonably profitable, the profit margins are less than certain other asset management strategies. It is therefore easy to speculate that even those CLO Investment Managers with significant capital resources will deploy their capital in areas in which the return on investment is anticipated to be greater, rather than to compete for new CLO investment management contracts. 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 thinkt it may well be too optimistic). 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]

Europe already has imposed risk retention on CLOs. So far in 2013, thirteen new European CLO transactions have priced, totaling 4.5 billion. By contrast, in the U.S. where no risk retention rules currently apply, 133 CLOs have priced so far this year, totaling $64.2 billion. While we will admit that risk retention rules are not the only reason why European CLO issuance has been so much less than U.S. CLO issuance, there is no doubt that it is a major contributing factor.

CLOs are a very important source of funding for the leveraged loan market. If the proposed rules were implemented and adversely affected CLOs in the manner most people anticipate, then borrower costs would increase in all likelihood, and many borrowers would be shut out of the loan market altogether. It does not take much imagination to see the effects of a reduction of investment on industry and ***employment***.

It would, of course, follow that the secondary market for leveraged loans would become considerably less liquid, and many investors would be denied a valuable and attractive set of

[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.

investment opportunities. Competition in the provision of loans and investment product would decrease.

IV. Additional Regulation of Open Market CLOs Is Unnecessary and Counterproductive to the Public Interest.

A. Commercial and Regulatory Factors Already Align the Interests of CLO Investment Managers and CLO Debt and Equity-holders.

The proposed credit risk retention rules fail to account for the very significant factors that already ensure that CLO Investment Managers select and manage CLO assets prudently and in investors' interests. As we indicated in section II, CLO Investment Managers do not employ the "originate-to-distribute" model of securitization that contributed to the financial crisis and prompted Congress to enact Section 941. We believe that Open Market CLOs are much more similar with other investment vehicles such as mutual funds and other private funds than other types of CDOs, except that CLOs employ more leverage than mutual funds and other private funds. This is because of the stable nature of leveraged loans relative to other asset classes such as equities and high yield bonds, rather than the risk tolerance of CLO Investment Managers or their clients. In the CLOs that WGHA manages (and we believe the overwhelming amount of other Open Market CLOs), there is no significant hedging with respect to assets. Also, all of the assets in WGHA's CLOs are loans bought with "cash" and there are no "derivative" or "synthetic" loans with a counterparty in the background. The nature of CLOs, and their role in the loan market and in the provision of securities to investors, ensures that they operate independently of other market participants (i.e. commercial banks and investment banks that actually originate, arrange and distribute the leveraged loans) and that CLO Investment Managers' interests are completely 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, CLO Investment Managers like WGHA act independently of loan originators and exercise independent judgment in selecting among leveraged loans originated by third-party commercial banks and investment banks. *WGHA's fees are almost completely dependent on its ability to select leveraged loans issued by creditworthy issuers of leveraged loans.* WGHA is completely free from potential conflicts and disincentives related to the originate-to-distribute model. CLO debt and equity-holders recognize this independence from banks and economic incentives for selecting "good" leveraged loans and invest with CLO Investment Managers in large part based on their experience and historical track record.

Second, CLO Investment Managers such as WGHA bear significant long term economic risk (and potential reward) through their deferred, contingent compensation structure that has been shaped and ratified by the market. As was discussed in Section II, CLO Investment 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, and a large component of their compensation is 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. Once again, CLO Investment Managers' compensation structure is almost exclusively contingent on the selection and management of leveraged loans, which completely aligns our interests with our client's interests, just like the manager of a mutual fund or other private fund. Our interests are already completely aligned with those of the CLO debt and equity-holders (i.e. our clients), we already have skin in the game through these Performance Fees that take years to earn – and creating that interest, which already exists for CLOs, is the entire point of the proposed regulations. It is our understanding that the agencies have recognized and acknowledged this alignment of investor and manager interests created by the compensation structure.[4]

Third, WGHA and most other CLO Investment Managers are registered investment advisors (under the '40 Act), with associated fiduciary duties – and potential liabilities – to their clients. This status triggers a separate and quite effective regulatory and supervisory regime for CLO Investment Managers.

Fourth, CLO Investment Managers actively manage their loan portfolios for much of the life of a CLO (see the discussion of sales, prepayments and reinvestments of the proceeds resulting from this in Section II) for most CLOs as opposed to assembling a portfolio on a one-time basis. This active role by CLO Investment Managers is unlike that for many other ABSs, and further protects investors. Once again this active role is similar to the role that managers of mutual funds and other private funds play. CLO Investment Managers can limit losses and secure additional gains by actively managing the loan portfolio. Through this active portfolio management, the CLO Investment Manager exercises independent judgment and has every incentive to act only in the best interest of CLO debt and equity-holders.

Finally, CLO managers select – and CLO debt and equity-holders require as documented in the CLO's governing documents– leveraged loans with features that protect CLO debt and equity-holders. For example, almost all CLOs' governing documents require that CLO Investment Managers select a portfolio consisting primarily (90% or better) of senior secured leveraged loans, rather than subordinated or second lien loans. This senior secured feature has historically ensured substantially higher recovery and loss protection even in the event of default than if the portfolio had been invested in high yield bonds, subordinated or second lien loans. It has been our experience that these governing documents severely limit (or eliminate) various strategies using derivative or synthetic products. This is one of the important reasons as to why CLOs performed so well during the recent financial crisis relative to other investment alternatives.

We believe that any review of the existing structures of Open Market CLOs would compel the reviewer to conclude that under the present system, CLO Managers are rewarded for their ability to select and purchase loans, construct portfolios and dispose of credit risk-assets.

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

B. We Believe that the Historical CLO Performance Confirms the Adequacy of Existing Incentives and Investor Protections.

The historically strong performance of CLOs demonstrated over several credit cycles, including the financial crisis of 2008, is partly attributable to strength of the leveraged loan asset class. This performance also demonstrates the adequacy of existing incentives between CLO Investment Managers and the CLO debt and equity-holders. As we indicated above, in the three traditional CLOs launched in 2006 and 2007 for which WGHA serves as CLO Investment Manager, the CLO equity-holders have *already* received cash on cash IRR returns of between 13 and 16%. Although CLO debt (including the three CLOs referred to above) experienced ratings downgrades, these CLOs as well as the vast majority of CLO notes managed by other CLO Investment Managers that were originally rated AAA retained ratings of AA or higher during the crisis.[5] And most significantly, it is our understanding that CLOs as a whole 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 really believe that this record of performance demonstrates that the existing incentive alignments in the CLO industry more than adequately meet the goals of Section 941.

C. Additional Regulations Are Designed to Fix Problems That Do Not Exist in Open Market CLOs and These Regulations Will Be Counterproductive to the Public Interest.

As we think we have established above, because existing commercial and regulatory incentives fully align the interests of CLO Investment Managers and CLO debt and equity-holders, additional risk retention requirements would not address any demonstrated CLO market failure or further align the interests between the CLO Investment Managers and the investors. CLO Investment Managers such as ourselves 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. The historical performance of CLOs confirms that no problems did arise that Risk Retention would have fixed.

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 CLO Investment Managers.[8] We at WGHA can only conclude that Congress did not intend

[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, 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

to impose business killing risk retention requirements on boutique CLO Investment Managers precisely because history has shown that CLOs present none of the problems Section 941 was designed to fix. As we have mentioned several times before, CLO Investment Managers like us facilitate the CLOs' purchase of assets from unaffiliated third parties; we do not directly or indirectly sell or transfer assets to the CLO – and thus WGHA is not within the scope of the statutory definition of "sponsor" as the agencies incorrectly assert.[9]

We believe that these regulations, which solve no problems, will reduce CLOs and CLO Investment Managers. The reduction of CLOs will reduce much needed investment in US Industry, which will have a negative effect on the current recovery underway. The reduction in CLO Investment Managers will both result in lost jobs and will reduce much needed competition in financial services and limit those in the CLO Investment Manager business to be only the largest financial services companies.

These regulations are not needed and we hope the agencies will exercise their statutory powers to exempt those managers from the credit risk retention requirements – assuming that those requirements even apply.[10] If the agencies believe 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.[11]

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 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 commercial loan markets.

For example, we are aware that the LSTA has proposed that CLO managers could

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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.

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

[10] *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.

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

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.[12] Both the securities and the equity interest would confirm the alignment of interests between the CLO manager and the CLO investors. The cash outlay for the proposed equity interest would probably be manageable for CLO Investment Managers, and we at WGHA have invested in the debt and/or equity of some CLOs we have managed. We endorse that approach as far preferable to the agencies' proposed regulations,; although once again we don't think it furthers the public interest in any way.

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. We believe that a substantial portion of the loans that we and other CLO managers select are higher-quality loans under any commercially reasonable definition, present very limited risks to investors, and this 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 Investment Manager be able to retain credit risk in a manner that would satisfy Section 941's requirements. While we endorse those proposals generally speaking, we think if such proposals are adopted in isolation, it will still result in fewer CLOs and CLO Investment Managers. It could be that a key investor works with a CLO Investment Manager in initiating the CLO and may play an advisory or other role in the selection of CLO assets. We suppose that having such third - parties, rather than the CLO Investment Manager, retain credit risk in such instances 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). In these instances, these 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 arise when the CLO Investment Manager is required to retain a comparable economic interest.

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West Gate Horizons Advisors, 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 Mike Hatley or Gray Wilcox if you have questions regarding these observations and conclusions.

Sincerely,

Michael Hatley
President

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