October 25, 2013

By Electronic Submission

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Attention: Comments
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Regulations Division
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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:

Acis Capital Management, L.P. ("Acis") 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.

Acis submits these comments, as both a manager and investor in CLOs, to address how the agencies' proposed regulations would adversely affect CLOs and the commercial loan market, how features of CLOs already protect investors and provide 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, Acis is very concerned that the regulations proposed by the agencies would significantly and adversely affect the formation and continued operation of CLOs, along with the support they provide to the commercial loan market. Open Market CLOs present none of the risks presented by the originate-to-distribute model that Section 941 was designed to address and a range of incentives ensure that CLO 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. 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. Our Experience with CLOs and Commercial Loan Markets.

Acis is an SEC registered investment advisor which currently manages approximately $1.5 billion of assets under management. Of that $1.5 billion, approximately $1.4 billion is managed through our CLO management platform. The Acis management team's previous experience in the CLO market includes the structuring and managing of 36 funds totaling almost $30 billion in assets, through its affiliate Highland Capital Management, L.P. The Acis management team has been an established investor in the leveraged loan market since 1993 and structured one of the first CLOs in 1996; therefore we are one of the most experienced leveraged loan and CLO investors in the market today. In addition to the management of CLOs, we also manage approximately $100 million in assets invested in the mezzanine and equity tranches of other third party manager's CLOs.

Acis' 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 Open Market CLO Managers, CLO Investors, Commercial Lending, Borrowers, and Investors.

Our experience in the CLO market, as both a manager and investor, leaves us with no doubt that the proposed rules would significantly and adversely affect the formation and scope of future CLOs.

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, such as us, 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. For other CLO managers that might have the financial capacity to hold such a significant position, doing so would require a restructuring of current business models and anticipated returns – making a once viable business much less profitable, requiring that managers instead devote those funds 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 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]

Our experience also indicates that this 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, many borrowers would be shut out of the loan market altogether, 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, and we believe there would be a substantial increase in the risk to the investors in the CLOs in existence at the time the regulations go into effect. Those adverse results pose broad risks to the efficient functioning of the loan markets, and the adverse effects on borrowers would have further adverse effects on production efficiency, innovation, employment, and consumer prices.

In addition, CLO securities are an attractive, transparent mechanism for securing yield

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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.

and exposure to and important credit sector. They permit that 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 very significant factors that already ensure that 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 that they operate independently and that 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, 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, 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. 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.[4]

Third, almost all Open Market CLO managers are registered investment advisors, with

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

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 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 very 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 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

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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.

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. We were able to attract third party capital during 2008 to invest in the asset class as it became dislocated to the fundamental value and protections offered through the CLO structure, and we continue to raise and manage capital dedicated to the CLO market. This resurgence in investment 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

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[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.

[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.

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 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, investors, and the commercial loan markets.

For example, the LSTA has proposed that CLO managers could 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.[13] 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 be manageable for most CLO managers. We endorse that approach as far preferable to the agencies' proposed regulations. We also believe that the standard CLO compensation structure aligns our interests with those of our investors, and that the proposed purchase of an equity interest is workable and should remove any doubt that appropriate incentives apply to CLO managers' asset selection decisions.

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[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.

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

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

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, present very limited risks to investors, and 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. Often, key investors or market participants work with a CLO manager in initiating 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 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 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 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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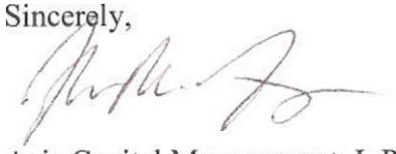
Acis appreciates the agencies' consideration of these comments and would be pleased to provide additional information or assessments that might assist the agencies' decision-making. Please feel free to contact Josh Terry at 972-628-4100 or jterry@hcmlp.com in the event you have questions regarding these observations and conclusions.

Sincerely,



Acis Capital Management, L.P.