October 29, 2013

By Electronic Submission

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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:

Halcyon Loan Management LLC ("HLM," together with Halcyon Asset Management LLC and their affiliates, "Halcyon") 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.

As presently constituted, the agencies' proposed regulations stand to severely curtail the formation and continued operation of CLOs, and as a consequence, dramatically erode an essential support mechanism for the U.S. commercial loan market. In the case of Halcyon, the proposed regulations would effectively prohibit us from establishing and managing new CLOs. As the performance of CLOs during the recent financial crisis plainly illustrates, CLOs are already structured such that the interests of CLO managers and their investors are closely aligned. Further, the "originate-to-distribute" model that Section 941 of the Dodd-Frank Act is intended to address is simply not implicated by the "Open Market CLOs" managed by Halcyon and numerous other similarly situated investment advisers. For all of these reasons, the proposed regulations miss the mark. We strongly urge the agencies to pursue alternative means to protect CLO investors, as the currently proposed regulations would not only radically reduce CLO market competition, but threaten the efficient function of the U.S. loan markets as a whole.

II. Halcyon's Extensive Experience with CLOs and Commercial Loan Markets Makes It Uniquely Situated To Comment On the Proposed Regulations

Founded in 1981, Halcyon is a global investment firm with approximately \$12.8 billion in assets under management as of October 1, 2013. Of that approximately \$12.8 billion, Halcyon, through its affiliates manages approximately \$7.3 billion in bank loan strategies, including CLOs, senior loan funds and separately managed accounts. HLM is an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Halcyon's London branch, Halcyon Asset Management (UK) LP, is authorized by the FSA.

HLM is headed by Ross Smead, Chief Investment Officer, who has more than 28 years of experience investing in and managing portfolios of corporate credit instruments, including bank loans. Brian Yorke is Portfolio Manager and Head Loan Trader of HLM, and has over 15 years of experience investing in bank loans and high-yield credit. Senior members of the HLM team have worked together for over 15 years, including an earlier tenure with Prudential Financial. The loan team employs a global, industry-focused investment process that invests in various strategies throughout the capital structure, including stressed and distressed debt, debtor-in-possession lending, capital structure arbitrage, and structured finance opportunities. The team manages assets in various vehicle types, including senior loan funds, separate accounts, 10 US CLOs, and 6 European CLOs.

Halcyon's legal and compliance team includes several former government employees who are especially qualified to assess the proposed regulations. Manish Mital, General Counsel and a Managing Principal of Halcyon, joined the firm in 2007 after having served as a Senior Counsel with the Division of Enforcement of the U.S. Securities and Exchange Commission, where he focused primarily on hedge fund malfeasance. Suzanne McDermott, Halcyon's Chief Compliance Officer and Associate General Counsel, joined the firm in 2008 following seven years as an Assistant United States Attorney in the Eastern District of New York, most recently in the Securities Fraud Unit where she focused on matters involving corruption in the hedge fund industry and corporate fraud.

Halcyon currently manages approximately \$3.8 billion in total assets under its existing 10 US CLOs. Subject to prevailing market conditions, Halcyon anticipates closing an additional three to four US CLOs in 2014.

The depth of Halcyon's CLO experience affords us a unique understanding of both the CLO market during and after the recent financial crisis and the unnecessarily punitive effects of the proposed regulations.

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

The proposed requirement that CLO managers retain five percent of the fair value of a CLO's capital structure – in addition to the very significant credit risks already assumed through a CLO manager's compensation structure – would dramatically restrict CLO formation. In the case of Halcyon, the proposed rules would effectively prohibit us from establishing and managing future CLOs, as we possess neither the infrastructure nor structural capacity to hold such illiquid positions. Numerous CLO managers are faced with similarly insurmountable obstacles, while others are simply too small to secure funds of that magnitude. For the limited number of CLO managers with the capacity and ability to hold such a significant position, doing so would likely require a wholesale restructuring of their current business models and anticipated returns, which in many cases would force such managers to reallocate their time and resources toward other, more profitable enterprises.

In an attempt to address the considerable obstacles brought about by the five percent retention requirement, the agencies have proposed an alternative approach, whereby certain CLO managers can satisfy the retention requirement by purchasing only "CLO-eligible loan tranches" (i.e., loan tranches in respect of which, among other things, the lead loan arranger retains 5% of the face amount) for inclusion in the CLO portfolio. But this approach is no less onerous. Notably, there is presently no such retention obligation for lead arrangers.

It is our belief that the likelihood of a significant number of lead arrangers retaining the requisite five percent is remote, and consequently, that only the largest, best capitalized managers will be able to comply with the proposed risk retention requirements. This would result in an undesirable consolidation among managers, and in turn, a marked reduction in competition and options for prospective investors. Effectively, the proposed regulations may create "too big to fail" managers of the type that prompted Congress to enact the Dodd-Frank Act in the first instance.

Even if certain arrangers were amenable to the five percent loan retention approach, such an approach could have the unintended effect of pushing the vast majority of CLO managers out of business. It stands to reason, for example, that certain lead arrangers would generate sufficient loan sales solely from those CLO managers who are able to retain five percent of their related CLO capital structures, thereby obviating the need for such arrangers to retain five percent of their own loan offerings. As a consequence, CLO managers such as Halcyon would be left with a severely diminished pool of risk retention compliant loans available for purchase.

Based on our extensive experience, we firmly believe that the proposed rules, if passed, would cause a sharp decline in the size of the CLO market, and significantly impair the market's functioning as a whole. In fact, a survey of CLO managers indicated that they anticipate an approximately 75 percent decrease in CLO offerings as a direct consequence of the proposed rules.[1] In our view, the decrease may be higher and that assessment too conservative.

The negative implications of the proposed rules we have identified in this letter are supported by a considerable number of comments and record evidence.[2] We agree that the factors identified in those comments will contribute to the sharp decline in CLO formation identified in the LSTA survey. Not surprisingly, the agencies also anticipate some of these same adverse effects on CLOs and market competition.[3]

Any decrease in the size and functioning of the CLO market would also adversely affect the loan market generally. CLOs play a critical role in supporting the loan syndication process, providing the liquidity necessary to the efficient functioning of some of the most important sectors of the commercial loan market. The proposed rules would decrease competition in the provision of loans and investment products, increasing borrower costs while shutting numerous borrowers out of the loan market entirely. The result would be a considerably less liquid secondary loan market, and, as a result, a denial to many investors of valuable and attractive investment opportunities. Taken as a whole, these undesirable results would significantly impair production efficiency, innovation, employment, and consumer prices; hardly what the agencies intended in formulating the proposed rules.

IV. The Proposed Regulation of Open Market CLOs Is Unwarranted and Unnecessary

A. Sufficient Incentives Presently Exist to Align the Interests of Managers and Investors

Sufficient incentives presently exist to ensure that Open Market CLO managers select and manage CLO assets prudently and in their investors' best interests. Section 941 of the Dodd-Frank Act was intended to address the "originate-to-distribute" model of securitization that contributed to the financial crisis. But this model is not utilized by Open Market CLO managers, and therefore the proposed regulations do not further Congress's statutory intent. There are a number of characteristics of Open Market CLOs, set forth below, that effectively align manager and investor interests, thereby underscoring the unwarranted nature of the risk retention regulations:

(1) <u>Open Market CLO Managers Do Not Utilize The "Originate-to-Distribute" Model</u>

Open Market CLO managers do not generate loans for sale or transfer to a securitizing vehicle, and thus do not avail themselves of the "originate-to-distribute" model. Such managers

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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.

therefore fall outside of the scope of Section 941 of the Dodd-Frank Act, which covers "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer."

Open Market CLO managers select loans originated by unaffiliated entities for inclusion in their CLO portfolios using their independent judgment. This independence and the resulting quality of asset selection are the very qualities that attract investors to Open Market CLO managers; indeed, they are the hallmarks of a model that continues to inspire investor trust and confidence. Managers and investors remain highly motivated to continue with this model.

(2) CLO Managers Already Have Skin In The Game

Open Market CLO management compensation is inextricably linked to CLO performance. A primary component of a CLO manager's compensation, for example, is only received after the CLO has performed strongly for all classes of investors, including the most subordinated class, over a sustained period of time. In other words, if CLO managers fail to deliver for those investors who bear the most risk, their compensation will suffer accordingly. This compensation structure incentivizes the managers to carefully select and diligently manage the CLO's assets for the benefit of the entire capital structure. This skin in the game structure has been shaped and ratified by the market.

The alignment of interests among financial institutions and investors is the driving force behind the Dodd-Frank Act. As such, the agencies' risk retention proposal as applied to Open Market CLOs seems glaringly superfluous. Even the agencies acknowledge that the current compensation structure of CLO managers "incorporate[s] credit risk sensitivity and contribute[s] to aligning the interests of the CLO manager and investors with respect to the quality of the securitized loans."[4]

(3) Most Open Market CLO Managers Are Registered Investment Advisors

Nearly all Open Market CLO managers – including Halcyon – are registered investment advisors. As a result, they are already subject to a separate and proven regulatory and supervisory regime. This regime further incentivizes CLO managers to prudently select and manage investor assets, and imposes potential liabilities for failure to do so.

(4) Open Market CLO Managers Select Assets That Have Been Thoroughly Vetted

Each asset comprising an Open Market CLO's collateral portfolio has been thoroughly vetted through an intensive process of underwriting and market decisions. First, the arranger must decide whether or not to underwrite the related loan. Once selected for underwriting, the market must evaluate each loan in connection with pricing and syndication. Finally, the CLO manager must decide whether or not to purchase the loan for its CLO, an analysis that is subject to an intensive and selective credit review process, as well as numerous diversification and concentration requirements relating to, among other things, industry, geographic and obligor

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

risk, set forth in the CLO's governing documentation. This process typically results in the selection by Open Market CLO managers of a pool of diverse, high-quality assets.

(5) CLO Managers Actively Manage Their Loan Portfolios

Unlike other asset-backed securities, Open Market CLOs are actively managed for much of the life of the transaction. CLO managers can and will react to future market forces in order to limit losses or secure additional gains. In actively managing their loan portfolios, CLO managers exercise independent judgment and, due in large part to their performance based compensation structure, have every incentive to act only in the best interest of CLO investors.

(6) CLO Managers Typically Select Senior Secured Loans

Open Market CLO investors demand – and CLO documentation therefore requires – a collateral portfolio comprised predominantly of senior secured loans with features that protect investors, even in the event of default. This fundamental feature of Open Market CLOs, together with the protections afforded investors by the asset selection process described above, are what set CLO performance apart from the performance of other asset-backed structured vehicles during the financial crisis.

B. Steady CLO Performance Throughout the Financial Crisis Confirms the Efficacy of Existing Incentives

CLOs have consistently generated positive investor returns. Indeed, despite the plummeting value of other asset classes during the financial crisis, CLOs continued to perform exceptionally well, experiencing only *de minimis* events of default and even lower rates of financial loss.[5] The Board of Governors of the Federal Reserve has specifically acknowledged the low default rate among CLOs during the financial crisis, which it attributed in part to the incentive alignment mechanisms inherent to CLOs.[6]

Numerous comments have already been submitted detailing the robust performance of CLOs during the financial crisis.[7] As direct participants in the industry, we strongly concur with the views expressed in these comments, namely that the historically strong performance of CLOs in markets both weak and strong only serves to confirm the efficacy of the current CLO management incentive structure.

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

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

[7] *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.

C. Existing Incentives and Strong Historical Performance Confirms That Additional Regulation Would Provide No Public Interest Benefits

As demonstrated above, the interests of Open Market CLO managers are already aligned with those of their investors under the present CLO regulatory and structural scheme. Open Market CLO managers engage in the independent selection of CLO assets within tightly crafted parameters, and do not employ the "originate-to-distribute" model of securitization that Section 941 of the Dodd-Frank Act was intended to police. Most significantly, the effectiveness of the current model has been proven by strong CLO performance both during and after the financial crisis. When viewed through this lens, the conclusion that additional regulation is unnecessary with respect to Open Market CLOs becomes self-evident.

Our belief that Congress did not intend to impose risk retention requirements on Open Market CLO managers is neither novel nor unique.[8] In fact, Congress may very well have shared our view that Open Market CLOs present none of the problems Section 941 was designed to address. Because Open Market CLO managers merely facilitate the CLOs' purchase of assets rather than directly or indirectly selling or transferring assets to the CLO, they are thus not within the scope of the statutory definition of "sponsor" as the agencies incorrectly assert.[9]

Further, our belief that the proposed credit risk retention requirements will impose high costs on Open Market CLO managers while creating little to no benefit for market participants is widely shared. The agencies should therefore exercise their statutory powers to exempt CLO managers such as Halcyon from the credit risk retention requirements.[10] If the agencies believe that certain types of CLOs pose a risk to investors, or that further restrictions as to 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]

Simply put, the agencies have failed to demonstrate – as they must – that the benefits of

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[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 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.

the proposed regulation exceed the costs that the rules would impose on borrowers, lenders, syndicate participants, CLO managers, investors and the public interest generally. The agencies may only act based on a reasonable construction of the statute, and any proposed rules must be rational and non-arbitrary. As presently drafted, the agencies' proposal falls considerably short of this standard.

V. There Are Sufficient Alternatives to the Agencies' Proposed Approach

While we firmly believe that the imposition of credit risk retention requirements on Open Market CLOs is unwarranted and unnecessary, we also believe there are sufficient alternatives to the proposed regulations that would meet the agencies' objectives without causing substantial harm to CLOs and 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 and alignment of CLO manager and investor interests currently endorsed by the market and purchasing an interest in the CLO's equity.[12] In our view, this is a far more preferable approach than the agencies' proposal. The standard CLO compensation structure already aligns our interests with those of our investors, and the proposed purchase of an equity interest is both financially viable and sufficient to remove any doubt that appropriate incentives apply to CLO managers' asset selection decisions. Further, this approach is considerably less costly, thus greatly increasing the likelihood of CLO manager compliance in general.

We also 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 and numerous other CLO managers already select what would be considered high-quality loans under any commercially reasonable definition. These loans present limited risks to investors. In determining the appropriate risk retention requirements for CLO managers, this must be taken into account.

Finally, we endorse those proposals by various commenters that certain parties associated with a CLO manager be able to retain credit risk in a manner that would satisfy Section 941's requirements. CLO managers frequently work with key investors or market participants in initiating a CLO. These individuals or institutions may play an advisory or other role in the selection of CLO assets. It would logically follow to have such parties, as opposed to the CLO manager, retain credit risk. This is consistent with the agencies' objectives, and similar to the agencies' proposed alternative relating to the retention of credit risk by third party loan arrangers. If a party coordinating with the CLO manager contributes to the selection of assets, there would seem no better way to incentivize that party to select high-quality assets than to require it to retain credit risk. Further, it is more appropriate that such parties retain the requisite interest, as their core business is often investment, rather than investment management. By requiring these associated parties – rather than the CLO manager – to retain the risk, the myriad disincentives and adverse impacts that arise when the CLO manager is required to retain a comparable economic interest could be avoided.

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

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Halcyon 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 Ross Smead (rsmead@halcyonllc.com; (212) 303-9440) should you have questions regarding these observations and conclusions.

Sincerely,

Manish K. Mital
General Counsel
Managing Principal

Halcyon Loan Management LLC

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