DENALI CAPITAL LLC
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October 30, 2013

By E-mail

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
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Mail Stop –9W-11
Washington, D.C. 20219

Robert DeV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551

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

Alfred M. Pollard, Esq.
General Counsel
Attention: Comments/RIN 2590-AA43
Federal Housing Finance Agency
Constitution Center
(OGC) Eighth Floor
400 7th Street, S.W.
Washington, D.C. 20024

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. R-1411); FHFA (RIN 2590-AA43); HUD (RIN 2501-AD53)

Dear Sirs and Madame:

DC Funding Partners LLC and its managing member, Denali Capital LLC (together "Denali") hereby comments on the joint Notice of Proposed Rulemaking concerning credit 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.

Denali submits these comments to share with you our perspective on how the agencies' proposed regulations would adversely affect the formation and continued operation of open market collateralized loan obligations (as such term is used in the Notice of Proposed Rulemaking) or "Open Market CLOs", along with the support they provide to the commercial loan market (and ultimately the impact they would have on the availability of capital to US businesses and the recovering US economy).

In particular, Denali is very concerned that the regulations proposed by the agencies would significantly and adversely affect the formation of CLOs, and consequently the support they provide to the commercial loan market. Open Market CLOs present none of the risks of the originate-to-distribute securitization model that the proposed regulations were designed to address, and a range of incentives ensure that their CLO managers act consistently with investors' interests. CLO performance during the recent financial crisis confirms the alignment 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 of Open Market CLOs to retain credit risk would produce no benefits and could substantially harm competition and the public.

II. Our Company.

Denali was formed in 2001 to serve as an investment management company, initially to specialize in the management of senior secured leveraged loans primarily through CLOs. We are located in the Oak Brook, Illinois, employ 22 persons and currently manage six CLO funds with total assets of about $1.7 billion. We are a registered investment adviser under the Investment Advisers Act of 1940, as amended. We are not currently in a position to secure or devote capital to retain five percent of the face value of CLO assets. We believe that such a requirement would significantly diminish our ability to grow our company, including employing additional professionals and, ultimately, managing new CLOs.

Denali's market role and experience in the loan market provides us with a clear understanding of the current CLO market, CLOs' performance before, during and since the recent financial crisis, and the likely adverse effects of the proposed regulations.

III. Proposed Rules Would Adversely Affect Us, Other CLO Managers, Lending to US Businesses and Investors.

CLOs are estimated to hold approximately 25% of all outstanding loans to US businesses and more than 50% of "institutional loans" to US businesses. Our experience in the CLO market leaves us with no doubt that the proposed regulations would significantly and adversely affect the formation and scope of future CLOs, thereby significantly reducing or possibly eliminating one of the largest sources of long term capital for US businesses today.

The requirement that CLO managers retain five percent of the face value of the CLO's assets – in addition to the very significant economic risks already assumed through the CLO managers' management fee structure – would adversely affect CLO formation. Many CLO

managers, including us, would likely be unable to secure or devote funds of that magnitude. Many managers follow a business model focused solely on managing loan investments for clients. To raise the capital necessary to invest such amounts in the CLO funds we manage would not only require a dramatic change in our business model (which may not be achievable) but we feel could present a range of other potential conflicts for our business.

We strongly believe that the proposed rules would cause a dramatic decrease in the size and functionality 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 believe that those factors will contribute to the magnitude of the decrease in CLO formation identified in the LSTA survey.

Our experience also indicates that this resulting decrease in the formation and scope of CLOs would have significant negative implications for the commercial loan market. CLOs are vital to supporting the syndication process for loans to US businesses (including facilitating a liquid and functioning secondary loan trading market) as well as providing the liquidity necessary to the efficient functioning of the commercial loan market. If the proposed rules were implemented and adversely affected CLOs in the manner we and other managers anticipate, then borrowing costs would increase, many companies would be precluded from accessing loan market capital, the secondary market would become considerably less liquid, and many investors would be denied a valuable and attractive set of investment opportunities. Ultimately, competition in the provision of loans and investment product would decrease. Those adverse results pose broad risks to the efficient functioning of the loan markets, and the adverse effects on borrowers would have further negative effects on production efficiency, innovation, employment, and consumer prices.

A vibrant secondary loan market for commercial loans spreads credit risk which reduces overall systemic risk. Ironically, limiting CLOs as market participants under the proposed regulations could increase overall systemic risk by concentrating loan holdings at primary lenders (mostly large banks). The reality is that a large CLO market with a diverse group of loan managers also improves access to capital for all businesses by allowing primary lenders to effectively and efficiently redeploy capital. Reducing the number of market participants (such as CLOs) reduces access to capital for all businesses.

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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.

On a personal level, the adverse impact of the proposal goes beyond the loan market as it will also severely stress smaller loan managers like us. We feel the proposal will impact our ability (and many other similarly situated manager's ability) to hire and grow in the future. We know of several other similarly situated loan management businesses here in the Midwest who share our concerns and believe that the proposed regulations will create an additional and unintended negative impact on our local economy.

IV. Additional Regulation of Open Market CLOs Is 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 CLO managers select and manage CLO assets prudently and in investors' interests. 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 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.

- 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 securitization 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.

- 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 produce good returns for their investors: they are compensated principally as the most subordinated CLO investors secure their returns, and a large component of their potential 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", which is the entire point of the proposed regulations; most importantly, the existing alignment proved successful as demonstrated by CLO performance through the financial crisis. The vast majority of CLO managers are registered investment advisers, with associated fiduciary

duties – and potential liabilities – to their investors. This status triggers a separate and quite effective regulatory and supervisory regime that also provides incentives for careful selection and management of assets.

- The assets selected by 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, rating and syndicating the loans, and the CLO manager's decisions in selecting the loans for the CLO to purchase.

- CLO managers actively manage their loan portfolios through the life of a CLO. This active role is unlike that for many mortgage and asset backed securitizations, and further protects investors. CLO managers can limit losses and secure additional gains based on the additional performance information provided for the particular loans and by the secondary market. In this management role, CLO managers exercise independent judgment and have every incentive to act only in the best interest of CLO investors.

- CLO managers select – and CLO investors demand – commercial loans with features that protect investors. Importantly, CLO managers largely select only senior secured loans as collateral securing the CLOs obligations to investors. 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.

- CLOs invest only in portions of commercial loans, thereby benefiting from the ongoing management of those loans between the primary lenders (mostly large banks) who originated those loans and the underlying sophisticated corporate borrowers. On the other hand, mortgage and asset backed securitizations contributed to the recent financial crisis because, in part, those structures housed entire mortgages or other assets owing by generally unsophisticated borrowers. When those assets deteriorated, the originators of those assets were no longer responsible for them or available to deal with the underlying obligors. While the CLO manager is responsible for the CLO's overall loan portfolio, unlike with a mortgage or asset backed securitization, the underlying loans are still managed by the banks who extended them, thereby providing an additional layer of oversight and protection to investors.

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 and, more importantly,[3] CLOs experienced *de minimis* events of default and even lower rates of financial loss.[4] 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.[5]

We are aware of numerous comments submitted in this rulemaking that confirm the strong performance of CLOs during the financial crisis.[6] Our experience as direct participants in the industry supports these views. We believe that this record of performance demonstrates that the existing safeguards and incentive alignments in the CLO industry more than adequately meet the goals of Section 941.

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

Because existing commercial and regulatory incentives 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" securitization model, the operations of CLOs present none of the risks to investors that Section 941 was designed to address. As set out above, the recent performance of CLOs 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 CLO managers.[7] Presumably, Congress did not intend to do so precisely because CLOs present none of the problems Section 941 was designed to fix. Because CLO managers facilitate the CLOs'

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

[4] *Id.*

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

[6] *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.

[7] *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.

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.[8]

We also agree with commenters that, in light of the high costs and absence of benefits arising from imposing credit risk retention requirements on 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.[9]

In view of the seemingly obvious potential harm that imposing risk retention requirements on CLO managers would have to our economy, we urge the agencies to find a way to avoid that adverse effect.

Thank you for the opportunity for us to provide our views.

Very truly yours,

David P. Killion
Chief Executive Officer

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

[9] *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.