US COURT OF APPEALS RULING CALLS FOR ELIMINATION OF RISK RETENTION OBLIGATIONS FOR OPEN-MARKET CLO MANAGERS

The US Court of Appeals for the District of Columbia ruled in favor of The Loan Syndications and Trading Association ("**LSTA**") on February 9, 2018 in a case that challenged the application of credit risk retention requirements to certain CLO managers (the "**Ruling**").[1] Specifically, the court decided that the US risk retention rules should not apply to managers of issuers of CLOs that are collateralized by loans purchased in the open market ("**open-market CLOs**"). The basis for the Ruling is that these CLO managers neither originate the underlying loans nor hold them as assets, and they therefore do not qualify as "securitizers" under the applicable statutory provision. The effectiveness of the Ruling is subject to an initial 45-day period during which the relevant governmental agencies may appeal, and opportunities for further appeal are available. Effectiveness of the Ruling would be further delayed during any appeal, and its practical effect could be influenced to the extent the relevant governmental agencies elect to implement or clarify the Ruling through the rulemaking process.

Scope of the Dodd-Frank Act's credit risk retention mandate

To discourage problematic lending practices that were seen to be a cause of the financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") mandated joint agency rulemaking to implement the credit risk retention requirements specified in Section 15G of the US Securities Exchange Act of 1934, as amended (the "**Exchange Act**"). This statutory mandate contemplates requiring any "**securitizer**" to retain not less than 5% of the credit risk for any asset that the securitizer transfers, sells, or conveys to a third party

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[1] *Loan Syndications & Trading Ass'n v. SEC et al.*, No. 17-5004, 17 (D.C. Cir. Feb. 9, 2018), available here.

through the issuance of an asset-backed security, subject to some exceptions. For this purpose, "**securitizer**" includes "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" as well as an issuer of an asset-backed security.

How did the agencies implement credit risk retention?

In October 2014, the US Securities and Exchange Commission ("**SEC**"), the US Federal Reserve Board ("**FRB**") and four other US governmental agencies jointly adopted implementing regulations.[2] These require "**sponsors**" to retain a 5% interest in connection with securitization transactions (subject to specified exceptions). In this context, "**sponsor**" means any person who organizes and initiates a securitization transaction by selling or transferring assets, directly or indirectly, to the issuing entity. By placing risk retention responsibility on sponsors instead of securitizers, the implementing regulations do not impose risk retention obligations on issuers.

Scope concerns raised by LSTA and other commenters during the proposal phase of the implementing regulations

During the proposal phase of the implementing regulations, the LSTA and other commenters had asserted that managers of open-market CLOs should not be classified as securitizers within the definition in Section 15G of the Exchange Act. They believed the agencies' proposal to impose a sponsor's risk retention requirement on these managers is contrary to the Section 15G of the Exchange Act. They maintained that "because the CLO managers themselves would never legally own, sell, or transfer the loans that comprised the CLO's collateral pool, but only direct which assets would be purchased by the CLO issuing entity, they should not be 'securitizers' for the purpose of Section 15G of the Exchange Act."[3]

After considering these and other comments, the purposes of Section 15G of the Exchange Act, and the features and dynamics of CLOs and the leveraged loan market, the agencies explicitly concluded that credit risk retention requirements should apply to managers of open-market CLOs.[4] In the supplementary text to the final implementing regulations, the agencies explained their basis for believing that open-market CLO managers were securitizers within the meaning of Section 15G of the Exchange Act. The agencies claimed these managers did "indirectly transfer" commercial loans to their CLOs because they:

- have sole authority to select the commercial loans to be purchased by the CLO issuing entity for inclusion in the CLO collateral pool;
- direct the issuing entity to purchase those loans in accordance with investment guidelines; and
- manage those loans once deposited in the CLO structure.[5]

What is an open-market CLO?

A CLO is an asset-backed security that is typically collateralized by portions of tranches of senior, secured commercial loans or similar obligations.

An open-market CLO securitizes commercial loans purchased through arms' length transactions. After the terms of an open-market CLO transaction are agreed upon with key investors, a special purpose vehicle is formed to issue asset-backed securities. These securities are collateralized by commercial loans that the CLO manager has selected in accordance with agreed-upon investment guidelines and directed the issuing entity to purchase. In contrast, balance sheet CLOs are usually created, directly or indirectly*, by the originators or original holders of the underlying loans* to transfer the loans off their balance sheets and into the securitization vehicle.

Open-market CLO managers operate independently of the originators of loans held in CLO structure. They typically have an obligation to actively manage the issuing entity's loan portfolio and earn fees for their management services.

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[2] Credit Risk Retention; Final Rule, 79 Fed. Reg. 77602 (Dec. 24, 2014) (the "**CRR Final Rule**"), available here.
[3] Credit Risk Retention; Proposed Rule, 78 Fed. Reg. 57928, 57961 (Sept. 20, 2013) (the "**2013 Reproposal**"), available here.
[4] CRR Final Rule, 79 Fed. Reg. at 77650; *see also* 2013 Reproposal, 78 Fed. Reg. at 57962.
[5] *Id.* at 77654.

Furthermore, the agencies noted that "developments in the CLO and leveraged loan market suggest that CLOs present many of the same incentive alignment and systemic risk concerns that the risk retention requirements of section 15G were intended to address."[6]

What litigation preceded the Ruling?

In November 2014, the LSTA sought court review of the risk retention implementing regulation as it applied to managers of open-market CLOs in the US Court of Appeals for the District of Columbia (the "**D.C. Circuit Court**"). In March 2016, that court declined to review the rulemaking and directed the LSTA to file its petition with the District Court for the District of Columbia (the "**D.C. District Court**"). The D.C. District Court dismissed the LSTA's suit in December 2016 and granted summary judgment in favor of the SEC and FRB.[7] The LSTA then appealed the dismissal to the D.C. Circuit Court. Consistent with the comments it made during the proposal phase for the implementing regulations, the LSTA argued that managers of open-market CLOs are neither sellers nor transferors of the underlying assets and therefore should not be considered "securitizers" subject to the risk retention requirements contemplated by Section 15G of the Exchange Act.

Why did the Court of Appeals conclude that credit risk retention requirements should not apply to open-market CLO managers?

The D.C. Circuit Court reviewed the agencies' risk retention regulations under the standard of *Chevron, USA, Inc. v. NRDC, Inc.*[8], pursuant to which a court generally defers to a governmental agency's reasonable interpretation of statutory language.[9] Accordingly, the issue was whether the agencies' interpretation of "securitizer" to include open-market CLO managers was reasonable. In this context, the court considered the words "transfer" and "retain" to pay a key role in determining whether the statutory mandate can be reasonably read to include managers of open-market CLOs managers. The court paraphrased the relevant statutory provision as "authorizing requirements that an entity which *transfers* assets to an issuer *retain* a portion of the credit risk from the underlying assets that it transfers."[10] In the absence of a statutory definition for these two terms, the court followed precedent in construing a statutory term in accordance with its ordinary or natural meaning. In considering the ordinary meaning of these words, the court found the statutory provision refers to "an entity that at some point possesses or owns the assets it is securitizing and can therefore *continue* to hold some portion of those assets or the credit risk those assets represent."[11] The court observed that open-market CLO managers do not hold the securitized loans at any point and therefore do not own or control any ownership interests in the loans that they could retain. The court found that the agencies' interpretation had overextended the meaning of "*transfer*" to include any third party who exerts some

Could the Ruling apply to any other securitization structures?

In its decision, the D.C. Circuit Court acknowledged that the Dodd-Frank Act's credit risk retention mandate did not extend to securitization structures where:

- the person organizing and initiating the securitization does not transfer the relevant assets to the issuing entity (either directly or indirectly through intermediaries or agents); and
- any persons who do transfer assets to the issuing entity are not organizing or initiating the securitization in any meaningful way.

It remains to be seen whether any securitization structures other than open-market CLOs are developed that would also fit within this gap, and whether these would be accepted by investors. The relevant governmental agencies have expressed concern about this possibility.

[6] CRR Final Rule, 79 Fed. Reg. at 77650.
[7] *Loan Syndications & Trading Ass'n v. SEC et al.*, 223 F. Supp. 3d 37 (D.D.C. 2016).
[8] 467 U.S. 837 (1984).
[9] Ruling at 4.
[10] *Id*. at 5.
[11] *Id*.

causal influence over a transaction, and that they had turned "*retain*" a credit risk into "*obtain*" a credit risk.[12] Accordingly, the court concluded that the agencies' interpretation of the relevant terms constituted an "unreasonable distortion of the text's ordinary meaning."[13]

When will the risk retention rules no longer apply to open-market CLO managers?

There are complicated questions as to when the Ruling takes effect, whether the Ruling's effect is retroactive to CLOs closed prior to the Ruling, whether an order of the D.C. District Court implementing the Ruling could be reversed by the U.S. Supreme Court later, and whether any subsequent rulemaking by the relevant government agencies could affect ultimate application of the Ruling by CLO market participants.

The Ruling of the D.C. Circuit Court reverses the D.C. District Court's summary judgment decision against the LSTA and remands the case to the D.C. District Court with instructions to enter an order that:

- grants summary judgement to the LSTA on the issue of whether the application of the implementing regulations to managers of open-market CLOs is valid under Section 15G of the Exchange Act;
- vacates its summary judgment with respect to how the five percent risk retention amount should be calculated, and
- vacates the CRR Final Rule insofar as it applies to managers of open-market CLOs.[14]

Managers of open-market CLOs will no longer be subject to risk retention only after the D.C. District Court issues an order implementing these instructions. The D.C. District Court will delay issuing its order (i) during a 45-day period (which began Feb. 9, 2018) during which the SEC and FRB may appeal the Ruling and (ii) until it receives a mandate from the D.C Circuit Court, which should occur seven days after such 45-day period. The SEC and FRB may agree not to appeal prior to the expiration of the 45-day period, which could accelerate the effectiveness of the Ruling. On the other hand, the D.C. District Court would also not issue the order while any appeal is pending with the D.C. Circuit, and there is the potential for the SEC and FRB to appeal the Ruling to the U.S. Supreme Court, either without or following an appeal to the D.C. Circuit Court. Were the U.S. Supreme Court to agree to hear an appeal of the Ruling, it could stay the effect of the Ruling until it rendered its decision. Were the U.S. Supreme Court to agree to hear an appeal of the Ruling but allow the Ruling to take effect prior to its decision, the effect of the Ruling could be nullified retroactively if the U.S. Supreme Court ultimately reversed the effect of the Ruling.

If and when the Ruling does take permanent effect, it is expected, based on existing U.S. case law, to apply retroactively from the relevant effective date of the

12 *Id*. at 7-11.
13 *Id*. at 12.
14 *Id*. at 17.

CRR Final Rule (i.e., December 2016). Retroactivity would need to be reflected in the order of the D.C. District Court.

As described below, practical questions have been raised as to how the Ruling applies to some variations of open-market CLO and other securitization structures. The relevant governmental agencies may engage in an additional rulemaking process to clarify some of the questions raised and/or to close "loopholes" they thought could arise if open-market CLO managers were not subject to US risk retention obligations.

Based on the US case law and policy, the general expectation is that this well-reasoned Ruling will not be successfully appealed. It is not currently possible, however, to determine definitively when the Ruling will be binding. Based on the recommended exception from risk retention for CLOs included the U.S. Treasury's October 2017 capital markets report,[15] it would appear that at least some U.S. governmental agencies would support relaxing risk retention requirements for open-market CLOs. This could affect positively the likelihood of a potential appeal of the Ruling as well as the type of appeal (if any). CLO managers currently required to comply with the U.S. risk retention requirements should consult with their advisers as the potential appeals and rulemaking processes unfold.

What should CLO managers consider now before the Ruling becomes effective?

For new issues of open-market CLOs offered before the Ruling becomes effective, open-market CLO managers and their advisers will want to consider:

- revising the offering document's risk retention related disclosures, including risk factors, to explain that U.S. credit risk retention requirements may not apply to open-market CLO managers in the future; and
- including flexibility to amend any contractual provisions related to risk retention and to acquire a retention interest if necessary in the future.

Managers of legacy CLOs will want to consider whether they could sell retained interests that they currently hold. In weighing their options, they will need to consider the extent to which they are permitted to do so and whether they have flexibility under their existing documentation to amend any provisions related to credit risk retention. They may also need to consider the impact of any risk retention related disclosures previously provided to CLO investors.

What practical questions have been raised by the Ruling that could affect its applicability?

In many ways, an open-market CLO is a managed fund structure. The Ruling pushed back the relevant governmental entities' attempt to require risk retention by CLO managers and alleviates concern by many in the securitization marketplace that fund managers or sponsors could have risk retention obligations in other structures. It is clear from the Ruling that the "sponsor" required to risk

15 U.S. Dep't of Treasury, A Financial System that Creates Economic Opportunities: Capital Markets, 103 (October 2017) ("Regarding the requirement that CLO managers retain risk even though they do not originate the loans that they select for inclusion in their securitization, Treasury recommends that the rulemaking agencies introduce a broad qualified exemption for CLO risk retention."). The full report is available here.

"retain" needs to transfer an asset from its or its affiliate's balance sheet. In defining a "balance sheet CLO" as a CLO usually created, *by the originators or original holders of the underlying loans* to transfer the loans off their balance sheets and into a securitization vehicle," the Ruling also confirms the intent of the Dodd-Frank Act to align the interests of those entities that *originate* loans to distribute with end investors. The Ruling also acknowledges that CLO and other managers that enter into arms-length and incentive-based agreements to manage acquired assets for investors are not subject to the same concerns that should require risk retention of true securitizers. Relatively insignificant investments in a CLO, or transfers of assets to a CLO, by a CLO manager should not cause a CLO manager to be considered a securitizer.

Application to CLOs. The following structures or transaction features should be considered by CLO managers and their advisers when applying the Ruling to their particular transactions:

- *Warehousing Structures* – To what extent would a CLO manager's investment in, and/or consolidation of, a CLO warehousing entity create an obligation of the CLO manager to risk retain? It would appear that warehoused loans selected by a CLO manager and acquired in the open market with a view toward a CLO transaction should not fall outside the scope of the Ruling.
- *Cash and Roll Transactions* – Some CLO transactions are effected, for contractual or practical reasons, by formation of a new CLO to purchase the assets of an existing liquidating CLO, with both CLOs managed by the same CLO manager. Similar to the warehousing analysis, assets of both the new and existing CLOs were purchased on the open market, and based on the Ruling the CLO manager itself should not be required to retain risk in the new CLO. The transfer from the existing CLO to the new CLO should be based on open-market terms to the extent possible.
- *EU Compliant Originator Structures* – Because US-based CLO managers have not qualified as "sponsors" under the EU risk retention requirements, some CLO managers have relied on the "originator-manager" leg of the EU risk retention requirements. This "originator-manager" approach permits a CLO manager to purchase for its own account a portion of the initial portfolio (5%-10%), hold it for a period of time while retaining the credit risk and then transfer those assets to the CLO before closing while also complying with a risk retention obligation for the life of the CLO transaction. "Origination" in this context has a specific meaning set out in the EU Capital Requirements Regulations, which is not the same meaning as is commonly understood in the US. Any discussion of the role of a CLO manager in "originating" the securitized loans must be very careful, therefore, to distinguish between the specified EU regulatory definition and the more general US use of the term. The better view for concluding that this activity should not cause a CLO manager to be a securitizer for US risk retention purposes would be that these assets were a relatively small portion of the CLO assets and were purchased on the open-market with a view toward an open-market CLO transaction. In addition, a CLO transaction structured to comply with the EU risk retention requirements could relatively easily comply with the US risk retention requirements if the appropriate disclosures were included. It should also be

noted that the revised EU Securitisation Regulation would generally permit US-based CLO managers to be "sponsors" under the EU risk retention regulations and would thus make it easier to comply with the EU risk retention requirements without subjecting a CLO manager to the US risk retention requirements.

- *Securitizations of Assets sold by Private Funds* – In the supplementary text to the final implementing regulations, the relevant government agencies somewhat obliquely took a position that an externally managed entity, such as a private fund, was not an appropriate entity to be sponsor for US risk retention purposes, with the inference that the sponsor should be the fund manager itself.[16] This inference was not uniformly agreed with. Applying the reasoning of the Ruling to a securitization of a private fund's assets, since the fund manager is not transferring the assets, the fund manager would not be the securitizer with the retention obligation. Since there would not be an entity that *both* "organizes and initiates" a securitization transaction by "transferring" assets, it may be *possible* to take the position that a securitization of a private fund's assets would, like an open-market CLO transaction, be a transaction without a sponsor and a U.S. risk retention obligation. This could create potential opportunities for investors in assets looking to securitize them, but could attract regulatory scrutiny.

***Application to other asset classes*.** Although the Ruling is focused on open-market CLOs, the logic and some of the language in the decision supports the view that U.S. credit risk retention requirements should not apply to other types of securitizations that involve direct open market purchases of assets by an issuer. The treatment of other asset classes will, however, require careful consideration of whether the assets are purchased in the "open market" and whether the sale to the issuer is made directly or indirectly by the originator.

It is possible that the relevant government agencies will consider clarifying all or some of these questions by issuing interpretive guidance or engaging in additional rule making.

[16] CRR Final Rule, 79 Fed. Reg. at 77608 - 77610.

CONTACTS

Lee Askenazi
Partner

T +1 212 878 8230
E lee.askenazi@cliffordchance.com

Jeff Berman
Partner

T +1 212 878 3460
E jeffrey.berman@cliffordchance.com

David Felsenthal
Partner

T +1 212 878 3452
E david.felsenthal@cliffordchance.com

Gareth Old
Partner

T +1 212 878 8539
E gareth.old@cliffordchance.com

Steven Kolyer
Partner

T +1 212 878 8473
E steven.kolyer@cliffordchance.com

Robert Villani
Partner

T +1 212 878 8214
E robert.villani@cliffordchance.com

Alistair Dunlop
Counsel

T +1 212 878 3259
E alistair.dunlop@cliffordchance.com

Marcie Kowlowitz
Associate

T +1 212 878 3234
E marcie.kowlowitz@cliffordchance.com

Rebecca O'Brien
Associate

T +1 212 878 8263
E rebecca.obrien@cliffordchance.com

Louis Vitale
Associate

T +1 212 878 8245
E louis.vitale@cliffordchance.com