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D.C. Circuit Rules Managers of Open-Market CLOs Are Not Required to Have "Skin in the Game"

By Jay Grushkin, Catherine Leef Martin, Sean M. Solis, Nicholas Robinson, and Ashley Whang*

The U.S. Court of Appeals for the D.C. Circuit held that the final rules implementing the requirements of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act do not apply to "open-market CLO" managers. The authors of this article discuss the decision.

A three-judge panel of the U.S. Court of Appeals for the D.C. Circuit ("D.C. Circuit") issued a unanimous decision[1] holding that the final rules implementing the requirements of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Risk Retention Rules" or the "Rule") do not apply to "open-market CLO" managers. Before the issuance of the D.C. Circuit's decision, the market was adjusting to the Rule's requirement that a collateralized loan obligation ("CLO") manager, as "sponsor" of a CLO, retain or cause to be retained by a "majority-owned affiliate" at least five percent of the securities issued in the CLO transaction.[2] The D.C. Circuit ruled that the federal agencies implementing the Rule (collectively, the "agencies")[3] incorrectly

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[1] *Loan Syndications & Trading Ass'n v. SEC*, No. 17-5004 (D.C. Cir. Feb. 9, 2018). The D.C. Circuit's decision reverses the district court's decision in *Loan Syndications & Trading Ass'n v. SEC*, 223 F. Supp. 3d 37 (D.D.C. 2016), and remands the case with instructions that the district court (among other things) vacate the rule insofar as it applies to open-market CLO managers.

[2] The required five percent can take the following forms: (1) an eligible vertical interest ("EVI") equal to five percent of the face value (*i.e.*, par value) of each class of CLO securities issued in the transaction, (2) an eligible horizontal residual interest ("EHRI") comprised of the first loss interest (*i.e.*, in the most subordinated class or classes of securities of the CLO) having a fair value of not less than five percent of the fair value of all securities issued by the CLO, determined under GAAP or (3) an "L-shaped interest" whereby the percentage of the fair value of the EHRI and the percentage of the face value of the EVI (by class) must equal at least five percent.

[3] The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Department of Housing and Urban Development, Federal Housing Finance Agency, Office of the Comptroller of the Currency, and Securities and Exchange Commission

characterized open-market CLO managers as "securitizers" required to retain the requisite credit risk because such managers have no "relationship to the assets such that one can reasonably say that they 'transfer' the assets and could be required to 'retain' a portion of the assets' risk."[4] Since the time of the D.C. Circuit's decision, it has proven to be, and is expected to continue over the long term to be, a shot in the arm to an already robust CLO market that is experiencing unprecedented deal volume in the form of refinancings, resets, re-issuances, and new issuances.

SCOPE OF THE D.C. CIRCUIT'S DECISION

The D.C. Circuit determined that the agencies' decision to apply credit risk retention requirements to managers of open-market CLOs represented an unreasonable interpretation of the authorizing statute, which calls for the agencies to adopt regulations requiring any "securitizer" to retain a portion of the credit risk for any asset the securitizer transfers or sells through the issuance of an asset-backed security.[5] The court relied on the plain reading of the text of the statute in concluding that "transfer" is a key element of the definition of "securitizer" and that, because they do not transfer assets, managers of open-market CLOs are not "securitizers" required to retain any credit risk. The D.C. Circuit's decision draws a distinction between open-market CLOs and balance sheet CLOs (which include many middle-market CLOs):

> [O]pen-market CLOs acquire their assets from . . . arms-length negotiations and trading on an open market. Balance sheet CLOs (sometimes called middle-market 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 a securitization vehicle. *Only [open-market CLOs] are governed by the rule at issue in this case* . . . . (emphasis added)

Given the D.C. Circuit's focus on the word "transfer" and its view that open-market CLOs are CLOs in which the entity initiating the securitization transaction did not own or possess the securitized assets prior to such assets being securitized, it is an open question whether a CLO that holds even a small

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were jointly responsible for implementing the Risk Retention Rules. Only the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System codified the Risk Retention Rules as applied to open-market CLOs, and thus only these agencies were named in the lawsuit.

[4] *Loan Syndications & Trading Ass'n v. SEC*, No. 17-5004, at *14.

[5] Section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

amount of balance sheet assets would qualify for the relief from the Rule that the court's decision would provide.

WHAT ABOUT STRUCTURES OTHER THAN OPEN-MARKET CLOs?

It remains to be seen to what extent the industry may seek further legislative or regulatory action to, or market participants may, apply the D.C. Circuit's reasoning to asset-backed securitization transactions other than open-market CLOs.

Take for instance CDOs and CBOs where the manager acts in a manner consistent with that of an open-market CLO manager. Some of the reasoning in the decision could support an argument that the Rule generally should not apply to any securitization, whether or not a CLO, "in which those 'organizing and initiating' the securitization do not do so by 'transferring' the securitized assets to the issuer, while those that do transfer the assets are not the entities who organize or initiate the securitization in any meaningful way."[6] To the extent this interpretation of the statute results in a "loophole," the opinion states, "it is one that the statute itself creates, and not one that the agencies may close with an unreasonable distortion of the text's ordinary meaning." The court also questions whether such a "loophole" would in fact be cause for concern, as the open-market business model and certain other policy considerations[7] could

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[6] *Loan Syndications & Trading Ass'n v. SEC*, 882 F.3d 220, 223 (D.C. Cir. 2018).

[7] "The loans underlying CLOs are very large loans made to already highly leveraged companies, often in the retail or manufacturing sectors of the economy. Usually no single bank originates the entirety of a loan. Rather, multiple banks 'syndicate' under a lead arranger, each holding only a portion of the loan. Syndicated loans are 'actively traded amongst financial institutions in a secondary market place,' and purchased on these markets by a range of investors, including institutional investors, hedge fund managers, and, of course, CLO vehicles. Wells Fargo Comment 27. The number of syndicated loans in a CLO pool is typically small relative to other asset-backed securitizations. Ordinarily, a pool is made up of 100 to 250 loans, usually all made to moderate or large companies that generate a wealth of risk profile data for review by CLO managers and investors. *See* Securities Industry and Financial Markets Association, Comment to Joint Regulators on Credit Risk Retention Proposed Rules 67–68 (June 10, 2011); JPMorgan Chase & Co., Comment to Joint Regulators on Credit Risk Retention Proposed Rules 58–59 (July 14, 2011). But CLO managers neither originate the loans nor hold them as assets at any point. Rather, like mutual fund or other asset managers, CLO managers only give directions to an SPV and receive compensation and management fees contingent on the performance of the asset pool over time. See American Securitization Forum, Comment to Joint Regulators on Credit Risk Retention Proposed Rules 133–34 (June 10, 2011); U.S. Treasury Department, Report: A Financial System that Creates Economic Opportunities 102 (Oct. 2017) ('Treasury Report'); Board Report 22. The agencies do not question these characterizations of the

be seen to mitigate the problems that the regulators were concerned about with the originate-to-distribute model.

How is the Rule to be interpreted in the case of an external manager of a fund that transfers assets on the balance sheet of the fund to a securitization issuer (the structure commonly used in many middle-market CLOs)? An argument could be made that such an external manager would not be a "securitizer" under the D.C. Circuit's reasoning because it would not itself possess the transferred assets at any point; requiring it to hold the retention interest would "turn 'retain' a credit risk into 'obtain' a credit risk" which, the opinion states, goes beyond the authorized scope of the Rule as it applies to open-market CLOs. If the D.C. Circuit's reasoning is taken to its logical conclusion, arguably, the externally managed fund as prior owner of the transferred assets would appear to be the only party that potentially satisfies the "securitizer" definition. Yet there is tension in coming to this conclusion, as the preamble to the Rule suggests that the agencies have concerns about allowing an externally managed vehicle to be a retention holder, and the policy considerations that underlie exempting open-market CLO managers from the Rule may not in certain cases apply to middle-market CLO managers. Because these concerns were not presented in the case (among other reasons), it is difficult to say exactly how the decision will affect the application of the Rule to many middle-market CLOs.

IMPLICATIONS FOR DUAL U.S./EU RISK RETENTION COMPLIANT CLOs

Many CLO managers that manage dual U.S./EU risk retention compliant deals utilize so-called "limb b" origination whereby a portion of the portfolio is acquired in the open market by the retention holder and later "transferred" to (and often directly settled with) the CLO issuer. This raises the question whether such a transfer of only a minor portion of assets by an originator-manager (in many cases, as little as five percent of the assets measured as of the closing date) could taint its treatment as an "open-market CLO." It may be argued that this type of "origination" activity would not render an otherwise open-market CLO a balance sheet CLO since such "origination" is not necessary for purposes of securitizing the assets but is done solely for purposes of complying with the EU risk retention rules and the portfolio of assets was sourced by the CLO manager from third-party sellers in the open market. As a practical matter, this question may have little impact on the market, as a deal that is compliant with the EU risk retention rules (via the use of an originator-manager) may be made compliant with the Rule by virtue of, in the

CLO securitization model. See Appellees Br. 4–7; Board Report 22–23."

case of horizontal retention, proper measurement and sizing of, and disclosure with respect to, the eligible horizontal residual interest, and in the case of vertical retention, proper disclosure with respect to the eligible vertical interest. In addition, since the D.C. Circuit decision, the market has been able to address this concern by structuring such "limb b" origination in the form of a contingent purchase agreement that avoids any "transfer" from the EU retention holder to the CLO issuer.

PRACTICAL IMPACT

The D.C. Circuit's decision marks the latest twist in a regulatory saga impacting the CLO industry dating back to 2010. Although this development is undeniably positive, the market has been adjusting to a post-risk retention world for open-market CLOs and will need to continue to be cognizant of the impact of the decision on all manner of CLO transactions in order to achieve an understanding of which CLOs may fall outside of the scope of the decision and of the various implications of the decision on existing and future transactions (*e.g.*, the impact on transfers of assets from warehouse vehicles, reset transactions and "call and roll" transactions). Some market participants that previously acquired risk retention stakes—particularly "vertical strips"—have already decided to sell their risk retention interests, and this trend may continue, to the extent no contractual obligation prevents them from doing so. In connection therewith, certain risk retention financings have been pre-paid, to the extent that the documents did not provide the lenders with call protection or disincentives. In the few months since the D.C. Circuit's decision, the regulatory landscape for open-market CLOs has changed dramatically, and we expect will continue to evolve in the coming months and years.