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This publication is intended to give an indication of legal issues upon which you may need advice. Full legal advice should be taken from a qualified professional when dealing with specific situations.

EDITORIAL

Welcome to the eleventh edition of *The International Comparative Legal Guide to: Securitisation*.

This guide provides the international practitioner and in-house counsel with a comprehensive worldwide legal analysis of the laws and regulations of securitisation.

It is divided into two main sections:

Five general chapters. These chapters are designed to provide readers with an overview of key securitisation issues, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in securitisation laws and regulations in 27 jurisdictions.

All chapters are written by leading securitisation lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor Sanjev Warna-kula-suriya of Latham & Watkins LLP for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.com.

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U.S. CLOs: The End of U.S. Risk Retention for Collateral Managers?

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Background on Risk Retention in the United States

In December 2014, the final risk retention requirements for securitisations promulgated by U.S. regulators were published in the U.S. Federal Register ("U.S. Risk Retention Rule").[1] The U.S. Risk Retention Rule requires the sponsor of the securitisation to retain an economic interest in the credit risk of the securitised assets in an amount equal to at least 5 per cent of the ABS interests issued in the transaction ("Required Retention Interest"), subject to certain exceptions. "Sponsor" is defined in the U.S. Risk Retention Rule as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity". The Required Retention Interest may be held in the form of an eligible vertical interest, an eligible horizontal residual interest or a combination of both. For a collateralised loan obligation transaction ("CLO"), the regulators determined that the collateral manager of the CLO is the sponsor of the securitisation; however, this determination was challenged by the Loan Syndications and Trading Association ("LSTA") in a suit against the U.S. regulators.[2] The U.S. Risk Retention Rule provides that a CLO manager may satisfy its risk retention obligations under the U.S. Risk Retention Rule by holding the Required Retention Interest either directly or through a "majority-owned affiliate". The U.S. Risk Retention Rule defines a majority-owned affiliate as "an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with" the CLO manager. For this purpose, majority control means the "ownership of more than 50 per cent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined by GAAP".

The U.S. D.C. Circuit Court Ruling

On February 9, 2018, a three-judge panel of the U.S. Court of Appeals for the District of Columbia (the "D.C. Circuit Court") unanimously ruled in favour of the LSTA in its lawsuit against the Securities and Exchange Commission ("SEC") and the Board of Governors of the Federal Reserve System ("FRB") over the application of U.S. credit risk retention requirements to managers of open-market CLOs.[3]

The D.C. Circuit Court concluded that managers of "open-market CLOs"[4] are not subject to the credit risk retention rules mandated by Section 941 of The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The D.C. Circuit Court reasoned that because open-market CLO managers do not sell or transfer assets to the CLO, they are not "securitizers"[5] under Section 941 of the Dodd-Frank Act, and therefore they need not retain any credit risk in the open-market CLOs they manage. In reaching its conclusion, the D.C. Circuit Court agreed with the LSTA's primary contention that "given the nature of the transactions performed by CLO managers, the language of the statute invoked by the agencies does not encompass their activities".

Background on the U.S. Risk Retention Rule's Application to Open-Market CLOs

In the release adopting the U.S. Risk Retention Rule ("Release"), the federal agencies (the SEC, the FRB, the Office of the Comptroller of Currency, the Federal Deposit Insurance Corporation, the Department of Housing and Urban Development and the Federal Housing Finance Agency) that jointly adopted the U.S. Risk Retention Rule ("Agencies") stated that the manager of an open-market CLO "generally acts as the sponsor by selecting the commercial loans to be purchased by the CLO issuing entity and managing the securitised assets once deposited in the CLO structure, which the [A]gencies believe is a transfer or indirect transfer of the assets". The Agencies rejected definitional and policy arguments that the manager of an open-market CLO is not a statutory "securitizer" under Section 941 of the Dodd-Frank Act, asserting that its interpretation of the term "securitizer" was both "reasonable" and "consistent with the context, purposes and legislative history of the statute".

The LSTA filed suit against the SEC and the FRB in November 2014, challenging the application of risk retention under the Final Rules to open-market CLO managers. Specifically, the LSTA argued that, in their promulgation of the U.S. Risk Retention Rule, the Agencies violated the Administrative Procedure Act by arbitrarily and capriciously: (1) construing the term "securitizer" to include open-market CLO managers; (2) requiring "securitizers" to retain a 5 per cent interest based on "fair value" instead of "credit risk", as required by statute; and (3) declining to exempt open-market CLO managers from the retention requirements or to modify those requirements to reflect industry best practices to retain the benchmark level of credit risk without committing excessive capital. The U.S. District Court for the District of Columbia ("District Court") granted judgment in favour of the SEC and FRB in December 2016,[6] after which the LSTA appealed to the D.C. Circuit Court.

The D.C. Circuit Court reversed the District Court decision, agreeing with the LSTA that an open-market CLO manager is not a "securitizer" under Section 941 of the Dodd-Frank Act and,

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consequently, is not subject to the statute's credit risk retention requirements. The D.C. Circuit Court observed that the statute is designed to reach those entities that organise and initiate securitisations "by transferring" assets to issuers. The D.C. Circuit Court acknowledged that the manager of an open-market CLO "organizes and initiates" a CLO transaction, but it dismissed the proposition that a manager's causal role in the acquisition of assets by a CLO issuer from third parties amounts to a "transfer" within the ordinary meaning of that term, or that a manager can be said to "retain" credit risk within the mandate of the statute by purchasing an interest (i.e., the retention interest) in an asset that it has never before held:

> "In their ordinary meaning, words directing that one who "transfers" an asset must "retain" some interest in the associated risk refer 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—that is, the entity is in a position to limit the scope of a transaction so that it transfers away less than all of the asset's credit risk."
>
> "The [A]gencies' interpretation seems to stretch the statute beyond the natural meaning of what Congress wrote; it turns 'retain' a credit risk into 'obtain' a credit risk."

Open-market CLO managers, the D.C. Circuit Court observed, "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". To be a "securitizer" within the meaning of the statute, the D.C. Circuit Court concluded, a party "must actually be a transferor, relinquishing ownership or control of assets to an issuer".

The Agencies did not seek review *en banc* of the D.C. Circuit Court ruling, and on April 5, 2018, the District Court granted a summary judgment in favour of the LSTA and vacated the U.S. Risk Retention Rule as it applied to collateral managers of open-market CLOs. The Agencies have the right to request review by the U.S. Supreme Court until May 10, 2018 (or a later date, if granted an extension), but as of the date of this article, the D.C. Circuit Court ruling is fully effective.

Reissuance Transactions

Immediately after the effective date of the U.S. Risk Retention Rule, many CLOs began refinancing, typically at the direction of holders of the CLO subordinated notes ("CLO equity"), CLO notes that were priced prior to December 24, 2014. In the Crescent no-action letter,[7] the SEC concluded that such CLOs could refinance each class of their senior notes once after December 23, 2016 without complying with the U.S. Risk Retention Rule, if the refinancing met the conditions in the letter. One of the conditions in the letter was that each class of notes will be subject to only one refinancing and the supplemental indenture executed in connection with the refinancing of each class will prohibit any further refinancing of the refinanced notes.

In the current market, many CLOs are conducting "resets" in which the holders of the CLO equity direct the refinancing of the senior debt and, in connection therewith, amend certain material terms of the CLO, including extending the maturity date, non-call periods and reinvestment periods. In CLOs that already refinanced based on the Crescent no-action letter, the indenture contains a prohibition against a subsequent refinancing even if the CLO manager complies with the U.S. Risk Retention Rule. In these instances, CLO investors are implementing "reissuances" or "call and roll" transactions, whereby the existing CLO conducts a redemption by liquidation of its notes and a sale of the CLO's assets to a new CLO managed by the same manager. Such sales are conducted on an arm's-length basis.

The market is grappling with the question as to whether or not the new CLO should be viewed as an open-market CLO under the D.C. Circuit Court's ruling in view of the transfer of assets from the existing CLO to the new CLO. We believe that the new CLO should be viewed as an open-market CLO. The D.C. Circuit Court decision is premised on the manner in which the loans are acquired by the CLO. In the new CLO, the manager of the CLO is directing the acquisition of the loans from the existing CLO on an arm's-length basis.

Dual Compliant CLOs

Many managers of U.S. CLOs have complied with the EU risk retention requirements in order to sell to European investors. The EU risk retention rules require the "originator", "sponsor" or "original lender" to retain the 5 per cent net economic interest.[8] A CLO manager may retain the risk of a CLO if it has been authorised as an investment firm subject to CRD IV or if it is the "originator" for the CLO. An "originator" is defined for purposes of Article 405 to include "an entity that purchases a third party's exposures for its own account and then securitizes them". To date, CLO transactions marketed in the EU have typically been structured on the basis that an entity which (i) acquires loans in the secondary market, (ii) holds those loans for a period of time and (iii) subsequently sells those loans to the CLO, may qualify as the originator for that CLO. In many cases, the CLO manager has also acted as the "originator" for the CLO. The D.C. Circuit Court decision did not address whether such "origination" activities would cause the CLO to no longer qualify as an open-market CLO and cause the CLO manager to be the "sponsor" of the CLO which is required to hold the Required Retention Interest. Market participants have begun changing the way a CLO manager "originates" loans for purposes of the EU risk retention requirements. Rather than having the CLO manager purchase the loans in the open market and holding the loans on its balance sheet for a period of time prior to selling the loans to the CLO issuer, the CLO issuer will purchase loans in the open market subject to the obligation of the CLO manager to purchase any loans from the CLO issuer that default prior to the requisite period of time being exhausted. Another more common method for a CLO manager to "originate" loans for a CLO is for the manager to simultaneously make a forward purchase of a loan from a dealer and a forward sale of the same loan to the CLO at the same price, so that if, on the forward settlement date the loan continues to meet the CLO's eligibility criteria, it will be purchased directly by the CLO from the dealer. Although this method of purchasing assets for a CLO was not addressed directly in the D.C. Circuit decision, we think there are compelling arguments that it is consistent with the CLO constituting an open-market CLO.

Middle-Market CLOs

Many lenders in the middle-market loan space are private investment funds managed by investment managers. The D.C. Circuit Court ruling carved out balance sheet and middle-market CLOs from its ruling by stating (in a footnote to the ruling) that their general use of the term "CLO" referred only to open-market CLOs. However, the ruling may have an impact on middle-market CLOs implemented by private investment funds. Currently, the managers of such CLOs have been viewed as the "sponsor" of the CLO. However,

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the D.C. Circuit Court ruling that managers of open-market CLOs do not "transfer" assets within the meaning of the statute opens the possibility that the U.S. Risk Retention Rule should not apply to managers of middle-market CLOs because such managers do not transfer assets to the CLOs which they manage; instead, the assets are transferred to the CLO by other funds under common management. However, in the Release, the Agencies stated that the investment manager of a private investment fund should be considered to be the "sponsor", since the fund itself would not qualify as a "sponsor". "Thus, for example, an entity that … only purchases assets at the direction of an independent asset or investment manager … would not qualify as a 'sponsor'". Therefore, one question is whether this precatory language in the Release has now been superseded (and in effect overruled) by the D.C. Circuit Court ruling, so that an investment fund which transfers loans to a CLO may act as the sponsor and hold any Required Retention Interest.

Applicability to Other Types of Transactions

The holding of the D.C. Circuit Court decision is by its terms limited to open-market CLOs. However, the principles of the decision can be applied to other types of securitisation transactions that are similar to open-market CLOs in that the party which heretofore has been identified as the "sponsor" does not itself transfer any of the securitised assets to the securitisation issuer. For example, collateralised bond obligation transactions ("CBOs") are structurally identical to open-market CLOs, except that they invest in bonds as well as loans. If a CBO issuer buys its bonds only through arm's-length market transactions, and the CBO manager has a similar role to a CLO manager, the U.S. Risk Retention Rule should not apply to the CBO manager under the same rationale that they do not apply to a CLO manager.

There are a range of other securitisation transactions that may no longer be covered by the U.S. Risk Retention Rule, because there may be no "sponsor" of the transaction based on the reasoning of the D.C. Circuit Court decision. The question will be whether or not there is a "transferor" within the meaning of the U.S. Risk Retention Rule. The D.C. Circuit Court rejected arguments advanced by the SEC and the FRB that interpreting Section 941 as not applying to open-market CLO managers "would do violence to the statutory scheme" and "creat[e] a loophole that would allow "securitizers" of other types of transactions to structure around their risk retention obligation", offering several explanations for why the "feared hypothetical loophole is unlikely to materialize".

Potential Legislative Actions

In March 2016, HR 4166 (which is sometimes referred to as the "QCLO Bill") passed the House Financial Services Committee 42-15, with 10 Democrats supporting the bill. The QCLO Bill proposed to reduce the risk retention requirements for "qualified" CLOs (a "QCLO"), which meet six requirements: (i) quality of assets; (ii) portfolio diversification; (iii) minimum capital structure; (iv) alignment of interests; (v) reporting and disclosure; and (vi) manager regulation. The risk retention requirement for a QCLO would be reduced to 5 per cent of the CLO equity, as opposed to equity which has a fair value equal to 5 per cent of the fair value of the securities issued by the CLO. If a CLO did not meet these restrictions, the CLO manager could still retain an eligible vertical interest or eligible horizontal residual interest under the existing rule.

Since 2017, Republicans have controlled the House, the Senate and the Presidency. Because the QCLO bill passed the House Financial Services Committee with bipartisan support, there had been hope that it would pass the full House. If it then was approved by the Senate, most commentators believed that President Trump would sign it. However, the QCLO Bill never passed the full House. On September 14, 2017, the QCLO Bill was re-introduced as H.R. 3772. This 2017 version of the QCLO Bill is almost identical to the 2016 version, with a slight Democratic-led amendment to the retention structure, whereby the retention amount was to remain the same, but was to be comprised of 70 per cent equity and the remaining 30 per cent in a vertical strip. However, President Trump and many Republican Congressmen have supported a broader effort to repeal much of the Dodd-Frank Act (pursuant to which the U.S. Risk Retention Rule was adopted), and the QCLO Bill, in either form, has yet to come up for a vote, and may be superseded or continue to be delayed by this broader legislative effort.

This legislative initiative has been supported by the LSTA, but the D.C. Circuit Court ruling discussed above would seem to obviate the need for any further movement on the current QCLO Bill which is still stalled in Congress.

Treasury Report

In its October 2017 report, the U.S. Department of the Treasury noted that, under Dodd-Frank, a sponsor of an asset-backed security is generally required to retain at least 5 per cent of the credit risk of the assets collateralising the securities. In the U.S. Risk Retention Rule, the Agencies subjected CLO managers to this risk retention requirement by determining that they fell within the statutory definition of a "securitizer". For most securitised products, an originator may originate the loans with the intention of selling them. In contrast, CLO managers do not originate the underlying loans which they choose for the CLO vehicle. CLO managers are typically compensated with management fees which are contingent on the performance on the underlying loans. In this way CLO managers are more like asset managers than "securitizers". Treating them like typical "securitizers", including the burden of credit risk retention, limits their access to capital in the markets. It could also cause smaller CLO managers to exit the market due to this reduced ability to raise capital, possibly creating an undesirable consolidation effect among the larger servicers.

In its report, the Treasury Department noted that credit risk retention is an "imprecise mechanism" for creating alignment between sponsors and investors. But, rather than a broad repeal of the requirement, it states that the regulators should expand exemptions based on the characteristics of eligible asset classes. For CLO managers specifically, the Treasury Department recommends a broad qualified exemption for CLO credit risk retention. Since CLO managers have the ability to discriminate as to the quality of loans they select, the qualified exemption should not be a complete exemption but instead a set of requirements for specific loan types which would be implemented through notice-and-comment rulemaking by the Agencies (where Congress should designate a lead agency from among the six Agencies in order to avoid procedural and interpretive challenges).

Conclusion

The D.C. Circuit Court ruling, if it is not challenged and overturned by the United States Supreme Court, invalidates the application of the U.S. Risk Retention Rule to managers of open-market CLO transactions. The D.C. Circuit Court's ruling is limited to open-market CLO transactions; however, the reasoning of the D.C. Circuit Court ruling extends to other types of CLOs and securitisations

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where the manager does not transfer assets to the CLO issuer. Until the regulators or the courts provide clarity on the applicability of the U.S. Risk Retention Rule to such transactions, it is likely that market practice will develop in a way that will apply the court's reasoning to other CLO structures and securitisations to which it is clearly applicable.

Acknowledgment

The authors would like to acknowledge the assistance, in the preparation of this chapter, of **Paul N. Watterson, Jr.**, a partner in the Structured Finance & Derivatives Group at Schulte Roth & Zabel LLP. Mr. Watterson concentrates on structured product and derivative transactions, the formation and representation of credit funds and capital markets regulation, and is counsel to many participants in the securitisation, credit and derivatives markets. He represents underwriters, issuers and managers in structured financings, including collateralised loan obligations (CLOs) and is involved in many structured finance transactions that use credit derivatives, including regulatory capital transactions and re-packagings. Mr. Watterson earned his A.B., *cum laude*, from Princeton University, and his J.D., *magna cum laude*, from Harvard Law School.

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Endnotes

1. Credit Risk Retention, 79 Fed. Reg. 77602 (December 24, 2014).
2. *In re The Loan Syndications and Trading Association v. United States Securities and Exchange Commission; Board of Governors of the Federal Reserve System*.
3. *Loan Syndications & Trading Ass'n v. SEC*, No. 17-5004 (D.C. Cir. February. 9, 2018).
4. The D.C. Circuit Court described "open-market CLOs" as CLOs in which the loan assets are acquired from "arms-length negotiations and trading on an open market", contrasting them with "balance sheet CLOs" which are "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". *Id*. at 3.
5. "Securitizer" means, with respect to a securitization transaction, either: (1) the depositor of the asset-backed securities (if the depositor is not the sponsor); or (2) the sponsor of the asset-backed securities.
6. *Loan Syndications & Trading Ass'n v. SEC*, 223 F. Supp. 3d 37 (D.D.C. 2016).
7. Crescent Capital LP, SEC No-Action Letter (July 17, 2015).
8. Regulation (EU) No 575/2013 of the European Parliament and of the Council of June 26, 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, 2013 O.J. L 176/1.

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- Class & Group Actions
- Competition Litigation
- Construction & Engineering Law
- Copyright
- Corporate Governance
- Corporate Immigration
- Corporate Investigations
- Corporate Recovery & Insolvency
- Corporate Tax
- Cybersecurity
- Data Protection
- Employment & Labour Law
- Enforcement of Foreign Judgments
- Environment & Climate Change Law
- Family Law
- Fintech
- Franchise
- Gambling
- Insurance & Reinsurance
- International Arbitration
- Lending & Secured Finance
- Litigation & Dispute Resolution
- Merger Control
- Mergers & Acquisitions
- Mining Law
- Oil & Gas Regulation
- Outsourcing
- Patents
- Pharmaceutical Advertising
- Private Client
- Private Equity
- Product Liability
- Project Finance
- Public Investment Funds
- Public Procurement
- Real Estate
- Securitisation
- Shipping Law
- Telecoms, Media & Internet
- Trade Marks
- Vertical Agreements and Dominant Firms

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