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Court of Appeals Decision: Managers of Open-Market CLOs Not Subject to Dodd-Frank Risk Retention

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Introduction

On February 9, 2018, a three-judge panel of the U.S. Court of Appeals for the District of Columbia Circuit unanimously ruled in favor of the Loan Syndications and Trading Association ("**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 collateralized loan obligations ("**CLOs**").[1]

The Court concluded that managers of "open-market CLOs"[2] are not subject to the credit risk retention rules mandated by Section 941 of The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), which requires the securitizer[3] of an asset-backed security ("**ABS**") to retain, on an unhedged basis, at least 5% of the credit risk of any asset the securitizer, through the issuance of such

ABS, transfers, sells or conveys to a third party.[4] The Court reasoned that because CLO managers are not securitizers under Section 941 of the Dodd-Frank Act, they need not retain any credit risk in respect of the CLOs they manage. In reaching its conclusion, the 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."

As discussed more fully below, if the ruling of the Court stands, it will have significant repercussions for managers of open-market CLOs and for the CLO market, generally.

Background

The final rules implementing Section 941 of the Dodd-Frank Act (the "**Final Rules**")[5] were issued in October 2014 and became effective with respect to CLOs on December 24, 2016. Under the Final Rules, the sponsor of a securitization transaction (or its majority-owned affiliate) is required to retain an economic interest in the credit risk of the securitized assets equal to at least 5% of all ABS interests in the issuing entity issued as part of the transaction, unless otherwise exempted. "**Sponsor**" is defined in the Final Rules 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."

In the preamble accompanying the Final Rules (the "**Preamble**"), the federal regulatory agencies that jointly prescribed the Final Rules (the "**Agencies**")[6] 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 securitized assets once deposited in the CLO structure, which the [A]gencies believe is a transfer or indirect transfer of the assets."[7] The Agencies rejected several 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."[8]

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 Final Rules, 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% 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 adjust those requirements to adhere to industry best practices to retain the benchmark level of credit risk without having to commit excessive capital. The U.S. District Court for the District of Columbia granted judgment in favor of the SEC and FRB in December 2016,[9] after which the LSTA appealed to the D.C. Circuit.

The Court of Appeals Ruling

The Court of Appeals 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, consequently, not subject to the statute's credit risk retention requirements.[10] The Court observed that the statute "is designed to reach those entities that 'organize[ ] and initiate[ ]' securitizations '*by* transferring' assets to issuers" (emphasis in original). The Court effectively acknowledged that the manager of an open-market CLO "organizes and initiates" a CLO transaction, but it dismissed the notion that a manager's causal role in the acquisition of assets by a CLO issuer amounts to a "transfer" within the ordinary meaning of that term,[11] or that a manager can be said to "retain" credit risk within the mandate of the statute by purchasing an asset (*i.e.,* the retention interest) 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."[12] (emphasis in original)
>
> "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."[13] (emphasis added)

Open-market CLO managers, the 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."[14] To be a "securitizer" within the meaning of the statute, the Court concluded, a party "must actually be a transferor, relinquishing ownership or control of assets to an issuer."

Additionally, the 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."[15]

Effectiveness of the Ruling

The ruling of the Court of Appeals panel is not immediately effective. The SEC and the FRB have 45 days from the date of the appellate court's February 9 judgment (*i.e.*, until March 26, 2018) to petition for rehearing before the panel that decided the case or *en banc* rehearing by the full D.C. Court of Appeals. If no petition for rehearing is filed, then within seven days of the expiration of the 45-day period (*i.e.*, by April 2, 2018), the Court of Appeals will issue a mandate to the District Court to enter judgment in favor of the LSTA. Any filing of a petition for rehearing, particularly if rehearing is permitted, will delay the Court's ruling from taking effect.

Note: Panel rehearings require the petitioner to demonstrate points of law or fact that the court overlooked or misunderstood and which, if considered correctly, would lead to a different outcome. En banc rehearings are disfavored and ordinarily not ordered unless necessary to maintain uniformity in the court's decisions. The petitioner would have to demonstrate that the decision conflicts with a decision from the Supreme Court or another decision from the D.C. Circuit, or raises questions of "exceptional importance." Consequently, we think it is unlikely the SEC and the FRB would seek a rehearing or that, if they did, rehearing would be granted. There is no conflict between the LSTA decision and decisions from other federal courts nor are we aware of any key legal or factual issue which the court ignored or misconstrued.

Note: If the October 2017 report on financial regulation released by the U.S. Department of the Treasury is any guide, the government may have little interest in petitioning for rehearing from a policy perspective. That report recommended, among other things, a broad qualified exemption for CLO risk retention.[16] In addition, we note that The Chamber of Commerce of the United States of America, which is often aligned with the Trump Administration on regulatory issues, filed an amicus brief in the Court of Appeals in support of the LSTA.

In addition to petitioning the Court of Appeals for rehearing, the SEC and the FRB have the right to file a petition for a writ of *certiorari* to the U.S. Supreme Court and request a stay of the mandate of the Court of Appeals pending a decision by the Supreme Court whether or not to grant *certiorari* and hear the case. A petition for *certiorari* may be filed up to 90 days from the date of the panel's opinion or the order denying a petition for rehearing, whichever is later. The government's ability to seek Supreme Court review is independent of its right to seek rehearing.

Note: The government could seek to petition for Supreme Court review given that the issues raised in the case involve interpretation of an important aspect of the Dodd-Frank Act. For that same reason, it is plausible that the Supreme Court would accept the case, and as a general matter, the Supreme Court is more likely to grant certiorari when sought by the government as opposed to private parties. This factor may be particularly relevant here because the Court of Appeals decision finds against the government even though the Court afforded the Agencies' interpretation of the statute deference under the Supreme Court's 1984 Chevron decision.[17]

Note: Notwithstanding the foregoing, we note that the Supreme Court grants writs of certiorari at its discretion and usually only if the case could have national significance, might harmonize conflicting decisions in the federal circuit courts, and/or could decide a significant question of federal law. The Supreme Court accepts and hears argument in about 80 of the approximately 7,000-8,000 cases that it is asked to review each year.[18]

Retroactivity

Once effective, the Court's ruling should have a retroactive effect to the effective date of the Final Rules, based on the application of a three-factor test articulated by the Supreme Court:[19]

1. Whether the rule is actually a departure from clear prior policy or instead a new policy for a new situation (or a clarification of a prior policy);
2. Whether retroactive application will be more likely to hinder than to further the operation of the new rule; and
3. Whether retroactive application would produce substantial inequitable results, with particular reference to other parties relied on the old standard.[20]

Based on a review of case law, the D.C. Circuit and other federal appellate courts typically give retroactive effect to their judicial decisions but still apply the three-factor *Chevron Oil* analysis before doing so, focusing primarily on the third factor. *In the majority of those cases, the D.C. Circuit has ruled in favor of retroactive application. In the present case, the SEC and the FRB would need to establish that it would face a substantial inequity if managers of open-market CLOs are not subject to the Final Rules. It seems unlikely they would be able to sustain that burden.*

Impact

The Court's ruling undoubtedly is a welcome development for the LSTA and the CLO industry participants it represents, which, along with other industry groups such as the Structured Finance Industry Group ("**SFIG**"), vigorously opposed application of risk retention to open-market CLO managers even prior to the promulgation of the Final Rules. Over the past several years, open-market CLO managers have spent a great deal of time, effort and capital developing new business structures and establishing relationships with financing providers in order to facilitate compliance with the Final Rules. The Court's ruling, once effective, restores the status quo that existed in the CLO market prior to the promulgation of the Final Rules, in which open-market CLO managers were free to purchase (including through an affiliate or a fund for which it or its affiliate served as investment advisor) interests in the CLO vehicles they managed, but without having to comply with the minimum size, form of interest or disclosure requirements mandated by, or the prohibitions on hedging or transferring such interests contained in, the Final Rules. This should make it easier for open-market CLO managers of comparatively smaller size to enter (or re-enter) the market, particularly since their transactions can be expected to price at wider spreads than those managed by larger or more established managers, all other things being equal. In addition, the effectiveness of the ruling clears the way for open-market CLO managers to sell the retention interests they have acquired since the Final Rules became effective, if such sales are not otherwise restricted contractually and are otherwise in the managers' financial interest.[21]

Market participants are still analyzing the Court's ruling and the impact its effectiveness would have on the CLO market going forward. After considering the ruling and obtaining preliminary feedback from market participants, we offer the following observations on the potential impact of the ruling:

Pace of CLO Issuance

It will take a certain period of time before market participants fully understand the impact of the decision. This may mean a temporary slowdown in the pace of CLO

issuance, particularly while the ruling remains subject to appeal. Until the appeals process has been exhausted, managers intending to price and close CLO transactions will need to agree to retain the requisite retention interest and otherwise comply with the requirements of the Final Rules. Barring any adverse market or economic developments generally, however, any such market slowdown is unlikely to last beyond the timing of the ruling's effectiveness. The elimination of risk retention requirements for open-market CLO managers should increase the supply of managers capable of launching deals (for the reasons described above) and also expand the number of existing CLO transactions that are candidates for refinancing or reset.

Do Open-Market CLOs Have a Sponsor?

Under the Court's ruling, the manager of an open-market CLO is not a "securitizer" within the ordinary meaning of Section 941 of the Dodd-Frank Act. This raises the question: if not the manager, who is the sponsor of an open-market CLO?

A portion of the Court's decision suggests that, in the absence of new joint rulemaking by the Agencies,[22] the answer is "no one." The Court noted the Agencies' concern that if Section 941 is interpreted to not cover CLO managers, then "[a]t the very least . . . CLOs would become a type of securitization 'without meaningful risk retention,' contrary to Congress's purposes."[23] However, the Court was unsympathetic to this argument, observing that the issue results in part from the Agencies' decision to interpret the reference to "issuer of an asset-backed security" in clause (A) of the definition of "securitizer" as referring to the "depositor"[24] of the securitization transaction.[25] "The protest that no securitizer can then be found to retain the risk arises because the [A]gencies have defined a whole class of securitizers—the issuing entities—out of Congress's statute."[26]

Call-and-Roll Transactions

There have been a wave of CLO "resets" in which the holders of the equity of an open-market CLO direct the refinancing of the outstanding rated indebtedness of the CLO issuer and, in connection therewith, amend certain material terms of the CLO issuer's securities, including their maturity date. In some instances, due to contractual provisions in the related indenture or the need to obtain 100% equity consent to the amendments,[27] the reset will involve a call (*i.e.*, redemption) of an existing CLO and a roll (*i.e.*, sale) of the CLO issuer's loan assets into a newly formed CLO issuer with the same manager who will, as was the case with the CLO being called, direct the acquisition of new loan assets in arm's-length negotiations and trading on an open market.

In the foregoing situation, a question is raised whether the new CLO should be properly viewed as an open-market CLO under the Court's ruling or the new CLO is somehow being "sponsored" by the old CLO issuer or the equity directing the call of the old CLO. Under these circumstances, we believe the new CLO should be properly viewed as a continuation of the old open-market CLO or simply a new open-market CLO. The rolling of the assets into the new CLO is necessitated by practical circumstances around the old CLO and, if such circumstances were not present, the

reset would have been done out of the existing CLO issuer which is structured as an open-market CLO. Based on the Court's decision, the hallmark of an open-market CLO is the manner in which loan assets are acquired by the CLO. In both the old and new CLO, the manager will direct the acquisition of new loan assets in arm's-length negotiations and trading on the open market. Furthermore, viewing the old CLO issuer as the sponsor of the new CLO would be inconsistent with the statements of the Agencies in the Preamble that "another asset-backed security issuer would not meet the "organization and initiation" criteria in the definition of "sponsor" as such an entity could not be the party that actively makes decisions regarding asset selection or underwriting."[28]

Dual U.S./EU Risk Retention-Compliant CLOs

In recent years, certain managers of U.S. open-market CLOs interested in attracting European investors have sought to achieve dual compliance with the U.S. and EU risk retention regulatory regimes by structuring the retention holder to qualify as an "originator" for purposes of the EU rules. This typically involves the retention holder purchasing in the open market a portion of the assets to be included in the initial CLO portfolio (usually between 5% and 10% of the total), holding the assets on its balance sheet for a certain seasoning period, and then selling them to the CLO issuer. It is unclear whether such "origination" activities, undertaken solely in order to satisfy EU risk retention requirements, would constitute a "transfer" within the meaning of the Dodd-Frank Act such that the U.S. risk retention requirements would apply to the manager, notwithstanding the Court's ruling.

> <u>Note</u>: *Cadwalader lawyers have considered alternative methods for U.S. managers acting as originators to satisfy the EU risk retention rules on origination without potentially falling outside the scope of the Court's ruling.*

Fund Balance Sheet CLOs

Fund balance sheet CLOs (which are common structures for middle market CLOs) are a variant of balance sheet CLOs in which an externally managed fund securitizes loan assets held on its balance sheet. Although the Court's ruling by its terms applies only to managers of open-market CLOs, it is unclear whether the ruling also impacts fund balance sheet CLOs. On the one hand, certain language in the Preamble suggests that the external manager of such a fund should be considered the "sponsor" since the fund itself would not be an acceptable holder of risk retention under the Final Rules. On the other hand, the reasoning in the Court's ruling that managers of open-market CLOs do not "transfer" assets or "retain" credit risk within the meaning of the statute conceivably could apply to external managers of fund balance sheet CLOs, as well, since such managers similarly do not transfer assets or retain credit risk. A logical reading of the Court's ruling raises the question of whether the externally managed fund itself could be considered the sponsor of such a CLO, but the ruling did not expressly discuss this topic.

Further Considerations

The textual analysis undertaken by the Court in its ruling makes it advisable for

participants in the CLO and securitization markets, in connection with structuring transactions and evaluating the application of credit risk retention requirements, to reconsider the meaning of a number of terms used in Section 941 of the Dodd-Frank Act, the Final Rules and the Court's decision, including, without limitation:

- affiliate
- at any point
- balance sheet
- by
- control
- directly or indirectly
- financial institution
- hold
- investors
- loophole
- middle market
- obtain
- organize and initiate
- retain
- transfer
- wholly independent

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

2 The Court of Appeals 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. For purposes of this memorandum, except as otherwise specified, the use of the term "CLO" refers only to open-market CLOs.

3 Section 941 of the Dodd-Frank Act defines a "**securitizer**" as "(A) an issuer of an asset-backed security; or (B) 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." 15 U.S.C. § 78o-11(a)(3).

4 15 U.S.C. § 78o-11(b)(1). Section 941 of the Dodd-Frank Act added Section 15G of the Securities Exchange Act of 1934, as amended.

5 79 Fed. Reg. 77,601 (Dec. 24, 2014).

6 Collectively, 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.

7 79 Fed. Reg. 77,654.

8 *Id.*

9 *Loan Syndications & Trading Ass'n v. SEC*, 223 F. Supp. 3d 37 (D.D.C. 2016).

10 In addition to remanding the case to the District Court with instructions to vacate the Final Rules insofar as they apply to open-market CLO managers, the Court of Appeals also instructed the District Court to vacate its ruling against the LSTA on the issue of whether calculation of the retention interest based on "fair value" is contrary to law. Because the appellate court did not need to reach that question, it did not actually address whether it agreed with that aspect of the lower court's decision.

11 "Occasionally cases may arise, *such as this one*, in which those 'organizing and initiating' the securitization do not do so "by transferring" the securitized assets to the issuer. . . ." *Loan Syndications & Trading Ass'n v. SEC*, No. 17-5004 at *12 (emphasis added).

12 *Id.* at *5.

13 *Id.* at *7.

14 *Id.*

15 *Id*. at *15-17.

16 U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities: Capital Markets* (October 2017) at 103.

17 *Chevron, USA, Inc. v. NRDC, Inc.*, 467 U.S. 837 (1984).

18 *Supreme Court of the United States—About the Court—FAQs—General Information*, https://www.supremecourt.gov/about/faq_general.aspx (last visited Feb. 15, 2018).

19 *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971).

20 *Id*. at 106-07.

21 Under the terms of agreements with third-party strategic investors, CLO managers may be restricted from disposing of retention interests.

22 Any new joint rulemaking would be subject to the same formal notice-and-comment process followed by the Agencies in connection with their promulgation of the Final Rules, and any such new rules would be subject to the Court of Appeals' interpretation of Section 941 of the Dodd-Frank Act. Assuming all of the Agencies were willing to undertake this process (perhaps unlikely under the current administration), the process would be expected to take over two years.

23 *Loan Syndications & Trading Ass'n v. SEC*, No. 17-5004 at *12.

24 "**Depositor**" is defined in the Final Rules as "(1) The person that receives or purchases and transfers or sells the securitized assets to the issuing entity; (2) The sponsor, in the case of a securitization transaction where there is not an intermediate transfer of the assets from the sponsor to the issuing entity; or (3) The

person that receives or purchases and transfers or sells the securitized assets to the issuing entity in the case of a securitization transaction where the person transferring or selling the securitized assets directly to the issuing entity is itself a trust." 79 Fed. Reg. 77,741.

25 79 Fed. Reg. 77,608-09.

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

27 It is not always possible to identify all of the equity investors due to the fact that the related securities frequently are held in book-entry form.

28 79 Fed. Reg. 77,609.

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