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Client Alert

Mortgage & Structured Finance

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D.C. Circuit Holds that Risk Retention Rules Not Applicable to Open-Market CLO Managers

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What You Need To Know:

- **In a decision in favor of the LSTA against the SEC, the D.C. Circuit Court held that CLO managers are not "securitizers" for purposes of the risk retention rules, and are therefore not subject to risk retention.**
- **The decision applies to open-market CLOs, but not CLOs where the loans are originated by the CLO manager or an affiliate.**
- **The decision remains subject to further appeal by the government.**

On February 9, 2018, the U.S. Court of Appeals for the D.C. Circuit ruled in favor of the Loan Syndications & Trading Association ("LSTA") in its lawsuit against the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System (the "Decision"), holding that managers of collateralized loan obligation investment vehicles ("CLOs") are not securitizers under the Credit Risk Retention Rule[1]–and, thus, the obligation to retain required credit risk retention in accordance therewith does not apply–if the CLOs managed are open market CLOs.[2] The LSTA did not seek relief from the Credit Risk Retention Rule for, nor was relief granted to, CLO managers of balance sheet CLOs.[3]

[1] Pursuant to the final rule on United States credit risk retention, adopted jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Federal Housing Finance Agency, and the Department of Housing and Urban Development (the "Credit Risk Retention Rule"), CLOs issued on or after December 24, 2016, whether publicly offered or privately placed, were required to satisfy the credit risk retention requirements of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, as promulgated pursuant to Section 15G of the Securities Exchange Act of 1934, as amended. The final Credit Risk Retention Rule obligated a sponsor, a majority-owned affiliate of a sponsor, or, as applicable, an asset originator to retain at least 5 percent of a CLO's credit risk, without hedging or transferring that credit risk.

[2] Open market CLOs, generally, are those in which the majority of the CLO's managed assets were acquired by the CLO directly (rather than through, for example, a depositor entity controlled by the CLO manager) and were not originated by the CLO manager or an affiliate.

[3] Balance sheet CLOs, generally, are those in which the majority of the CLO's managed assets were originated or acquired by the CLO manager or an affiliate.

Assuming the Decision stands (as discussed further below), it applies to all open market CLOs, including those that have closed or priced. But because each CLO has its own asset origination/acquisition chain, the application of the ruling will be fact-specific. Likewise, while the ruling would free open market CLO managers from holding required credit risk retention interests, the transaction documents governing each structure may contain requirements that the CLO manager comply with risk retention rules, and therefore may require amendments. An analysis of winding down existing risk retention structures for closed CLOs, therefore, would be specific to the transaction documents that govern those structures.

While the Decision has been issued, it remains subject to further appeal. The government is entitled to seek an en banc hearing of this Decision or petition the U.S. Supreme Court. The deadline to apply for an en banc hearing is 45 days from the date of the Decision. The deadline to petition the U.S. Supreme Court is 90 days from the date of the Decision. The government can also seek an en banc hearing and then appeal to the Supreme Court after the en banc hearing, which would extend uncertainty. Under those circumstances, a final determination of the applicability of the Credit Risk Retention Rule to open market CLO managers will not be known until those appeals are exhausted. Alternatively, the government could decide not to seek an appeal or petition, in which case the Decision would stand as issued.

Contacts

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