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U.S. RISK RETENTION RULES: WHAT CONSTITUTES AN OPEN-MARKET CLO?

The authors discuss the LSTA *case and argue that a new CLO that would otherwise qualify as an open-market CLO should not be deemed a balance-sheet CLO solely because it acquired certain assets from an existing account rather than in open-market transactions. They close with five factors that should make it more likely for a new CLO to qualify as open-market.*

By Deborah Festa and Andrew Keller *

On February 9, 2018, the U.S. Court of Appeals for the D.C. Circuit issued a decision holding that the U.S. Risk Retention Rules[1] do not apply to managers of open-market CLOs (the "*LSTA Case*"). As a result, collateral managers of open-market CLOs no longer need to retain (or cause any of their affiliates to retain) a 5% interest in the credit risk of the CLOs that they manage. The D.C. Circuit, however, did not discuss in detail the parameters of what constitutes an open-market CLO compared with a balance sheet CLO. There is more room for uncertainty here than may originally appear. In transactions where a CLO issuer ("New CLO") acquires assets not solely on the open market, but also from an existing CLO, warehouse vehicle, investment fund, or separately managed account ("*Existing Account*") such New CLO could be deemed a balance sheet CLO and therefore its manager would need to retain a Required Retention Interest (as defined below) under the Risk Retention Rules. This article will discuss and analyze in what circumstances a New CLO that would otherwise qualify as an open-market CLO may be deemed to be a balance sheet CLO as a result of having acquired some of its assets from an Existing Account.

[1] The final rules published by 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 (collectively, the "*Agencies*") entitled "Credit Risk Retention" on December 24, 2014, implementing the requirements of Section 941 of the Dodd-Frank Act, codified at 17 C.F.R. Part 246 (the "*Risk Retention Rules*" or the "*Rules*").

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I. BACKGROUND ON APPLICABILITY OF RISK RETENTION RULES

A. Risk Retention Rules Become Effective

The Risk Retention Rules, which were promulgated by the Agencies pursuant to the Dodd-Frank Act, became effective for CLOs on December 24, 2016. At that time, the Rules required the "sponsor" of a CLO to retain, and to refrain from transferring, selling, conveying to a third party, or hedging, an economic interest in the credit risk of the securitized assets in an amount equal to at least 5% of the CLO securities issued in the transaction (the "*Required Retention Interest*"). The Rules generally required the CLO manager,[2] as the sponsor of the CLO, or majority-owned affiliates of the CLO manager, to retain the Required Retention Interest. The sponsor had the option of retaining the Required Retention Interest as an eligible vertical interest, an eligible horizontal residual interest, or any combination of the two.

B. The LSTA *Case*

During the comment period prior to publication of the Risk Retention Rules in the Federal Register on December 24, 2014, certain industry participants, including the Loan Syndications and Trading Association ("LSTA") and the Structured Finance Industry Group ("SFIG"), submitted letters to the Agencies arguing that the Risk Retention Rules should not apply to open-market CLOs. The letters advanced certain policy reasons for not applying the Rules, pointing out, among other things, that the interests of CLO managers are already aligned with the interests of investors due to the compensation structure of CLOs and therefore CLO managers already had "skin in the game."[3] This differentiates CLO managers from sponsors of mortgage-backed securitizations and other collaterized debt obligations that merely make a fee from closing a transaction and then walk away. CLO managers, by contrast, remain intensely invested in the success of the CLO transactions that they manage. Most CLO managers get paid at three levels of the priority of payments in a CLO: a base management fee paid prior to payments on the CLO notes, a subordinated management fee paid after interest on the secured notes but prior to distributions to equity, and an incentive fee paid only after the equity has reached a certain target internal rate of return. Because collateral managers receive most of their fees at the subordinated fee level or incentive fee level of a CLO, if the CLO is not performing well, the bulk of the CLO manager's fees will be deferred or not paid at all.

Additionally, the LSTA presented the argument that applying the Risk Retention Rules to open-market CLOs would be inconsistent with the plain language of the Dodd-Frank Act (specifically the definition of "securitizer") because CLO managers do not "transfer" assets to the CLO issuer.[4] The Agencies apparently found the LSTA and SFIG letters unpersuasive, and issued rules providing that managers of CLOs would be required to retain a Required Retention Interest. Subsequently, the LSTA filed suit in federal court challenging the applicability of the Risk Retention Rules to managers of open-market CLOs.

Although the LSTA lost the case in the District Court, the industry group appealed to the D.C. Circuit. The LSTA made its case that CLO managers do not "transfer" assets into CLOs and therefore cannot be sponsors under the plain language of the Dodd-Frank Act. The D.C. Circuit agreed with the LSTA and issued a unanimous decision holding that the Risk Retention Rules do not apply to "open-market CLO" managers. The Agencies did not petition for a rehearing *en banc* by a full panel of judges and, on April 5, 2018, the United States District Court for the District of Columbia issued

[2] As a result of the repeal by the Dodd-Frank Act of the private adviser exemption from registration with the SEC as an adviser under the Investment Advisers Act of 1940, CLO managers were required to register with the SEC beginning in March 2012.

[3] Structured Finance Industry Group Letter Comment, October 30, 2013 at 96 (*available* online at https://www.sec.gov/comments/s7-14-11/s71411.shtml) (hereinafter, "SFIG Letter").

[4] Securitizer is defined 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).

an order vacating the Risk Retention Rules "insofar as [they apply] to investment managers of open-market collateralized loan obligations."[5] Consequently, as of the date of this Article, managers of open-market CLOs are not required to retain a Required Retention Interest in the CLOs that they manage.

C. Risk Retention Rules Remain in Effect for Balance Sheet CLOs

The D.C. Circuit limited its holding to so-called "open-market CLOs," vacating the Rules only with respect to open-market CLO managers.[6] Therefore, managers of balance sheet CLOs (and all other CLOs that are not open-market CLOs) must still comply with the Risk Retention Rules by holding a Required Retention Interest. Although the court's opinion did not expressly define the term "open-market CLO," the Rules, the preamble to the Rules, and the court's opinion itself provide some guidance.

The Risk Retention Rules define open-market CLO as follows:

> "Open-market CLO means a CLO:
>
> (i) whose assets consist of senior, secured, syndicated loans acquired by such CLO directly from the sellers thereof in open-market transactions and of servicing assets;
>
> (ii) that is managed by a CLO manager; and
>
> (iii) that holds less than 50% of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or the CLO manager or originated by originators that are affiliates of the CLO or the CLO manager."[7]

Although this section of the Risk Retention Rules uses the same term as the D.C. Circuit — open-market CLO — it is important to note that this defined term is only used in the Rules in the context of describing an alternative to the standard options for vertical or horizontal risk retention. Under this alternative, the sponsor of an open-market CLO may comply with the Rules by having the CLO acquire only loan tranches of which the firm serving as lead arranger for each loan tranche retained at least 5% of the face amount of the loan tranche. For various practical reasons, the market rejected this proposed alternative method of compliance. Therefore, the definition is only potentially indicative of how the Agencies think of an open-market CLO generally. To that end, clause (i) of the definition is most relevant here. Because clause (i) requires the assets to have been purchased "directly" in open-market transactions, transfers of assets from an Existing Account to a New CLO would not on their face qualify. Particularly in light of the fact that this arranger-driven method of compliance was never used, however, this definition should not be viewed as controlling for the D.C. Circuit or any other court's analysis.

The Agencies also contrasted open-market CLOs with balance sheet CLOs in the preamble to the Risk Retention Rules, stating that "a balance sheet CLO securitizes loans already held by a single institution or its affiliates in portfolio (including assets originated by the institution or its affiliate) and an open-market CLO securitizes assets purchased on the secondary market, in accordance with investment guidelines."[8]

Regarding the D.C. Circuit's understanding of what constitutes an open-market CLO, the court in its opinion distinguished between open-market CLOs and balance sheet CLOs as follows:

> "CLOs can take two forms. As explained further below, open-market CLOs acquire their assets from, as the name implies, 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 the former are governed by the rule at issue in this case, so our general use of "CLO" refers only to open-market CLOs."[9]

II. INTERPRETATION OF THE RULES

Classifying New CLOs that acquire assets from Existing Accounts as open-market CLOs should be within the spirit of the D.C. Circuit's ruling in certain circumstances. However, as discussed in Section II.B below, because the plain language of the Rules raises

[5] *Loan Syndications and Trading Ass'n v. SEC*, 882 F.3d 220 at 229 (D.C. Cir. 2018).

[6] 882 F.3d 220 at 229.

[7] 79 FR 77750.

[8] 79 FR 77650.

[9] 882 F.3d 220 at 221 (footnote 2).

some concerns, managers may want to structure New CLOs with a view to consideration of the factors discussed in Section III below unless the manager intends to hold a Required Retention Interest in the applicable CLO.

A. Allowing New CLOs to source certain assets from Existing Accounts is within the spirit of the Risk Retention Rules

There are strong arguments that a New CLO that would otherwise qualify as an open-market CLO should not be deemed a balance sheet CLO solely because it acquired some of its assets from an Existing Account. The D.C. Circuit stated that balance sheet CLOs are usually created by the originators or original holders of the underlying loans.[10] In the hypothetical New CLOs, the transferor would be neither an originator nor an original holder of the loans. Rather, because the transferor would be an Existing Account that acquired the loans on the open market pursuant to its investment guidelines, the New CLO fits more within the D.C. Circuit's description of an open-market CLO than a balance sheet CLO. Furthermore, in the New CLOs, the Existing Account will have acquired the loans for the purpose of "arbitrage" (*i.e.*, creating returns for the investors in the CLO).[11] Although the transferor would be transferring the loans to a securitization vehicle, the transferor itself in many cases would be another securitization vehicle, managed account or investment fund (*i.e.*, not a bank, etc. that originates loans and wants to get the loans off its balance sheet such as in an "originate to distribute model"). Conceptually, a New CLO should be viewed as an open-market CLO just like the Existing Account is (where the transferor is a CLO), because the assets transferred from the Existing Account to the New CLO are syndicated loans traded in the market, even if in our hypothetical transactions the purchase of the assets by the New CLO was not accomplished directly by means of bidding in an open market.

B. D.C. Circuit's textualist approach bespeaks caution

On the other hand, the D.C. Circuit took a very textualist approach in the LSTA decision, focusing on the plain language of the statute. In ruling in favor of the LSTA, the D.C. Circuit noted that the Dodd Frank Act defines "securitizer" as a person that "transfers" assets into the transaction and that CLO managers do not transfer the loans into CLOs. Therefore, the D.C. Circuit reasoned that CLO managers cannot be securitizers within the plain meaning of the language of the Dodd Frank Act because they cannot transfer assets that they themselves never owned. If the Agencies take a similarly textualist approach in interpreting the Risk Retention Rules,[12] they may focus on the words "directly from the sellers thereof in open-market transactions" in the definition of open-market CLO. In a transaction where a New CLO purchases assets from an Existing Account, there would be no bidders for those assets and therefore it cannot be said that those assets were purchased in the "open market." Therefore, it may not help that the assets were originally purchased in an open-market transaction by the Existing Account because the plain meaning of the Rules is that the assets must have been purchased "directly"[13] in the open market. On the other hand, as mentioned above, the definition in the Rules is not dispositive because it was created for purposes of an exemption where arrangers would hold the risk retention interest. To the extent that the definition is relevant, however, the question then becomes what percentage of assets need to be acquired in the open market in the immediate instance for the New CLO to be deemed an open-market CLO rather than a balance sheet CLO. As discussed below, the presence of certain factors should increase the likelihood of a New CLO being viewed as an open-market CLO.

III. FACTORS THAT SHOULD STRENGTHEN A NEW CLO'S STATUS AS AN OPEN-MARKET CLO

Although, as described above, there is a dearth of authority on the question of what exactly is an "open-

[10] 882 F.3d 220 at 221 (footnote 2).

[11] In their brief in the LSTA case, the Agencies quoted the following excerpt to explain the concept of an arbitrage CLO: "Arbitrage transactions are typically motivated by the desire to acquire collateral with a yield higher than that of the liabilities to create arbitrage investment opportunities for equity investors. Balance sheet transactions, in contrast, may be motivated primarily by an issuing institution's desire to reduce or remove the credit risk of assets on its balance sheet . . . ." Brief of Agencies filed July 31, 2015, quoting Richard W. Stewart, *Collateralized Loan Obligations: A Primer*, *in The Handbook of Loan Syndications and Trading* 646, 647, 657 (Allison Taylor & Alicia Sansone (of LSTA) eds., 2007).

[12] A statute such as The Dodd Frank Act is entitled to more deference than a rule issued by the Agencies. However, the Agencies may still follow the plain meaning of a rule that they issued.

[13] Contrast this with the text in Dodd Frank definition of securitizer that says a securitizer is a person that "either directly or indirectly" transfers the assets into the deal. 15 U.S.C. §78o-11(a)(3).

market CLO" for purposes of the D.C. Circuit's opinion, it stands to reason that the presence of more, rather than fewer, of the following factors should make it more likely for a New CLO to qualify as an open-market CLO:

1. A relatively small percentage of the assets of the CLO are acquired from an Existing Account.

The higher the percentage of a New CLO's assets that are acquired directly in open-market transactions, the stronger is the case for it to be an open-market CLO. As discussed in II.B above, under the plain language of the definition of "open-market CLO" in the Risk Retention Rules, assets acquired from an Existing Account are not acquired on the open market because there are no other bidders for those assets at the time the New CLO acquires them. Therefore, the risk of a New CLO being deemed a balance sheet CLO might increase if such New CLO acquires a substantial amount of its assets from an Existing Account. Unfortunately there is no bright-line rule here and while there is no definite guidance on this point from any court or the Agencies, a reasonable common-sense interpretation is that the more assets acquired on the open market, the better. For example, it would make sense that a New CLO should be considered an open-market CLO if it acquired only a *de minimus* amount of its assets from an Existing Account, whereas a case where it acquired more than 50% of its assets from an Existing Account would require a careful analysis of the additional factors discussed below.

2. The manager or an affiliate does not own significant equity in the Existing Account that is the transferor.

Where an Existing Account transferor's debt or equity is consolidated for accounting purposes on the manager's balance sheet, the New CLO in question might look in some respects like a balance sheet CLO. Even if we ignore accounting treatment, the manager's or one or more of its affiliates' ownership of a significant amount of the equity of an Existing Account transferor may be associated with balance sheet treatment.[14] Furthermore, in a case where manager entities own the Existing Accounts, it could be viewed that the manager and its affiliates are directly or indirectly using the CLO structure to finance loan portfolios for their own account. On the other hand, where third-party investors own the transferor, it should be more likely for the CLO to be deemed an open-market CLO.

It is uncertain what level of control by the manager of the Existing Accounts would lead to a conclusion that the manager owns such accounts. We could look at the treatment of principal transactions under the Investment Advisers Act test for an analogy. Under the Advisers Act, as explained by the SEC in the Gardner no-action letter,[15] 25% ownership is the threshold for rendering a transaction a principal transaction, meaning that if an investment adviser owns 25% or more of the equity of its advised fund, sales of assets owned by that fund will be deemed to be principal transactions of the adviser for its account and will be subject to the disclosure and consent requirements of Section 206(3). Alternatively, it might make more sense to draw a parallel to the definition of "majority-owned affiliate" in the Rules[16] because that definition describes the SEC's view of the types of entities that are so closely associated with a collateral manager sponsor of a CLO that such entities are deemed acceptable proxies for the collateral manager for purposes of holding any Required Retention Interest. That definition states that a "majority-owned affiliate" means an entity (other than the issuing entity in the securitization, which in this case would be a New CLO) that, "directly or indirectly, majority controls, is majority

[14] "Balance sheet financing CLOs are consolidated on the balance sheet of the sponsor who typically acquires and holds all or a controlling portion of the equity in the transaction directly or indirectly through one or more special purpose subsidiaries." SFIG Letter at 96.

[15] Gardner Russo & Gardner, SEC No-Action Letter (June 7, 2006*), available at*: www.sec.gov/divisions/investment/noaction/gardner060706.htm. The Gardner no-action letter addressed the question of what constitutes a principal transaction under Section 206(3) of the Investment Advisers Act. The SEC stated that the restrictions of Section 206(3) would apply to cross transactions "between a client account and an account of which the investment adviser and/or a controlling person, in the aggregate, own(s) more than 25%." Ownership interests under 25% would be in the clear, as the SEC stated that: "we believe that section 206(3) would not apply to a cross transaction between a client account and an account of which the investment adviser and/or its controlling persons, in the aggregate, own 25% or less."

[16] The Agencies made the following comment in the Preamble to the Rules: "The agencies decided in the reproposal to limit the sponsor's ability to have all or a portion of the required retention held by its affiliates to only a sponsor's majority-owned affiliates rather than all consolidated affiliates as would have been allowed in the original proposal. The agencies have included this approach in the final rule because it ensures that any loss suffered by the holder of risk retention will be by either the sponsor or an entity in which the sponsor has a substantial economic interest." 79 FR 77606.

controlled by or is under common majority control with, such person," where "majority control means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP."[17]

3. The transferor does not hold the assets for a long time prior to selling them to the CLO.

If the transferor has recently acquired the assets on the open market, then the New CLO's purchase of such assets is not far removed from an open-market transaction. In contrast, if the assets have been held by the Existing Account for a significant amount of time, such assets may have suffered declines in credit quality and no longer be of a type tradeable on an open market.

4. The assets were originally sourced in the open market.

Assets that were originally sourced in an open market are likely to be of the same type as assets owned by open-market CLOs. Contrast this with the assets owned by balance sheet CLOs, which in most cases (i) never traded on an open market and (ii) were originated with the purpose of being sold into a particular CLO rather than syndicated and traded in the secondary loan market. Consider the following example: If an Existing Account merged into a New CLO, would the surviving entity not be an open-market CLO because it acquired its assets via merger instead of in transactions in the open market? It seems more reasonable to deem the New CLO to be an open-market CLO. In such case, which bears some resemblance to our hypothetical New CLOs, it would make sense to treat the New CLO as an open-market CLO, as the New CLO would succeed to the assets and obligations of the merged open-market CLO. Likewise in the New CLOs, if assets are sold from an existing open-market CLO or warehouse CLO vehicle into a New CLO, then all other things being equal, that New CLO should be classified as an open-market CLO.

5. The assets were transferred at fair market value.

The D.C. Circuit stated that open-market CLOs "acquire their assets from… arms-length negotiations."[18] Therefore, in order to fit within the definition of open-market CLO, a New CLO should acquire assets from an Existing Account, if any, at fair market value. Helpfully in this regard, most CLO management agreements require any cross-trades and principal transactions that the CLO manager enters into on behalf of its CLO client to be on arm's length terms.

IV. CONCLUSION

Available interpretive authority to date addressing the definition of "open-market CLO" in the Risk Retention Rules is limited, and to our knowledge, other than the LSTA case and as discussed herein, there is no judicial decisional authority and no SEC interpretation of what constitutes an open-market (vs. balance-sheet) CLO under the Risk Retention Rules. In the absence of a judicial decision or clarification from the Agencies, market practice may create some consensus. Of course CLO managers and their counsel should evaluate each New CLO individually. In our view, the more a New CLO satisfies the five criteria set forth in Section III above, the more reasonable it would be to classify it as an open-market CLO. ■

[17] 79 FR 77741.

[18] 882 F.3d 220 at 221 (footnote 2).