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September 20, 2018

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CLO Group Client Alert: SEC No-Action Letter Grants Relief to Middle Market/Balance Sheet CLO Manager and External Adviser to BDCs, Permitting Transfer of 100% of Risk Retention Interest to BDCs

On September 7, 2018, the staff of the Division of Investment Management of the SEC (the "Staff") issued a no-action letter (the "Letter") resolving a conflict between the U.S. Risk Retention Rules[1] and the U.S. Investment Company Act of 1940, as amended (the "1940 Act") in favor of a collateral manager of certain balance sheet collateralized loan obligation transactions ("CLOs")[2] that had requested relief in connection with a transfer of 100% of its risk retention interest to its externally managed business development company ("BDC") originators. The Letter was addressed to Golub Capital BDC, Inc. and certain of its affiliates ("Golub"), which had requested assurance that the Staff would not recommend that the SEC take enforcement action under the 1940 Act in connection with the proposed risk retention interest transfer and related transactions.

BACKGROUND

The Risk Retention Rules, which became effective for CLOs in December 2016, require a CLO sponsor to hold an economic interest in the credit risk of the securitized assets in an amount equal to at least five percent of the CLO securities issued in the transaction (the "Required Retention Interest"). Until recently, collateral managers have generally assumed responsibility for holding, either directly or through

[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 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").

[2] The CLOs described in the Letter were to hold loans originated by the BDCs for small-to-medium sized company borrowers.

majority-owned affiliates[3], the Required Retention Interest as "sponsor" of a CLO[4]. In April, the D.C. Circuit Court of Appeals issued a decision[5] holding that collateral managers of open-market CLOs need not hold a Required Retention Interest, but left undisturbed the application of the Risk Retention Rules to balance sheet CLOs.

The Letter states that the staff of the Division of Corporation Finance concurred with Golub's determination that the Golub investment adviser (the "Adviser") is considered to be the sponsor of the CLO transactions described in the Letter. The Rules expressly permit a sponsor to transfer all or a portion of the Required Retention Interest to an originator, provided certain conditions are met.[6] In practice, however, collateral managers of balance-sheet CLOs with BDC originators historically have avoided this method of compliance because of a conflict with Section 57(a) of the 1940 Act and Rule 17d-1 thereunder, which prohibit certain principal transactions between a BDC and its investment adviser that would include, among others, a transfer by the investment adviser of the Required Retention Interest to the BDC. Through the no-action letter process, Golub sought—and received—assurance that it would not be subject to a 1940 Act-related enforcement action for exercising its right to the "originator" method of compliance available under the Risk Retention Rules.

SCOPE OF THE LETTER

The Letter's scope is limited to the facts set forth therein, including those that describe the following proposed transactions (the "Proposed Transactions"). The BDC[7] will transfer a portion of the loans it originated to the Adviser, which the Adviser will then immediately transfer to the CLO. The CLO in turn will issue the Required Retention Interest in the form of CLO equity to the Adviser, which the Adviser will immediately transfer to the BDC. The BDC will simultaneously transfer the remainder of the

[3] "Majority-owned affiliate of a person means an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person. For purposes of this definition, majority control means ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP". Credit Risk Retention, 79 Fed. Reg. at 77741.

[4] See footnote 42 to the preamble to the proposed rule: "For example, in the context of collateralized loan obligations (CLOs), the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool, and then manages the securitized assets once deposited in the CLO structure." The proposed rule is available at http://sec.gov/rules/proposed/2011/34-64148.pdf.

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

[6] Credit Risk Retention, 79 Fed. Reg. at 77752, 77753 (SubPart C, §__.11).

[7] Although the Letter contemplates transfers from a single Golub BDC originator to a single CLO, the Rules permit transfers by more than one originator to a CLO under certain circumstances where each transferor originates at least 20% of the CLO's collateral loans and holds no more than the corresponding percentage of the Required Retention Interest.

collateral loans it originated[8] (none of which will pass through the Adviser) directly to the CLO in exchange for receipt by the BDC of the net cash proceeds from the CLO issuance and certain CLO securities that may include CLO notes or any portion of the CLO equity not constituting the Required Retention Interest.

The Letter expressly conditions the Staff's relief on the following additional facts and representations made by Golub, and includes the customary admonishment that any different facts or representations might require a different conclusion:

1. Each of the Proposed Transactions would be effected solely to satisfy the Risk Retention Rules.

2. Each Proposed Transaction would occur immediately following completion of the prior Proposed Transaction.

3. The Adviser would not receive any compensation for effectuating, or achieve any profits or losses as a result of, the Proposed Transactions.

4. Each BDC would purchase the Required Retention Interest from the Adviser for the same price and on the same terms that the Adviser acquired the Required Retention Interest from the CLO.[9]

5. Title to the collateral loans transferred in the Proposed Transactions would never be recorded in the name of the Adviser.[10]

6. At the time of the Proposed Transactions, the Adviser would not be insolvent, and the collateral loans or Required Retention Interest transferred through the Adviser in the Proposed Transactions would not be encumbered by any lien solely by virtue of such Proposed Transactions.

7. Before proceeding with the Proposed Transactions, the applicable BDC's board of directors, including a majority of directors who are not "interested persons" of the BDC (as defined in Section 2(a)(19) of the 1940 Act) would approve the BDC's participation in the Proposed Transactions on the basis of such Proposed Transactions (i) being no less advantageous to the applicable BDC than other

[8] Only an amount of loans corresponding to the value of the Required Retention Interest would be transferred through the Adviser. The remainder of the loans would be transferred by the BDC directly to the CLO.

[9] Along these lines, the Letter provides that the purchase price of the Required Retention Interest will be netted out of the price paid by the CLO for the collateral loans, resulting in a complete offset for the Adviser.

[10] In this regard, the Letter clearly indicates that at no point will the Adviser hold legal title to or bear any economic risk with respect to either the collateral loans or the Required Retention Interest.

participants of the Proposed Transactions, (ii) being reasonable and fair, and (iii) not involving overreaching on the part of any person concerned.

Other noteworthy facts in the Letter not specifically enumerated above include that (i) none of the non-BDC investors in the CLO securities will be an affiliate of Golub, (ii) the CLO will acquire all of its assets (directly or indirectly) from the BDC (and not on the open market), (iii) the collateral manager of the CLO will be the same entity as the external adviser to the BDC, and (iv) any other relevant conditions for complying with the "allocation to originator" method of compliance under the Risk Retention Rules will be met.

ADDITIONAL REQUIREMENTS OF THE "ALLOCATION TO ORIGINATOR" METHOD OF COMPLIANCE

In the "allocation to originator" method of compliance under the Risk Retention Rules, a sponsor can offset its risk retention requirements by having an originator hold all or a portion of the Required Retention Interest, provided that certain requirements are met, including that:

(i) the originator must acquire its portion of the Required Retention Interest from the sponsor and retain it in the same manner and proportion (as between horizontal and vertical interests) as the sponsor did;

(ii) the originator cannot hold a greater percentage of the Required Retention Interest than the percentage of assets of the CLO originated by the originator[11]; and

(iii) the originator must acquire and retain at least 20% of the Required Retention Interest.

Additionally, the sponsor must disclose, in the "Credit Risk Retention" section of the CLO offering document, certain information regarding the originator and the nature of the Required Retention Interest to be held by the originator. The originator and its affiliates must comply with the hedging, transferring and pledging restrictions with respect to the Required Retention Interest. The sponsor must monitor such compliance by the originator and notify the investors in the CLO of any noncompliance by the originator with the Risk Retention Rules.

[11] In the Proposed Transactions, this would be a non-issue as the originator would originate 100% of the CLO assets and retain 100% of the Required Retention Interest.

WHAT THE LETTER MEANS (AND DOESN'T MEAN) FOR THE CLO MARKET

The Letter provides a clear path for a CLO manager sponsor to allocate to its externally managed BDCs all of its Required Retention Interest if the manager proceeds in a manner consistent with the Proposed Transactions set forth in the Letter and otherwise complies with the "allocation to originator" method of compliance under the Rules. This should be a welcome development for advisers that can operate accordingly because they will not need to raise or otherwise source capital directly or through "majority-owned affiliates" to meet their obligations under the Rules. Instead, they will be permitted to have their BDCs hold 100% of the Required Retention Interest, providing them freer access to the long-term and typically lower cost financing that the CLO market provides.

Because the Letter merely eliminates a potential conflict between 1940 Act-driven prohibitions on affiliate transactions for BDCs and the "originator" compliance option under the Risk Retention Rules, however, its direct import with respect to any other open questions relating to compliance with the Rules with which the market may be grappling is questionable at best.[12]

More broadly, however, the Letter is noteworthy for the Staff's willingness to grant relief when other federal regulations conflict with the Risk Retention Rules and to offer guidance on how to comply with potentially conflicting regulatory regimes.

[12] The Letter stated that the Staff was not expressing a view on "any question pertaining to the applicability of, or the compliance of the Proposed Transactions with, the Risk Retention Rules." See footnote 2 of the Letter at: https://www.sec.gov/divisions/investment/noaction/2018/golub-capital-bdc-090718-17d1.htm.

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Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the members of our CLO Group.

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