Dodd–Frank credit risk retention rules and ‘open-market CLOs’ (LSTA v Securities and Exchange Commission and Board of Governors of the Federal Reserve System)

18/04/2018

Banking and Finance analysis: Neil J Weidner, partner, and Peter J Williams, special counsel, in the capital markets group at Cadwalader, Wickersham & Taft LLP in New York, explain the implications of the US Court of Appeals’ risk retention ruling on collateralised loan obligations (CLOs).

LSTA v Securities and Exchange Commission and Board of Governors of the Federal Reserve System

What are the practical implications of this case?

The ruling in this case effectively exempts most CLOs from the credit risk retention rules under Dodd–Frank (ie the Dodd–Frank Wall Street Reform and Consumer Protection Act signed into US federal law in July 2010). Those rules became effective with respect to CLOs in December 2016, and since that time CLO managers have been required to purchase and retain 5% of the credit risk of the CLOs they bring to market. The retention requirement applied to both new-issue CLOs and refinancings and resets of existing CLOs, although the Securities and Exchange Commission (SEC) provided, in the form of a no-action letter, a narrow exemption for the refinancing of CLOs that priced before the publication of the final rules in December 2014, so long as the terms of the refinancing met certain conditions.

Prior to the rulemaking in this area, it was not uncommon for CLO managers to invest in the CLO vehicles they managed, sometimes directly but more often through an affiliate or a managed fund. The Dodd–Frank rules, however, mandated 5% risk retention by CLO managers or their majority-owned affiliates, prescribed the particular forms the retention interest could take, and imposed certain disclosure requirements as well as restrictions on the transfer, hedging and financing of retention interests.

Most CLO managers were not structured or capitalised in a way that they could meet the Dodd–Frank retention requirements. Consequently, over the last several years—beginning even prior to the publication of the final rules—CLO managers have devoted a great deal of time, effort and capital to developing new business structures and establishing relationships with financing providers in order to facilitate compliance with the Dodd–Frank rules.

Now that the ruling in this case has been implemented, the credit risk retention rules under Dodd–Frank no longer apply to managers of ‘open-market CLOs’, which the court described as CLOs in which the loan assets are acquired from ‘arms-length negotiations and trading on an open market.’. These CLOs are sometimes referred to in the market as ‘arbitrage CLOs’ or ‘broadly syndicated loan deals’, and they account for the lion’s share of CLO issuance. Managers of open-market CLOs may bring to market new-issue deals, or refinance or reset existing ones, without having to satisfy risk retention under Dodd–Frank. This should make it easier for open-market CLO managers of comparatively smaller size to enter (or re-enter) the market.

The market should also see an increase in overall volumes of CLO issuance, to the extent not otherwise constrained by the availability of loan collateral or ‘arbitrage’ pricing considerations. Managers of open-market CLOs may also, if they choose to do so, sell the retention interests they have acquired since the final rules became effective, although those sales may be subject to certain restrictions under the terms of agreements between managers and their third-party strategic investors.

There are a couple of caveats to note. First, risk retention under Dodd–Frank still applies to ‘balance sheet CLOs’, which the court in this case described as CLOs ‘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 securitisation vehicle’. This type of structure is commonly used in CLOs of middle market (as opposed to broadly syndicated) loan portfolios. Second, the US federal agencies that issued the final rules have until 10 May 2018 to seek review of the case by the US Supreme Court. The consensus view among legal observers, however, which we share, is that the agencies are unlikely to seek such review and, even if they did, it is unlikely that the US Supreme Court would agree to hear the case.

In the wake of this ruling, one uncertainty is whether managers of US open-market CLOs that have marketed ‘dual-compliant’ structures in order to attract European investors will be able to structure deals that satisfy EU risk retention requirements without falling outside the scope of the court’s ruling. Also, securitisation market participants are only just beginning to consider how the principles identified by the court in this ruling might apply to other types of asset-backed securities transactions such that the related sponsors would need not comply with the Dodd–Frank risk retention requirements.

What was the background?

Section 941 of the Dodd–Frank Act required several US federal agencies to jointly adopt regulations that would require a ‘securitiser’ to retain at least 5% of the credit risk of any asset it securitises. The final rules announced by those agencies in October 2014 require the ‘sponsor’ of a securitisation transaction (or its ‘majority-owned affiliate’) to retain 5% of the credit risk of the securitised assets, subject to certain exemptions. ‘Sponsor’ is defined in the final rules as ‘a person who organises and initiates a securitisation transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.’

In their issuing release, the agencies stated that in the context of CLOs, the manager is the sponsor because it selects and manages the loans that are included in the CLO portfolio, which the agencies concluded is a transfer or indirect transfer of the securitised assets. The agencies rejected several definitional and policy arguments made by market participants during the rulemaking process that the manager of an open-market CLO is not a statutory ‘securitiser.’

In November 2014, the Loan Syndications and Trading Association (LSTA), which is the trade association in the US for the corporate loan market, filed suit against two of the agencies, the SEC and the Federal Reserve Board. The LSTA argued, among other things, that the agencies should not have construed the statutory term ‘securitiser’ to include open-market CLO managers. After a US District Court ruled against it in December 2016, the LSTA appealed to the US Court of Appeals.

What did the court decide?

On 9 February 2018, the US Court of Appeals reversed the lower court, agreeing with the LSTA that an open-market CLO manager is not a ‘securitiser’ under section 941 of the Dodd–Frank Act and vacating the final rules as applied to open-market CLO managers. The court dismissed the idea 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, or that a manager can be said to ‘retain’ credit risk within the mandate of the statute by purchasing credit exposure to assets that it has never before owned.

According to the court, open-market CLO managers are more properly understood as performing functions similar to mutual fund managers or other asset managers. To be a 'securitiser' within the meaning of the statute, the court said, a party must actually transfer assets by relinquishing ownership or control. The court also dismissed the agencies' argument that if managers of open-market CLOs are not covered by Dodd–Frank s 941, then it will create a loophole in the regulatory scheme. This last point is a significant element of the ruling, as it effectively means that in the absence of new joint rulemaking by the agencies, no other party to an open-market CLO is subject to the risk retention requirements under the Dodd–Frank rules.

Neil J Weidner represents underwriters, issuers, institutional investors, collateral managers and sponsors in a wide range of matters involving the securitisation or re-packaging of traditional and non-traditional assets. He has extensive experience using 'cash flow,' 'market value,' and hybrid structures, and is recognised as a leading practitioner in the CLO 2.0 market.

Peter J Williams' practice encompasses a variety of complex financial transactions, with an emphasis on structures that utilise securitisation techniques and derivatives. He regularly advises deal arrangers, asset managers, institutional investors and lenders on transactional and regulatory matters in connection with CLOs, securities repackagings and other credit-linked products.

Interviewed by Kate Beaumont.

The views expressed by our Legal Analysis interviewees are not necessarily those of the proprietor.