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Risk Retention for Managed CLOs: Are Regulators Overstepping Their Authority?

We have heard much from the participants in the managed collateralized loan obligation fund market about how the US risk retention requirements do not fit CLOs and will injure or eliminate the CLO market. We agree with the numerous law firm memoranda and trade group statements arguing that the law does not fit, or work with, a managed CLO. The debate, however, has skipped over a threshold issue: does the law (as written under the Dodd-Frank Wall Street Reform and Consumer Protection Act and as proposed in the recent credit risk retention rules) provide the means to achieve the regulatory end asserted by the regulators? Returning to the text yields a fairly clear result: the law's plain language does not expressly provide the statutory authority that the Agencies assert. While the definition of asset-backed security is expansive and would include managed CLOs, the risk retention requirement language under the law and the proposed rules is explicitly tailored and, as written, does not cover managed CLOs.

We recognize that, in the current political environment and under the common law, regulators have many arguments and options available to them when interpreting the scope of the risk retention obligation. However, a proper discussion of the law's scope must begin with the first rule of statutory construction: a review of the plain language of the law. Notwithstanding the assertion of the regulators, the plain language of the statute and the resulting proposed risk retention rules simply do not provide for risk retention by an investment adviser to a managed CLO. With a plain meaning in clear conflict with the regulators' proposed interpretation, regulators may face a credible legal challenge to their regulatory authority, requiring them to demonstrate their legal authority for the inclusion of managed CLOs in the risk retention regime.

Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act[1] (the "Dodd-Frank Act"), enacted in July 2010, mandates that the Department of the Treasury, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (collectively, the "Banking Agencies") and the Securities and Exchange Commission (the "SEC" and, together with the Banking Agencies, the "Agencies") propose regulations requiring "any securitizer to retain an economic interest in a portion of the credit risk for any asset that [it]…sells, or conveys to a third party."[2] In response to this directive, the Agencies recently published a joint notice of proposed rulemaking on credit risk retention in securitization transactions[3] (the "proposed rules").

If you have questions or comments regarding this Client Alert, please contact:

John Donovan
Partner, New York
+ 1 212 819 8530
jdonovan@whitecase.com

Charles Pesant
Partner, New York
+ 1 212 819 8847
cpesant@whitecase.com

David Thatch
Partner, New York
+ 1 212 819 8342
dthatch@whitecase.com

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

Footnote 42 of the proposed rules indicates that the Agencies intend for managed collateralize loan obligation funds[4] ("CLOs") to be one of the types of asset-backed security transactions subject to the risk retention requirements. However, a review of relevant portions of the Dodd-Frank Act and the proposed rules suggests that managed CLOs, and the parties thereto, do not fall easily within the plain language of the risk retention rules and related definitions.

The securities issued in a CLO transaction are, with little doubt, asset-backed securities. Each security issued by a CLO is "collateralized by…self-liquidating financial asset[s] (including a loan…) that allow the holder of the security to receive payments that depend primarily on cash flow from the asset[s]."[5] However, application of the risk retention obligations to CLOs is far less certain. As discussed herein, no party involved in a typical managed CLO fits into the plain language of the "sponsor" definition set forth in the proposed rules. If there is no sponsor to retain the credit risk, it raises the question: how can the Agencies justify applying the risk retention regime to a managed CLO when the plain meaning of the "sponsor" definition set forth in the proposed rules does not actually require retention by any party involved in a managed CLO?

Set forth below is a textual analysis of certain provisions of the Dodd-Frank Act and the proposed rules, together with a brief overview of the structure of a CLO fund and the roles of the various parties to such funds. The analysis shows that the proposed rules' application of the Dodd-Frank Act's risk retention requirement to CLO managers is not supported by the plain language of the Dodd-Frank Act or the proposed rules.

The Plain Text of the Dodd-Frank Act and the Proposed Rules

In all the commentary surrounding the release of the proposed rules and how they apply to CLOs, one analysis we have found notably absent is basic statutory construction. The first rule of statutory construction is that the purpose and meaning of the statute begins with the statute's plain language.[6] "[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says…"[7] Accordingly, proper statutory interpretation begins with the premise that a statute reflects the intention of the legislature. Where the language of the statute is plain, courts must look no further than the statute and enforce it according to its terms.[8] This is known as the "plain meaning rule." By extension, seeking "legislative intent" in the nebulous collection of information that informed and preceded the promulgation of the statute is unhelpful. Proper statutory construction avoids delving into legislative intent unless the plain meaning is ambiguous or unclear. Barring such a result, courts will examine the text of the statute to the exclusion of all else when interpreting it. We therefore begin our analysis with a plain meaning of the Dodd-Frank Act and the proposed rules.

Retention of Risk by the Securitizer/Sponsor

To begin, the Agencies named the proposed rules "Credit Risk Retention." The name itself implies that someone must have exposure to risk in order to be able to retain some of that risk.[9] More specifically, Section 941(b) of the Dodd-Frank Act mandated that the Agencies:

> jointly prescribe regulations to require any **securitizer** to **retain** an economic interest in a portion of the credit risk for any asset **that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys** to a third party[10].

Much could be debated about what Congress "really meant" in its direction to the Agencies, but the Dodd-Frank Act is explicit that a "securitizer" must "retain" some interest in the credit risk that it transfers, sells or conveys to others. The Dodd-Frank Act did not define what it means to "retain", but it did define 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[.][11]

After some discussion in the proposed rules, the Agencies ultimately concluded that the "issuer" of an asset-backed security is the same as a depositor. The Agencies also concluded, in their collective interpretation, that the "sponsor" of a transaction, and not the depositor (or issuer), is responsible for risk retention, thereby effectively ignoring the first prong of the securitizer definition.[13] Clause (B) of the Dodd-Frank Act's definition of securitizer thus became the Agencies' definition of sponsor under the proposed rules:

> "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[.]"[14]

The plain meaning of the definition appears to be clear: to be a sponsor, and therefore to be required to retain credit risk, a party to a securitization must both (1) organize and initiate an asset-backed securities transaction and (2) do so by selling or transferring assets to the issuer (whether directly or indirectly). The use of the phrase "by selling or transferring assets" is interesting and important because the acts of organizing and initiating by a party to a transaction appear to be tethered to such party's effectuation of the transaction through the act of selling or transferring assets.

Managed CLOs Appear to Lack a "Sponsor"

In the proposed rules, the Agencies proposed that the investment adviser of a managed CLO would be the sponsor:

> [I]n the context of 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."[15]

However, in the case of a managed CLO, this text either (1) presupposes that the CLO manager performs each of the actions required in the definition of sponsor or (2) purports to expand the definition of "sponsor" beyond the clear language of the definition in order to capture CLO managers under its purview.

Background on CLO Transactions

The process of establishing a managed CLO begins with an investment adviser's engagement of an investment bank or other structurer (the "Arranger"), who assists the investment adviser in establishing the issuer, works with the rating agencies to establish the appropriate capital structure for the issuer and assists in the marketing of the issuer's securities.

Investors interested in the issuer's most subordinated form of securities are seeking exposure to leveraged corporate bank loans, and the ultimate investment return to these investors (and the incentive compensation for the investment adviser) will be most significantly affected by the ability of the investment adviser to select loans that will not default and/or decrease in market value. The issuer's debt securities, which are rated by one or more national statistical rating organizations ("rating agencies"), are generally Rule 144A eligible and issued pursuant to a full offering memorandum, which describes the securities, the issuer, the investment adviser, risk factors and other legal and structural information material to the investors. The offering memorandum includes the eligibility criteria for the loans that may be purchased by the issuer and covenants for the entire portfolio of loans, including: obligor concentration limits, minimum ratings for individual assets and average ratings for the portfolio, minimum estimated recovery rates, a minimum weighted average spread test and more.

The issuer is typically established early in the transaction, so that the investment adviser has sufficient time to cause the issuer to acquire[16] a portfolio of loans satisfactory to the investment adviser during this "warehouse" period. The cost of warehouse financing (if any) and the allocation of credit risk from the portfolio is highly negotiated between the Arranger and the investment adviser. Generally speaking, the return on the portfolio during the warehouse period is allocated to the person taking the risk during the period.

Using its investment criteria, the investment adviser selects the loans to be included as collateral in the transaction and is responsible for complying with the investment parameters set by the rating agencies. The investment adviser selects loans for the issuer to purchase from market participants, which may include affiliates of the Arranger, and the investment adviser will negotiate the amount of a loan to be purchased as well as the purchase price for the loan.

No Party to a CLO Meets the Sponsor Criteria

As discussed in the prior section, an investment adviser is typically involved in initiating and organizing the CLO and therefore appears to satisfy the first element of the definition of sponsor. However, to be a sponsor, a person must initiate the transaction by selling or transferring assets to the issuer. As noted in the proposed rules, a CLO manager selects the commercial loans to be purchased by the issuer, but it is difficult to understand how a person who merely *selects* assets for inclusion in a securitization transaction can be considered the person who *sells or transfers* the assets to the issuer. While courts will often give regulators leeway to interpret a statute's intent when the language is ambiguous, they will not typically allow a regulator to rewrite the text when the plain language expresses a clear Congressional intent.[17]

Having reached the conclusion that the Agencies' naming the investment adviser as the sponsor of a managed CLO conflicts with the text of the statute, other participants in the transaction, like the Arrangers, may become concerned that the Agencies will identify them as the sponsor of the transaction. While the concern is understandable, the Agencies must work within the meaning of the Dodd-Frank Act's text. The Arranger neither (1) "initiates" the transaction, when they are engaged by the investment adviser nor (2) effectuates the initiation and organization **by** selling or transferring assets to the issuer. It is possible that an Arranger's affiliates sell assets to the issuer, but those sales are on market terms, and that syndication and trading business is separate and apart from the activity of organizing and initiating the transaction. Without a more direct link between (1) an Arranger's activity in assisting with CLO's organization and (2) its selling or transferring of assets (directly or indirectly) to an issuer, concluding that an Arranger would be a sponsor significantly stretches the text of the Dodd–Frank Act and the proposed rules. Note that, in the proposed rules, the Agencies made no assertions that an Arranger would be a sponsor, an originator or otherwise be required to retain credit risk.

Warehousing loans by an Arranger or its affiliate, without a third party taking the risk on the warehoused loans, likely increases the risk that an Arranger or its affiliates would be viewed as a sponsor. As discussed above, the definition of sponsor contains essentially three elements relating to a securitization: (1) initiating it, (2) organizing it and (3) selling or transferring its assets to the issuer (directly or through an affiliate). If the Arranger or its affiliate accumulates loans for a CLO and takes all risk on those loans prior to the CLO closing and ultimately sells/transfers the loans to the issuer, the activities more easily fall within two of three elements of the definition. While identifying the Arranger as the sponsor still appears outside the text of the statute (as the Arranger did not "initiate" the CLO transaction), we would advise Arrangers to avoid warehouse facilities that do not involve a third-party taking the risk of loss during the warehouse period in order to reduce the risk.

On the face of the text, it is simply difficult to conclude that a managed CLO has a "sponsor" within the plain meaning of the text.

Conclusions About the Statutory Analysis

We believe that the plain language of the text of the Dodd-Frank Act and the proposed rules, which must be within the confines of the Dodd-Frank Act, fails to adequately address risk retention for a managed CLO. While the definition of asset-backed securities likely includes managed CLOs, the text of the Dodd-Frank Act and the proposed rules do not properly provide for a risk retention regime that addresses the managed CLO market. Therefore, unless the plain text of the Dodd-Frank Act is ignored, or regulators significantly alter the proposed rules interpreting the statute or successfully justify an expansive reading of the law, regulators appear to lack the proper authority to require risk retention for managed CLOs as currently proposed.

Endnotes

1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter *Dodd-Frank Act*].

2 Dodd-Frank Act § 941(b) (as codified at § 15G(b)(1) of the Securities Exchange Act of 1934, 15 USC. §78o-11, §78o-11(b), (c)(1)(A), and (c)(1)(B)(ii)).

3 Credit Risk Retention (proposed Mar. 29, 2011) (to be codified at 12 C.F.R. pt. 86, 12 C.F.R. pt. 244, 12 C.F.R. pt. 373, 17 C.F.R. pt. 246 and 12 C.F.R. pt. 1234), *available at* http://www.sec.gov/rules/proposed/2011/34-64148.pdf (last visited Apr. 19, 2011) [hereinafter *Credit Risk Retention*].

4 Note, this analysis is relevant to managed CLO funds, not balance sheet CLOs. CLOs come in two basic forms: (1) managed leveraged funds, where the loans securing the debt securities issued by a CLO are selected as investments by an investment adviser and (2) originator-sponsored vehicles, where the loans securing the debt securities issued by a CLO are selected by the originator. The transaction referred to in clause (2) is generally known as a "balance sheet CLO" because the assets come from the balance sheet of the originator of the loans. A balance sheet CLO falls squarely within the definition of "asset-backed security" and shares many risks of other originator-sponsored asset-backed securities. This discussion of CLOs relates solely to managed CLOs.

5 *See*, Credit Risk Retention at 26 & n. 30, *citing* Securities Exchange Act § 78c(a) (77).

6 *See Connecticut Nat'l Bank v. Germain*, 503 US 249, 253-54 (1992) ("[I]n interpreting a statute a court should always turn to one cardinal canon before all others…[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there…[W]hen the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete.'").

7 *Conn. Nat'l Bank v. Germain*, 503 US 249, 254-54 (1992).

8 *See*, *Caminetti v. US*, 242 US 470, 485 (1917).

9 Another incongruence between the Dodd-Frank Act and the proposed rules is that the Dodd-Frank Act requires a sponsor to retain an economic interest in a portion of the credit risk transferred. As noted in the discussion below, the investment adviser selects loans for the issuer to purchase from market participants but the investment adviser owns no economic interest in the assets that it can "retain"— as it never owned the asset in the first place.

10 *See supra* note 2.

11 Dodd-Frank Act §941(b) (as codified at §15G(a)(3) of the Securities Exchange Act).

12 Credit Risk Retention at 30-1 providing:

> The term "issuer" when used in the federal securities laws may have different meanings depending on the context in which it is used. For example, for several purposes under the federal securities laws, including the Securities Act and the Exchange Act and the rules promulgated under these Acts, the term "issuer" when used with respect to an ABS transaction is defined to mean the entity—the depositor—that deposits the assets that collateralize the ABS with the issuing entity. The Agencies interpret the reference in section 15G(a)(3)(A) to an "issuer of an asset-backed security" as referring to the "depositor" of the ABS, consistent with how that term has been defined and used under the federal securities laws in connection with ABS.

13 The proposed rules provide: "[T]he proposed rules generally would apply the risk retention requirements of section 15G to a sponsor of a securitization transaction (and not the depositor for the securitization transaction)." Credit Risk Retention at 31. The Agencies focused on the second prong of the definition of securitizer, equating it with the definition of "sponsor" in the SEC's Regulation AB and asserting that the application of risk retention requirements to the sponsor of an asset-backed security "is appropriate in light of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting the assets to be securitized." *Id.* at 29-30 (proposed Mar. 31, 2011).

14 *Id.* at 29 (emphasis added).

15 *Id.* at at 30 & n. 42 (emphasis added). We note that the proposed rules in footnote 42 provide that loans are purchased by an agent bank. In our experience in the managed CLO market, a direct purchase by the agent bank is unusual and typically avoided as it can result in dual assignment fees as well as dual trading and settlement processes. Perhaps the Agencies were referring to a warehouse structure in which the issuer is the purchaser of the loan, holding legal title, but the credit risk of the loan remains with the agent bank.

16 Sometimes there is a process of amassing the portfolio of loans by the Arranger or its affiliate **at the direction** of the investment advisers. In the short term, the loans would be maintained on the balance sheet of the Arranger or its affiliate with the understanding that, at closing of the CLO, those loans would be acquired into the issuer at a prearranged price. This form of warehousing makes the warehouse provider, or its affiliate, more susceptible to becoming a sponsor under the proposed rules due to the roles of the affiliates in organizing the transaction and transferring the assets to the issuer.

17 *See, e.g.*, *California Livestock Production Credit Association v. Farm Credit Administration*, 748 F.Supp. 416, 419 (E.D. Va. 1990).

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