Client Alert | Capital Markets

Court Agrees, Agencies Overstepped Their Authority. What's Next for CLO Managers?

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Recent Developments in the Application of US Risk Retention to CLOs

On February 9, 2018, the United States Court of Appeals for the District of Columbia Circuit (the "***DC Circuit Court***") issued an opinion addressing Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "***Dodd-Frank Act***")[1] and the credit risk retention rules applicable to issuances of asset-backed securities (the "***Risk Retention Rules***")[2] promulgated thereunder. The DC Circuit Court held that the Risk Retention Rules do not apply to investment managers ("***CLO Managers***") of open-market collateralized loan obligations ("***CLOs***").[3] The case was heard by the DC Circuit Court on appeal by the Loan Syndications and Trading Association (the "***LSTA***") of the decision from the United States District Court for the District of Columbia (the "***District Court***"). As a result of the decision, the ruling of the District Court was overturned and the District Court was instructed to grant summary judgement in favor of the LSTA.

The DC Circuit Court's full decision is available here.

How did the decision come to the DC Circuit Court?

When promulgating the Risk Retention Rules, the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System, among other federal agencies (collectively, the "***Agencies***"), imposed credit risk retention requirements described in the Dodd-Frank Act on CLO Managers, despite significant industry-wide pushback indicating that their approach overstepped the Agencies' legislative authority. The LSTA filed suit in the District Court arguing that the Agencies' interpretation was an unreasonable expansion of Section 941 of the Dodd-Frank Act. The District Court sided with the Agencies and granted summary judgment to the Agencies, finding that the Agencies could reasonably treat CLO Managers as being subject to Section 941 of the Dodd-Frank Act. The LSTA appealed the decision to the DC Circuit Court, arguing that the District Court made a mistake in interpreting the law and that a plain language interpretation of Section 941 should prevail.

What is the foundation of the legal argument?

While not mentioned in the opinion itself, the issue addressed by the DC Circuit Court is rooted in the United States Constitution and its separation of powers among the three branches of government: Congress, the Executive Branch and the Judiciary. On a basic level, the United States Constitution and the common law

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

[2] Credit Risk Retention Rule, 79 Fed. Reg. 77,601 (Dec. 24, 2014).

[3] The DC Circuit Court defined open-market CLOs as CLOs that "acquire their assets from, as the name implies, arms-length negotiations and trading on an open market."

interpreting it provide that Congress creates the laws, the Executive Branch enforces the laws and the Judiciary interprets the laws. Congress may delegate rulemaking (and thus a limited amount of lawmaking) to the Executive Branch but the Constitution and common law impose limitations on the Executive Branch's ability to make rules that exceed the mandate from Congress. Generally, where Congress is clear and specific in its delegation, the Executive Branch must follow that delegation and any deviation from that delegation is an invalid attempt to create law. However, if a delegation from Congress is subject to interpretation (i.e. it is a broad delegation or subject to ambiguity), courts will defer to the Executive Branch's reasonable interpretation of that delegation. In this particular case, the DC Circuit Court reached a conclusion that the Agencies' interpretation of Section 941 of the Dodd-Frank Act, as applied to CLO Managers under the Risk Retention Rules, was unreasonable and, consequently, the Agencies did not have the necessary delegated authority from Congress to impose risk retention requirements on CLO Managers.

Does this mean the law is invalidated as it applies to CLO Managers?

Not just yet; the Agencies have a right to request an appeal of the DC Circuit Court's opinion and ask for the opinion to be overturned. The law is thus still "on the books."

In its original filing, the LSTA asked the District Court to invalidate the Risk Retention Rules as applied to CLO Managers. The District Court refused to grant the LSTA's motion for summary judgement. The DC Circuit Court, as a superior court to the District Court, ordered the District Court to grant summary judgment to the LSTA and thus invalidate the Risk Retention Rules as applied to CLO Managers. The District Court is required to do so, but until the District Court grants summary judgment in favor of the LSTA, the Risk Retention Rules remain in effect for CLO Managers. In practice, the District Court is unlikely to grant the summary judgment in favor the LSTA until the appeal period for an en banc rehearing at the DC Circuit Court passes. Until the District Court issues the summary judgment, the Risk Retention Rules will still apply to CLO Managers.

What is the timing of the appeal process?

Under appealable District of Columbia rules, the Agencies have 45 days to appeal the decision of the DC Circuit Court and request an en banc hearing. The Agencies also have 90 days from the entry of a judgement to request a writ of certiorari to the Supreme Court. In both cases, the Agencies do not have a right to have the appeal heard. For the DC Circuit Court, a rehearing en banc is not favored and ordinarily will not be ordered outside of two circumstances[4] that do not appear to apply here. In the case of the Supreme Court, receiving a writ of certiorari is the exception and not the rule.

If the decision of the DC Circuit Court is not appealed and the Agencies do not otherwise indicate that they will not appeal, we believe the District Court will likely issue its summary judgment in favor of the LSTA shortly after the 45-day appeal window passes.

What is the likelihood of the DC Circuit Court's decision being overturned?

It is difficult to predict how the Agencies will respond to the judgment of the DC Circuit Court. However, we believe that it is unlikely the DC Circuit Court's ruling will be overturned on appeal for the following reasons:

- **Deference to Regulators is a Hot Button**. The issue decided here, while important to many of us, is not significant in the scope of administrative law, and we do not believe the Agencies will risk the possibility of a broader holding from a higher court on this particular set of facts. Under the DC Circuit Court's opinion, the Agencies may have lost the ability to impose risk retention on CLO Managers, but a broader opinion from a higher authority could restrict the Executive Branch's authority to edit, correct and supplement Congressional delegations in more meaningful circumstances affecting the power of the Executive Branch. We believe, therefore, the Agencies will likely not want to risk an unfavorable ruling that could lead to other challenges of Executive Branch actions.

[4] These circumstances include (1) the panel decision conflicts with a decision of the Supreme Court or the DC Circuit Court and en banc consideration is necessary for maintaining uniformity of the court's decisions and (2) the proceeding involves a question of exceptional importance (e.g. the panel decision conflicts with a decision of a sister circuit).

- **The Quality of the Decision**. The written decision of the DC Circuit Court demonstrated intimate knowledge of the law as applied to the CLO market. While the circumstances and facts leading into the Risk Retention Rules and this litigation are complex, the decision of the DC Circuit Court was based upon a simple plain language reading of Section 941 of the Dodd-Frank Act. Our April 2011 client alert (available here) responding to the proposed rules of the Agencies that would become the Risk Retention Rules raised the exact legal issue framed by the DC Circuit Court and focused on almost the identical language. To those who understood the facts and the law, the DC Circuit Court's holding was a natural conclusion.
- **The Decision Was Unanimous**. All three judges agreed that the Agencies went beyond their authority. The unanimous conclusion, coupled with the well-written description of the facts and textual analysis, not to mention the DC Circuit Court's acknowledgment of the strong performance of the CLO market and the protections in place for CLO investors, lead us to believe that an appeal is unlikely.
- **The Trump Factor**. The current political environment seems more anti-regulation than pro-regulation right now. It would be surprising if the Trump administration were to pursue an appeal that would have to be based on an expansive view of a federal regulator's power to interpret a Congressional statute.

What should we do during the appeals process?

While we believe the DC Circuit Court's conclusion will ultimately remain the law of the land, there is a practical problem in the short term. Until there is absolute certainty that the DC Circuit Court's opinion will not be overturned, a securities offering that fails to comply with the Risk Retention Rules poses a risk to both the CLO Manager and the investment bank distributing the securities.

CLO Managers and investment banks must make a decision about the likelihood of the decision being overturned. It is possible that CLO Managers and investment banks will determine that the decision of the DC Circuit Court is unlikely to be overturned and will therefore move forward without a CLO Manager complying with the Risk Retention Rules. However, we believe that CLO Managers will continue to comply with the Risk Retention Rules for closings that occur prior to the expiration of the appeals process and, to the extent CLO Managers wish to preserve flexibility to dispose of retention interests purchased solely to comply with the Risk Retention Rules, we recommend including disclosure to indicate that investors should not rely upon the CLO Manager (or its majority-owned affiliate) continuing to hold any retention interest.

Can a CLO Manager's organization sell securities from transactions that have closed already?

Before selling securities purchased as retention interests in previously closed transactions, CLO Managers should consider both (1) the likelihood of the DC Circuit Court's decision being overturned and (2) the information previously disclosed to investors in the related transaction (as well as any contractual undertakings in respect of a retention interest held in a previously closed transaction). The first consideration will no longer be applicable if the judgment of the DC Circuit Court is not appealed prior to the expiration of the appeal window. The second consideration is more fact-specific. To the extent offering materials induced investors to rely upon the CLO Manager's (or its majority-owned affiliate's) investment in the CLO, a CLO Manager should make an assessment as to whether selling all or any portion of a retention interest would materially conflict with the disclosure in the offering materials for the transaction. In some cases, CLO Managers may have entered into a covenant to retain a retention interest beyond the period at which a disposition of such retention interest would be permitted under law. Such contractual restrictions should also be considered prior to any sale.

How does the DC Circuit Court's Opinion impact my Crescent refinanced deals?

If the Risk Retention Rules as applied to CLO Managers are permanently invalidated, CLO Managers seeking to refinance a transaction that was refinanced in reliance on the Crescent No-Action Letter[5] (i.e. the original deal priced prior to December 24, 2014 and followed the requirements of the Crescent No-Action Letter) would not be subject to any restrictions imposed by the Crescent No-Action Letter. However, contractual provisions adopted in order to rely upon the Crescent No-Action Letter may restrict the ability of individual transactions to refinance. The DC Circuit Court opinion does not invalidate any contractual provisions, so we recommend that all questions about specific transactions be reviewed by CLO counsel.

What is the effect on US/EU dual compliant CLO transactions?

The DC Circuit Court's opinion only applies to the Risk Retention Rules for open-market CLOs. The risk retention regime in the European Union (and in the United Kingdom following Brexit) is not affected by the judgment of the DC Circuit Court. In addition, the documentation for many transactions structured to comply with the European Union rules requires a CLO Manager or other entities to retain retention interests issued by the issuing entity. Therefore, contractual provisions may require a CLO Manager or another party to maintain ownership of a portion of the securities issued in a CLO transaction. As the DC Circuit Court opinion does not invalidate, or relieve a party from compliance with, any contractual provisions, entities that have contracted to hold securities will continue to be bound by those contractual provisions.

If a CLO Manager were to rely on the "originator-manager" structure for compliance with EU risk retention, the CLO Manager should consider whether that structure is inconsistent with qualification as an open-market CLO for purposes of the DC Circuit's opinion and the Risk Retention Rules. The CLO Manager could be making inconsistent arguments for the EU and US if it were to claim that it should be an originator for EU purposes but not for US purposes. Perhaps a CLO Manager could credibly make such an argument based on the limited amount of assets it "originates" for purposes of EU risk retention (typically 5-10 percent of target par). If a CLO Manager were to determine that the Risk Retention Rules applies because of its originating activities, from an economic perspective compliance with the EU risk retention rules and the Risk Retention Rules is not much different. However, the Risk Retention Rules have additional disclosure requirements for the fair value calculation required by the Risk Retention Rules and it's possible the fair value calculation changes slightly how much must be retained by the CLO Manager.

What is an "open-market CLO"?

The DC Circuit Court's opinion is limited to open-market CLOs, which it described as CLOs that "…acquire their assets from, as the name implies, arms-length negotiations and trading on an open market." For most broadly-syndicated CLOs, the articulated standard should be easily met. For European compliant transactions relying on the "originator-manager" structure, however, the organization will need to consider whether that structure would cause the transaction in question to no longer qualify as an open-market CLO for purposes of US law.

Is the decision product specific to CLOs?

This question likely will come up from time to time, including for CLOs that have a bond bucket (e.g. European CLOs issued into the United States and certain US CLOs that are not structured to be loan securitizations). While the holding of the decision only applied to open-market CLOs, the reasoning of the case focuses on the activity of the CLO Manager in selecting the assets and not the type of assets underlying the CLO. In addition, in dismissing the Agencies concerns over the creation of a loophole for "CDO squared deals", the DC Circuit Court dismissed the Agencies argument and noted that "any CLO[6] so constituted must, by definition, have acquired the [asset

[5] The Response of the Office of Structured Finance of the Division of Corporation Finance of the Securities and Exchange Commission, dated July 17, 2015, with regards to the letter of Crescent Capital Group LP (the "Crescent No-Action Letter").

[6] While the DC District Court used "CLO" here, based on the surrounding context, we believe they meant to say "CDO."

back securities] in open-market purchases at the direction of the investors." This statement indicates that a bond may be included in a transaction and that the decision likely applies to any structure where a collateral manager selects the assets on the open-market.

Does the ruling apply to balance sheet CLOs[7] or those who originate the loans for the CLO?

No. The DC Circuit Court's opinion only applies to CLO Managers who purchase loans in the open market on behalf of the issuing entity. If a CLO Manager is not independent from the loan originator, then the DC Circuit Court's opinion would not apply to that CLO Manager. In addition, if a CLO Manager holds loans for its own account prior to transferring the loans to the issuing entity, the DC Circuit Court's opinion may not apply to that CLO Manager. We advise any CLO Managers who are related to a loan originator or who are in an agency relationship with a loan originator to discuss the particular facts and circumstances with CLO counsel to determine whether the Risk Retention Rules applies to them.

What can the Agencies do under their US risk retention rule-making authority?

The DC Circuit Court's opinion held that the Agencies lacked Congressional authorization to impose credit risk retention upon CLO Managers. We do not believe that the Agencies will use their rule-making authority to circumvent the DC Circuit Court's holding and attempt to impose credit risk retention under Section 941 of the Dodd-Frank Act on CLO Managers in a different manner.

Importantly however, the opinion did not conclude that the risk retention requirements described in Section 941 of the Dodd-Frank Act are inapplicable to CLO transactions. In fact, the DC Circuit Court noted that CLOs could still be captured under Section 941 by noting the Agencies eliminated the "issuer" as a person who could "retain" credit risk as specified under Section 941 of the Dodd-Frank Act. Perhaps the Agencies will resurrect the issuer as an entity that can retain credit risk and attempt to impose the risk retention requirements of Section 941 of the Dodd-Frank Act on CLOs through other means, including by requiring the CLO issuing entity to maintain a certain portion of its capital as equity capital.

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[7] The DC Circuit Court defined balance sheet CLOs as those that 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."