THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 51 No. 13 July 18, 2018

THE *LSTA* CASE AND THE FUTURE OF CREDIT RISK RETENTION FOR SECURITIZATIONS

In an appeal by the LSTA*, the D.C. Circuit holds that managers of open-market CLOs are not subject to the Dodd-Frank credit risk retention rules. The author discusses the decision, beginning with an overview of the rules, the structure of open-market CLOs, and the controversy surrounding the identification of open-market CLO managers as sponsors. He then turns to the holding and rationale of the decision, the potential exemption of other securitization structures, and implications for identification of the sponsor in other securitization structures.*

By Charles A. Sweet *

Under the credit risk retention rules adopted[1] pursuant to the Dodd-Frank Act, the sponsor in an issuance of asset-backed securities ("ABS") generally must retain at least five percent of the credit risk of any asset that is transferred, sold, or conveyed to any third party by means of the securitization, through one of several specified mechanisms.

A "sponsor" of a securitization organizes and initiates that transaction by either selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. When the risk retention rules were proposed, the Loan Syndications and Trading Association (the "LSTA") and other commenters argued that the manager of an open-market collateralized loan obligation transaction (a "CLO") cannot be a "sponsor" because it does not sell or transfer assets to the issuing entity. However, the rules as adopted imposed risk retention requirements on open-market CLO managers, on the grounds that a "CLO manager indirectly transfers the assets to the CLO-issuing entity because the CLO manager has sole authority to select the commercial loans to be purchased by the CLO-issuing entity for inclusion in the CLO collateral pool, directs the issuing entity to purchase such assets in accordance with investment guidelines, and manages the securitized assets once deposited in the CLO structure."[2]

The LSTA sued the SEC and the Board of Governors of the Federal Reserve in the U.S. District Court for the

---

[1] Credit Risk Retention, SEC Rel. No. 34-73407, 79 Fed. Reg. 77602 (Dec. 24, 2014) (the "Adopting Release"). The risk retention rules became effective December 24, 2015 for ABS backed by residential mortgage loans, and on December 24, 2016 for all other asset classes.

[2] Adopting Release, at 77654.

---

* *CHARLES A. SWEET is a partner in the Washington, D.C. office of Morgan Lewis & Bockius LLP, where he serves as the practice development leader of the firm's structured transactions practice group. His e-mail address is charles.sweet@morganlewis.com.*

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (937) 387-0473 or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 0884-2426.

District of Columbia, challenging their authority to apply the risk retention rules to open-market CLOs. The District Court ruled against the LSTA[3] and the LSTA appealed to the Court of Appeals for the D.C. Circuit. On February 9, 2018, the Circuit Court overturned the decision of the District Court, holding that managers of open-market CLOs are not subject to the credit risk retention rules. The Circuit Court directed the District Court to enter judgment in favor of the LSTA and to invalidate the credit risk retention rules as they apply to open-market CLOs.[4] The District Court entered that order on April 5, 2018.[5]

By its specific terms, the *LSTA* ruling addresses only the need for open-market CLO managers to hold risk retention. However, its holdings and reasoning may have significant implications for several other issues, including whether other securitization structures may also be exempt from credit risk retention requirements, and (where risk retention is still required) how to identify the sponsor that is required to hold that risk.

OVERVIEW OF THE CREDIT RISK RETENTION RULES

The credit risk retention rules were adopted jointly by the SEC, the Department of the Treasury, the Office of the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation (the "Banking Agencies"), and by the Federal Housing Finance Agency and the Department of Housing and Urban Development (together with the SEC and the Banking Agencies, the "Agencies") to implement the mandate of Section 941(b) of the Dodd-Frank Act. Section 941(b) has been codified as Section 15G of the Securities Exchange Act of 1934.[6] Under Section 15G, the SEC and the Banking Agencies were directed to jointly prescribe regulations that require "securitizers" to retain, generally, not less than five percent of the credit risk of any asset that the securitizer, through the issuance of ABS, transfers, sells, or conveys to a third party, subject to certain exceptions.

As defined, a "securitizer" includes "an issuer of an asset-backed security."[7] In adopting the rules, the Agencies interpreted this prong of the term "securitizer" as referring to the "depositor" of a securitization transaction.[8] The definition of "securitizer" also includes 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,"[9] a phrase which the Agencies noted is substantially identical to the definition of "sponsor" under Regulation AB. The Agencies generally required that the sponsor of a securitization hold the required risk retention interest,[10] due to the active and direct role that it typically plays in selecting the pool assets and managing the securitization process.[11] A sponsor also may satisfy the risk retention requirements by causing a "majority-owned affiliate" to retain that interest.[12]

---

[3] *Loan Syndications & Trading Ass'n* v. SEC, 223 F. Supp. 3d 37 (D.D.C. 2016).

[4] *The Loan Syndications & Trading Ass'n v SEC and Board of Governors of the Federal Reserve System,* 883 F.3d 220 (D.C. Cir. 2018) (hereinafter "*LSTA*").

[5] *The Loan Syndications & Trading Ass'n v SEC and Board of Governors of the Federal Reserve System,* No. 16-652 (D.D.C. Apr. 9, 2018) (order granting summary judgment). The Agencies (as defined below) neither sought *en banc* review of the Circuit Court's decision nor petitioned the Supreme Court for *certiorari*.

[6] 15 U.S.C. Section 78o-11 (2018).

[7] 15 U.S.C. Section 78o-11(a)(3)(A) (2018).

[8] Adopting Release, at 77,609. A depositor is a special purpose vehicle formed for the purpose of facilitating securitizations. In a common, "plain vanilla" term securitization structure, the depositor usually is a corporation or limited liability company that is a bankruptcy-remote subsidiary of the transaction's sponsor. The pool assets that collateralize the ABS issued in the securitization ordinarily are transferred from sponsor to the depositor, then from the depositor to the issuing entity.

[9] 15 U.S.C. Section 78o-11(a)(3)(B) (2018).

[10] 12 C.F.R. Section 244.3(a) (2018).

[11] Adopting Release, at 77,608.

[12] 12 C.F.R. Section 244.3(a) (2018).

For most securitizations, risk retention may take any of three forms provided by the so-called "standard" approach, subject to multiple rigorous and highly technical conditions:

- vertical, by holding at least five percent of each class of "ABS interests" issued by the issuing entity;
- horizontal, by holding a residual interest equal to at least five percent of the "fair value" (calculated under United States generally accepted accounting principles) of all ABS interests issued by the issuing entity; and
- Combined (or "L shaped"), by holding a combination, in any proportion, of the vertical and horizontal methods of risk retention.[13]

Sponsors and other parties that retain ABS interests to satisfy the credit risk retention requirement generally are prohibited from transferring the retained interests (other than to their majority-owned affiliates), hedging the retained credit risk, or pledging the retained interests on other than a full recourse basis. The rules generally provide sunset timeframes for expiration of these restrictions.[14]

Disclosure to investors (and to regulators, upon request) is required regarding, among other things, the form and amount of risk that is retained as required.[15]

THE STRUCTURE OF OPEN-MARKET CLOS

A CLO is a type of securitization where the ABS issued typically are collateralized by portions of tranches of senior, secured, commercial loans to borrowers that are of lower credit quality, or as to which there has been no third-party evaluation of the likelihood of timely payment of principal and interest. The *LSTA* case addresses a specific type of *CLO* known as an "open-market CLO," which the Circuit Court described as a CLO issuer that directly "acquire[s its] assets from, as the name implies, arms-length negotiations and trading on an open market."[16] In contrast, a "balance sheet CLO" securitizes loans that are already held by a single institution or its affiliates, which may have been either originated by that institution or its affiliates, or purchased by them for their portfolio.[17]

CLOs usually are organized and initiated by the CLO manager. A special purpose CLO-issuing entity is formed to warehouse the assets and ultimately to issue the CLO's ABS. The CLO manager engages an investment bank to provide structuring and placement services, and to assist in financing the acquisition of loans during the warehouse phase (*i.e.*, prior to the CLO's issuance of ABS backed by those loans). The CLO manager selects the loans to be securitized and causes the CLO-issuing entity to purchase them directly. After the terms of a CLO transaction, including investment guidelines, are agreed upon with key investors, and after the issuance of the ABS, the CLO manager usually has sole discretion to actively manage the asset portfolio in accordance with those guidelines, including conducting asset acquisitions and dispositions. The CLO manager usually earns management and performance fees for the management services it provides.

Open-Market CLO Managers as Sponsors

As described above, Section 15G of the Exchange Act imposes credit risk retention requirements on any "securitizer" of ABS, which the Agencies generally interpreted to mean the sponsor of the transaction. For open-market CLOs, the Agencies required the CLO manager to satisfy the risk retention requirements. In their view, a CLO manager generally acts as the sponsor of the CLO by selecting the commercial loans to be purchased by the issuing entity and managing the pool assets once deposited in the CLO structure. According to the Agencies, this constitutes an indirect transfer of the securitized assets by the CLO manager to the issuer.[18]

The LSTA and other commenters on the proposed rules had disagreed, asserting that open-market CLO managers are not "securitizers" and therefore are not subject to Section 15G of the Exchange Act. According to these commenters, under plain language of Section 15G, open-market CLO managers cannot "sell" or "transfer" the assets securitized through the CLO because they do not own, possess, or control the assets. Additionally, commenters asserted that an open-market CLO manager acts as an agent to the CLO-issuing entity in directing the purchase of assets. For this reason, it cannot sell or transfer the assets to a third party to meet

[13] *Id.* at Section 244.4.

[14] *Id.* at Section 244.12.

[15] *E.g.*, *id.* at Section 244.4(c).

[16] *LSTA*, 772 F.3d at 221 n.2.

[17] *Id.*

[18] Adopting Release, at 77,664.

the definition, because that would be equivalent to selling or transferring the assets to itself. According to these arguments, the use of "indirectly" in the definition of "securitizer" was intended to prevent the party that originates a loan from avoiding risk retention obligations by passing the loan through an associated intermediary that organized and initiated the securitization.[19]

THE HOLDING AND RATIONALE OF THE *LSTA* CASE

In the *LSTA* case, the LSTA reiterated the arguments that it and other commenters had made during the comment process for the credit risk retention rules. The District Court was not persuaded, and it granted summary judgment in the Agencies' favor, finding that they could reasonably read Section 15G to treat open-market CLO managers as "securitizers."[20]

The Circuit Court disagreed with the conclusion of the District Court, and reversed. The Circuit Court applied the "reasonableness" standard of *Chevron, USA, Inc. v. NRDC, Inc.*,[21] which holds that a reasonable agency interpretation of a statute within its purview will prevail.[22] However, according to the Circuit Court, in the case of open-market CLO managers the Agencies turned the statutory obligation to "retain" a credit risk into the obligation to "obtain" a credit risk, and "[e]ven under Chevron, . . . agencies only 'possess whatever degree of discretion [an] ambiguity allows.'"[23]

In order to "transfer" (and "retain") assets, a party first must have either possession of or control over those assets; it cannot itself "transfer" them by directing them to be transferred between two other independent parties.[24] The Circuit Court noted that "[t]he language does not seem to apply to a person or firm that causes [a special purpose vehicle], whose value belongs to the investors, to make an open-market purchase from wholly independent third parties."[25] Open-market CLO managers do not originate the commercial loans backing the ABS, nor do they or their affiliates hold them before their acquisition by the issuing entity. The issuing entity, using the warehouse lenders' or investors' money, purchases the loans on the open market at the manager's recommendation, solely for the purpose of securitizing them. Open-market CLO managers function similarly to mutual fund or other asset managers, in that they only give directions to the issuing entity, and their compensation and management fees are contingent on the performance of the asset pool.

According to the Circuit Court, in addition to "revers[ing] the apparent flow of the 'transfer,' the agencies' disregard of context [led] them to embrace a reading of 'transfer' that would include any third party who exerts some causal influence over a transaction."[26] This theoretically could lead to the imposition of risk retention requirements on a variety of other parties that obviously do not act in a sponsor capacity, such as brokers, lawyers, and non-CLO investment managers.[27]

The Circuit Court cited several prior cases holding, in other contexts, that the words "directly" and "indirectly" can modify the word "retain," but not completely erase its meaning. According to the Circuit Court:

> [These] adverbs were meant to assure that, despite often complicated array of affiliates, depositors, and [special purpose vehicles] that financial institutions use to create and sell [ABS], the credit retention rule would reach a transferor no matter how many intermediaries it used. But to be covered . . . , the party must actually be a transferor, relinquishing ownership or control of assets to an issuer.[28]

According to the Circuit Court, by interpreting "retain" as "obtain," the Agencies required open-market CLO managers to actually acquire investments that they had not acquired before, "necessitating significant amounts of capital that they may neither have nor have access to."[29] This result "seems too large a surprise to have been intended."[30]

---

19 *E.g.*, comment letter from Bram Smith, Executive Director, Loan Syndications and Trading Ass'n (Aug. 1, 2011).

20 *Loan Syndications & Trading Ass'n v. SEC*, 223 F. Supp. 3d 37, 54–59 (D.D.C. 2016).

21 467 U.S. 837 (1984).

22 *LSTA*, 882 F.3d at 222.

23 *Id.*, at 224 (*quoting City of Arlington v. FCC*, 569 U.S. 290, 296 (2013), *quoting Smiley v. Citibank (S.D.), N.A.*, 517 U.S. 735, 740–41 (1996).

24 *Id.*, at 223-24.

25 *Id.*, at 224.

26 *Id.*

27 *Id.*

28 *Id.*, at 225.

29 *Id.*

30 *Id.*, at 226.

POTENTIAL EXEMPTION OF OTHER SECURITIZATION STRUCTURES FROM RISK RETENTION

The Circuit Court acknowledged that the *LSTA* ruling may result in the CLO structure becoming more widespread in the structured finance industry, but concluded that "it is highly doubtful that their falling outside the reasonable coverage of the statute need be a cause of concern."[31] The Circuit Court accepted the LSTA's position that open-market CLO managers have "skin in the game" because of their compensation structure, that the purchase of pool assets in arms-length transactions means that the assets are likely less risky than those originated in an "originate to distribute" model, and the "superior incentives and relative transparency" reduce the risk that CLOs will generate the kind of decline in underwriting standards that characterized the recent financial crisis.[32]

The *LSTA* ruling also contained extensive discussion about whether the principles underlying the decision could extend to structures that differ more substantively from open-market CLOs.

In their arguments, the Agencies expressed concern that, were the LSTA to prevail, "any securitizer could 'evade risk retention by hiring a third-party manager to 'select' assets for purchase by the issuing entity that have been pre-approved by the sponsor."[33] This would entail the engagement of a supposedly third-party "manager" to sponsor a securitization without transferring assets, thus "creating 'a situation in which no party to a securitization can be found to be a 'securitizer' because the party that organizes the transaction and has the most influence over the quality of the securitized assets could avoid legally owning or possessing the assets."[34] The Circuit Court responded that if the third-party manager in this example is effectively acting as an agent of the owner of the assets, then the owner is simply transferring "through agents and intermediaries"[35] risk that it is already holding, and it is subject to the credit risk retention rules. In contrast, open-market CLO managers "act as independent contractors with investors rather than as agents of an originating financial institution."[36]

The Circuit Court specifically acknowledged that there may be other cases where "those 'organizing and initiating' the securitization do not do so 'by transferring' the assets to the issuer, while those that do transfer the assets are not the entities who organize or initiate the securitization in any meaningful way."[37] However, according to the Circuit Court, this is a legislative gap in the Dodd-Frank Act, which must be closed by legislative rather than regulatory action. The definition of "sponsor" cannot be stretched to include "those who do not . . . have a relationship to the assets such that one can reasonably say they 'transfer' the assets or could be required to 'retain' a portion of the assets' risk."[38]

Therefore, there may be other structures where those "organizing and initiating" the securitization do not do so by "transferring" the assets to the issuer, while those that do transfer the assets are not the entities who organize or initiate the securitization in any meaningful way. The question is, how broad is this universe of structures?

In analyzing any particular structure, it may be helpful to determine how closely it resembles the unique open-market CLO model. In an open-market CLO, the two parties to the asset transfer (the seller of assets and the purchaser, the special purpose issuing entity) generally are unrelated to the collateral manager that causes the transfer of the assets between those parties.[39] In contrast, in many other structures in which the sponsor is not directly in the chain of title to the pool assets, the sponsor directly or indirectly owns or controls the depositor, the equity in the issuing entity, the originator or seller of the assets, or some other entity that is in the chain of title of the securitized assets. This direct or indirect ownership or control relationship may be sufficient to conclude that these entities "have a relationship to the assets such that one can reasonably say that they 'transfer the assets or could be required to 'retain' a portion of the assets' risk."[40]

[31] *Id.*, at 228.

[32] *Id.*, at 228-29.

[33] *Id.*, at 226.

[34] *Id.*, at 228.

[35] *Id.*

[36] *Id.*

[37] *Id.*, at 226.

[38] *Id.*, at 227.

[39] An open-market CLO manager may own equity in the issuing entity during the warehouse phase, but this went unremarked by and did not seem to trouble the Circuit Court.

[40] *LSTA*, 882 F.3d at 227.

IMPLICATIONS FOR IDENTIFICATION OF THE SPONSOR

The *LSTA* case may also have implications for the identification of sponsors in more complex structures where risk retention is still required.

In a simple securitization structure, determining the identity of the sponsor that is required to retain risk is often straightforward. Consider, for example, an automobile retail contract securitization by a captive finance company of a manufacturer. In this scenario, the finance company is likely to have originated all the receivables, to service the receivables on an ongoing basis, to own the depositor, to select the receivables for the asset pool, to transfer the receivables through the depositor to the issuing entity, and to structure and control the securitization of those receivables through its employees. In these circumstances, the finance company clearly is the sponsor. It has the most significant ability to influence the quality of its securitization, it transfers the pool assets downstream into the securitization vehicle, it controls the securitization process, and it will likely have the financial capacity to fund the acquisition and long-term holding of the risk retention interest.

In a more complicated organization, where securitization roles are more dispersed within the group that acquires and securitizes receivables, the identity of the sponsor may be far less clear. For example, an investment fund group may invest in and securitize receivables (such as marketplace loans or private label residential mortgage loans) that were originated by and are serviced by unrelated third parties. The receivables may be acquired and held by multiple separate funds, each of which is managed by the same investment adviser, with assets selected and the securitization structured and managed by personnel housed at both the investment manager and at other entities within the fund group's corporate structure. The depositor may or may not be owned by the investment manager. Identifying a single entity as the sponsor in such an organization obviously can be quite difficult. Even if one can identify a single sponsor, that entity may not be the source of the securitized receivables, and may not be financially capable of acquiring or maintaining the required risk retention position. Assuming that risk retention is required for the securitization structure chosen, the identification of an appropriate sponsor may require a significant restructuring of roles and responsibilities among existing or even newly created entities to reach an appropriate result.

Based on the language of the credit risk retention rules themselves and on the statements made by the Agencies, many industry participants have used a multifactor test to identify the appropriate sponsor. Until the *LSTA* case, the most important factor generally was considered to be active underwriting or selection of the assets to be securitized. This factor is derived from the Agencies' statement that, "in order to qualify as a party that organizes and initiates a securitization transaction and, thus, as a . . . sponsor, the party must have actively participated in the organization and initiation activities that would be expected to impact the quality of the securitized assets underlying the asset-backed securitization transaction, typically through underwriting and/or asset selection."[41]

Another sponsorship factor that has been considered key is undertaking all required organizational and initiation activities through its own personnel, rather than at the direction of a third party or acting solely as a "rubber stamp." This factor is based on the Agencies' assertion that an entity that purchases assets at the direction of an independent investment manager, pre-approves the purchase of assets before their selection, or approves the purchase of assets after the fact, would not qualify because "negotiation of underwriting criteria or asset selection criteria or merely acting as a "rubber stamp" for decisions made by other transaction parties does not sufficiently distinguish passive investment from the level of active participation expected of a sponsor . . . ."[42]

Other historically significant functions of a sponsor that often have been considered to help reach a conclusion that an entity "organizes and initiates" a securitization include:

- ownership of the equity of the depositor;
- formation of the issuing entity;
- selection of the underwriter, initial purchaser, or placement agent for the securitization and negotiation of the related contractual arrangements;
- structuring the securitization, in cooperation with underwriter, initial purchaser, or placement agent;
- engagement of issuer's counsel and accountants;
- selection of and contracting with any third-party due diligence service providers (other than those engaged by the underwriter, initial purchaser, or placement agent);

[41] Adopting Release, at 77,609.

[42] *Id*., at 77,609.

- performance of all due diligence not performed by the underwriter, initial purchaser, or placement agent and hired third-party providers;
- drafting, together with issuer's counsel, the transaction documents and the disclosure documents;
- servicing the assets to the extent that they are not serviced by third-party servicers and overseeing any servicing undertaken by third-party servicers;
- selection and negotiation of the terms of engagement of the transaction parties on behalf of the issuer, including the trustees, custodians, servicers, and rating agencies;
- payment of the costs and expenses of the transaction;
- providing representations and warranties with respect to the pool assets, to the extent they are not being given by third-party originators or other appropriate third parties; and
- providing the required indemnities to the underwriter, initial purchaser, or placement agent regarding the prospectus or private placement memorandum, and other disclosure documents.

Finally, there is the explicit requirement of the definition of "sponsor" addressed in the *LSTA* case: sale or transfer of the pool assets, either directly or indirectly, including through an affiliate, to the issuing entity. Prior to the *LSTA* case, this factor often was given shorter shrift than the prior factors, based largely on the Agencies' conclusion that it is not necessary for a CLO collateral manager ever to have legally owned or possessed the pool assets to be deemed to have "transferred" them to the issuing entity. The *LSTA* case eliminated that rationale, so an entity's connection with the pool assets now takes on an increased importance in the sponsorship analysis.

Post-*LSTA*, an entity that, like an open-market CLO manager, is wholly independent from the seller of pool assets and the issuing entity, is unlikely to be appropriately identified as a sponsor. However, in many other structures in which the identified sponsor is not in the direct chain of title to the assets, that entity may have a significant ownership interest in or control over an entity that is in the chain of title, such as the depositor, the issuing entity, or the originator or seller of the assets. In these situations, that entity may still be appropriately designated as a sponsor of the securitization because it is transferring risk that it already holds "through agents and intermediaries."

CONCLUSION

Open-market CLO managers are no longer required to acquire and hold risk retention in open-market CLO transactions. Open-market CLO managers who wish to avail themselves of this change should carefully consider all implications of ceasing to hold risk retention. For both existing transactions and future deals, CLO managers should consider the possible market impact of no longer holding risk retention. In addition, a decision as to whether to continue to hold risk retention interests issued in prior transactions may be impacted by the effect of the risk retention disclosures and securitization agreements for those deals.

Sponsors in other securitization structures where those "organizing and initiating" the securitization do not do so by "transferring" the assets to the issuer, while those that do transfer the assets do not undertake meaningful activities to organize or initiate the securitization, should consider carefully their next steps. Among other things, they should consider whether they need to take additional actions if they wish to rely on the ruling in the *LSTA* case.

Sponsors in securitization structures that do not directly own or possess the pool assets also should carefully consider the impact of the *LSTA* case. However, they may not ultimately reach a different sponsorship conclusion if they have an ownership interest in or control over an entity that is in the assets' chain of title, such as the depositor, the issuing entity, or the originator or seller of the assets. ■