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Court Rejects Application of Risk Retention Rules to CLOs

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The Ruling

On 9 February in an appeal brought by the LSTA, the United States Court of Appeals for the District of Columbia ruled that CLO managers of "open-market CLOs" (described in the ruling as CLOs where assets are acquired from "arms-length negotiations and trading on an open market") are not subject to the risk retention requirements of the Dodd-Frank Act (the "Act").

The judgement turns on the court's interpretation of the requirement of the Act, which directs the agencies to issue 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." (emphasis added).

The court held that the terms *retain* and *transfer* should be interpreted in accordance with their ordinary or natural meaning. The court said that "In their ordinary meaning, words directing that one who "transfers" an asset must "retain" some interest in the associated risk refer to an entity that at some point possesses or owns the asset it is securitizing and therefore *continue* to hold some portion of those assets or the credit risk those assets represent-that is, the entity is in a position to limit the scope of a transaction so that it transfers away less than all of the asset's credit risk".

The court could not see how the language of the Act sustains the rule's application to managers of open-market CLOs.

Timing and effectiveness of the ruling

The applicable U.S. governmental agencies will have the right to (a) petition for en banc review of the decision by the entire court or (b) file a petition for certiorari requesting the case to be heard by the Supreme Court. The U.S. Risk Retention requirements will remain in effect until a new judgment is entered in the U.S. district court in which the case was originally filed, which will not occur until the DC Circuit Court issues a mandate to the district court to do so (which will occur within one week after the deadline for a petition for rehearing has passed). That will not occur if a petition for rehearing is filed; the deadline for a rehearing is 45 days from the issuance of the decision by the DC Circuit Court. If a petition for rehearing is filed, the DC Circuit Court will not issue a mandate to the district court to issue such judgment during the consideration of the petition. If the petition for rehearing is denied, the mandate from the DC Circuit Court must be issued within a week from such denial unless a motion to stay the mandate is also filed pending a petition for writ of certiorari to the United States Supreme Court. If the motion to stay the mandate is granted and a petition for a writ of certiorari is filed in the United States Supreme Court, the stay will remain in effect until the Supreme Court's work on the matter (either through a denial of certiorari or a ruling on the merits) is complete.

Implications for CLOs seeking to comply with the EU Risk retention Rules

Most U.S. CLOs and many European CLOs seeking to satisfy the EU risk retention requirements do so by the retention holder (typically the CLO manager) seeking to qualify as an "originator".

For the purposes of the CRR, an "originator" is defined as:

> "an entity which: (a) itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or (b) purchases a third party's exposures for its own account and then securitises them"[1].

Limb (a) relates to primary market origination, requiring that the originator (or a related entity thereto) is involved in negotiating and or approval of the original loan documentation;

Limb (b) relates to secondary market origination, requiring that the originator itself has purchased the asset 'for its own account' prior to selling it to a securitisation portfolio. The term 'for its own account' is not defined in the CRR. However, it is generally accepted that this requires that the originator must actually hold the asset on its own balance sheet and be exposed to the credit risk of the asset, before selling to a securitization.

Originator retention under limb (b) is typically the method used by U.S. CLO managers seeking to have their deals comply with the EU risk retention requirements.

The question arises whether the ruling in the LSTA case might require U.S. CLO managers that structure their transactions to comply with EU risk retention requirements to continue to comply with the U.S. risk retention requirements. To qualify as a limb (b) originator it is necessary for the retention holder to purchase assets and (after an appropriate seasoning period) transfer the assets to the CLO issuer.

On the face of it, collateral managers may conclude that such a transfer requires them to comply with the U.S. risk retention requirements notwithstanding the judgement in the LSTA case. This suggests that structuring U.S. CLOs to enable placement of securities with EU investors by complying with the EU risk retention requirements may become less attractive to U.S. CLO managers.

As far as EU CLOs are concerned, they will continue to seek to satisfy the EU risk retention requirements. Those that seek to comply through the "sponsor" route will be able to rely on the ruling in the LSTA case and be able to place securities with U.S. investors without needing to comply with the U.S. risk retention rules. However those EU CLOs which seek to comply with the EU risk retention requirements through the "originator" route may either have to (a) rely on the U.S. foreign safe harbour exemption (less than 10% placement with U.S. investors) or (b) hold the retention in compliance with the U.S. risk retention rules. (this should not impose any additional retention obligation as satisfaction of the EU risk retention requirements should satisfy the U.S. risk retention rules).

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[1] [1] Article 4(1)(13) of the CRR