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Risk Retention Rule Overturned for Open-Market CLO Managers: Implications for Managers and Investors

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On February 9, 2018, a three-judge panel of the United States Court of Appeals for the District of Columbia Circuit (the "D.C. Circuit Court") invalidated the credit risk retention rule, 79 Fed. Reg. 77,601 (Dec. 24, 2014) (the "Risk Retention Rule"), as it applies to the collateral managers of open-market collateralized loan obligation transactions, or CLOs. Under the Risk Retention Rule, CLO collateral managers are currently required to purchase notes representing at least 5% of the credit risk associated with each CLO that they structure.

The Risk Retention Rule was adopted in 2014 pursuant to Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which requires any "securitizer" of asset-backed securities to retain at least 5% of the credit risk associated with the assets collateralizing such securities. In 2016, in response to a lawsuit filed by the Loan Syndications and Trading Association, a District of Columbia district court held that the Risk Retention Rule was a valid exercise of federal agency authority and that collateral managers of open-market CLOs – the most typical CLO arrangement, in which assets are purchased at arm's length transactions on the open market rather than being acquired from an entity involved in the structuring of the CLO – could appropriately be considered "securitizers" under Section 941. *Loan Syndications & Trading Ass'n v. SEC*, 223 F. Supp. 3d 37 (D.D.C. Dec. 22, 2016).

Last Friday, the D.C. Circuit Court disagreed, ruling that collateral managers of open-market CLOs are not "securitizers" under the Dodd-Frank Act and are accordingly not subject to the requirements of the Risk Retention Rule. *See* -- F.3d --, 2018 WL 798290 (D.C. Cir. Feb. 9, 2018). The D.C. Circuit Court emphasized that, whereas the Dodd-Frank Act defines a "securitizer" as, among other things, an entity that *transfers* assets to an issuer of asset-backed securities, managers of open-market CLOs typically never own the assets that collateralize a CLO, and thus cannot *transfer* them to the issuer. Instead, the manager acts as an agent of the issuer in selecting the assets to be purchased by the issuer from third parties. The D.C. Circuit Court thus invalidated the Risk Retention Rule insofar as it applies to managers of open-market CLOs, and remanded the case to the D.C. District Court with instructions to "vacate the Risk Retention Rule insofar as it applies to open-market CLO managers." *Id.* at *7.

The D.C. Circuit Court's decision is subject to possible rehearing en banc by the entire D.C. Circuit Court, or even a petition for certiorari to the U.S. Supreme Court. The federal agencies defending the lawsuit have until March 26, 2018 to seek rehearing, absent any extension. And, although it is impossible to say at this point whether those agencies will seek rehearing, any effort to overturn the D.C. Circuit Court's decision faces significant headwinds. For one, the Trump Administration has publicly stated that it is in favor of exempting CLO managers from the Risk Retention Rule. *See* U.S. Dep't of Treasury, *Report to President Donald J. Trump: Executive Order 13772 on Core Principles for Regulating the U.S. Financial System, available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf, at 102-04. En banc review by the D.C. Circuit Court is also extraordinarily rare. And given that challenges to agency action are typically (though not always) addressed by the D.C. Circuit Court, it is relatively unlikely that a different Circuit Court will issue a conflicting opinion.

Absent a grant of further review by the D.C. Circuit Court or U.S. Supreme Court in the coming months, market participants can expect the D.C. District Court to issue an order vacating the Risk Retention Rule as it applies to open-market CLO managers. Over the long term, the vacating of the Risk Retention Rule as it applies to open-market CLO managers should give a boost to new CLO issuance and to refinancing activity, as managers in general will no longer need to source capital to invest in each CLO that they set up or refinance. Investment managers involved in other types of securitizations may also benefit. Although the decision was limited to open-market CLOs, the court's interpretation of the term "securitizer" suggests that the Risk Retention Rule may not apply to investment managers whose role is limited to negotiating the terms of the relevant securitization and selecting the assets to be acquired by the issuing entity.

The near-term implications of the D.C. Circuit's decision are less clear, since uncertainty over the rule's validity and application may lead some managers to hold off on CLO issuances pending the issuance of an order vacating the rule as it applies to such CLOs. In addition, absent further litigation or clarification by the relevant federal agencies, open-market CLO managers that originate or hold assets in an effort to comply with EU risk retention requirements may continue to be subject to the Risk Retention Rule in the U.S. as well.

For existing CLO risk retention investments, and the debt and equity financing arrangements that have been put in place to finance them, the impact of the decision will depend on the terms of relevant transaction documents. For example, many collateral managers that have established private investment funds to finance their risk retention investments, and investors in such funds, should consult the relevant fund documents to determine whether the investors will continue to be required to fund their commitments to such funds if the Risk Retention Rule no longer applies or whether, conversely, the manager or the investors have the right to cancel such arrangements.

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