WHITE & CASE

Client**Alert**

Capital Markets

December 2013

CLO Risk Retention: Late-Season Predictions

For college football fans, the regular season is drawing to an end, which means it is time for the pundits to start breaking out the bowl game predictions. Of course the experts never get it fully correct (who could have predicted the wild outcomes this past weekend?), but looking into the crystal ball is at least entertaining for the rest of us.

While our topic—risk retention—is not so lighthearted and fun, we thought throwing out a prediction now that the comment period has passed would be slightly more exciting than yet another recitation of the proposed rules under the Dodd-Frank Wall Street and Consumer Protection Act (the "Dodd-Frank Act").[1] Although nobody can predict with certainty how the regulators proposing the rules (the "Agencies")[2] will ultimately act, we believe that rationality will carry the day.

Overview of Key Factors

Notwithstanding the strong regulatory climate, we believe the Agencies will offer the managed collateralized loan obligation ("CLO")[3] industry a workable approach to risk retention when they issue their final rules. Five years out from the credit crisis, several factors weigh against CLOs being subject to the same risk retention regime as other asset-backed securities:

- **Litigation Risk.** The litigation risk to the Agencies is real and binary. While the Agencies asserted their right to impose risk retention on CLO investment advisor, there are strong legal arguments to the contrary. Ultimately, the scope of the Agencies' authority will be decided by the courts, and it only takes one judge's decision against the Agencies to significantly undermine that authority.

1 The final risk retention rules will be part of the final implementation of Section 941(b) of the Dodd-Frank Act, codified as Section 15G of the Securities Exchange Act of 1934 (as amended, the "Exchange Act"). The Agencies issued proposals of these rules in 2011 (76 Fed. Reg. 83 (March 29, 2011): the "Initial Proposal") and again in 2013 (78 Fed. Reg. 57928 (September 20, 2013): the "Re-Proposal").

2 Office of the Comptroller of the Currency of the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Department of Housing and Urban Development and the Federal Housing Finance Agency.

3 For the purposes of this article, a "CLO" refers to a broadly syndicated collateralized loan obligation vehicle that is managed by an independent asset manager and acquires its portfolio of assets in arm's-length transactions.

If you have questions or comments regarding this Alert, please contact one of the lawyers listed below:

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

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

Patrick Boyle
Associate, New York
+ 1 212 819 8610
pboyle@whitecase.com

James Fogarty
Associate, New York
+ 1 212 819 8333
jfogarty@whitecase.com

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

- **CLOs Performed.** While not determinative, performance truly matters; it offers hard evidence upon which to base an informed viewpoint. Data on CLO performance is now available across several years and through several credit cycles, including the financial crisis. The positive performance data demonstrates that the CLO market has been able to self-regulate to a much greater extent than other asset-backed security markets.

- **The Agencies Know More**. With all the noise around the Dodd-Frank Act early on, the Agencies had very little time to understand that while a "loan" may be a "debt", a CLO is not a CDO.[4] Having had more time to obtain and digest information showing that CLOs and their underlying assets are more transparent than the transactions that Congress intended to regulate, the Agencies can feel confident allowing the CLO market to continue largely intact.

- **The Unknown Unknowns.** Many have speculated about the negative consequences that will ensue if the final risk retention rules cause a significant shrinking of the managed CLO industry. The practical reality is that nobody knows exactly what will happen if the CLO industry shrinks or is shut down. The Agencies face a difficult cost-benefit analysis: Is asserting regulatory authority under the weak statutory wording of the Dodd-Frank Act and possibly shutting off an important source of credit in a weak economy worth the risk—especially when the specific market performed well during and after the financial crisis?

Does this mean that the managed CLO industry is somehow free from the Dodd-Frank Act's reach? Not exactly. While we feel it would be difficult for the Agencies to stake out a bold position threatening the availability of credit, we also believe there is room for tailored regulation. We predict that the Agencies will assert broad regulatory authority over the CLO industry while providing a significant exemption, exception or adjustment for managed CLOs. This approach allows regulators to maintain authority, set precedent for that authority and, working within the confines of the Dodd-Frank Act, provide the managed CLO industry a regulatory framework it can willingly accept without legal challenge.

1. A Legal Focus—the Litigation Option

One underlying premise of our fortunetelling is that if the Agencies issue broad regulation and impose risk retention on CLO investment advisor, they face a significant probability of legal challenge to their statutory authority. Whether the litigation occurs depends both on the existence of a credible legal challenge and the existence of a plaintiff willing to make the challenge; we discuss both below. We also note that a litigation loss for the Agencies brings a severe consequence: a practical inability to impose risk retention on CLOs and similar financial instruments.

The Fundamental Problem With the Statute and Legislative Analysis Under *Chevron*

As we have addressed at length previously, the CLO problem begins with the poorly drafted, ambiguous Dodd-Frank Act that the Agencies are charged with interpreting and using as the basis for logical and effective regulation.[5] The leading Supreme Court decision for analyzing an executive agency's interpretation of a statute is *Chevron U.S.A. Inc. v. Natural Resources Def. Council*, Inc., 467 U.S. 837 (1984) (*"Chevron"*). A court applying a *Chevron* analysis will ask, as a threshold matter, whether Congress has spoken to the precise question at issue.[6] If a statute is silent or ambiguous with respect to the specific issue, a court will then ask whether the agency's proposal is based on a permissible construction of the statute.[7]

A brief analysis of certain of the Dodd-Frank Act's definitions under the *Chevron* test reveals the extent of the ambiguity of the statute's language. On one hand, the statute clearly delegates authority to the Agencies to prescribe rules requiring risk retention of securitizers in asset-backed securities transactions. On the other hand, the definition of securitizer specifically refers to the party that both organizes and initiates the asset-backed securities transaction and transfers assets, directly or indirectly, to the issuer.[8] For asset-backed securities transactions where sponsors either originate assets or acquire an ownership in assets and then sell or contribute them to an issuer, it appears evident that there is a "securitizer" and Congress has clearly spoken. However,

4 For an in-depth comparison of CDOs and CLOs, see Annex A of the *White & Case LLP Comment Letter*, Submitted October 30, 2013 (available at http://www.sec.gov/comments/s7-14-11/s71411-509.pdf) ("W&C Comment Letter #2").

5 Our plain-language analysis of the relevant definitions in the Dodd-Frank Act and Section 15G of the Securities Act can be read in full at: *White & Case LLP April 2011 Client Alert, Risk Retention for Managed CLOs: Are Regulators Overstepping their Authority?* (available at www.whitecase.com) and *White & Case LLP Comment Letter*, submitted June 10, 2011 (available at http://www.sec.gov/comments/s7-14-11/s71411-134.pdf).

6 Chevron at 842-843.

7 Id.

8 The Dodd-Frank Act defines a securitizer, in part, as "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." Dodd-Frank Act §941(b) (as codified at §15G(a)(3) of the Securities Exchange Act).

a CLO's investment adviser never owns assets in which to retain an interest and, therefore, cannot sell or contribute assets to the issuer. Congress's intent towards such a transaction—one without a specifically defined securitizer—is unspecified in the statute.

Courts may turn to the legislative history to better understand Congress's intent. In this case, such a review is largely uninstructive; the statute's legislative history reveals Congress's deliberate intent to regulate originate-to-distribute securitizations and to provide more transparency in securitizations. CLOs do not clearly fall into the originate-to-distribute model described in the legislative history, nor do CLOs contain the opacity issues and incentive misalignment that plague other securitization structures.

As a threshold matter, the Agencies' interpretation faces a credible legal challenge. Many lawyers, across different organizations, have reviewed the Agencies' two proposals and have reached the same conclusion. These groups, including the Agencies' own lawyers, have acknowledged that the plain language of the statute does not include a CLO investment adviser as a risk retainer. Without a foundation in the plain language of the statute, the Agencies must construct a permissible reading of the statute that can impose risk retention on CLO investment advisor.

In the Re-Proposal, the Agencies addressed the plain-language challenge by asserting that an investment adviser "indirectly" transfers assets to the issuer by selecting assets for the issuer to purchase. While the Agencies could, and would be compelled to, make that argument to a court, we believe that the position is questionable. Legal and industry commenters widely believe that the word "indirectly" was not meant to modify the requirement that a person have some economic interest in the assets being transferred, especially given the plain meaning of risk retention and the Congressional focus on the originate-to-distribute model.

While the Agencies are entitled to deference in their statutory interpretation, they have a difficult narrative for a court. Indeed, numerous commentators filed letters challenging the Agencies' position.[9] In light of this opposition, it is clear that the Agencies face a very credible challenge to their statutory interpretation if they assert that investment advisor to CLOs must retain significant risk in their managed CLOs.

The Willing Plaintiff

In addition to a credible legal argument, there must also be an appropriate party willing to act as plaintiff and challenge the Agencies' position. Under the current risk retention regime set forth in the Re-Proposal, investment advisor who do not have the capital required to invest in a CLO are highly incentivized to challenge the law. In essence, a risk retention regime in the format presented in the Re-Proposal could force CLO investment advisor into a "bet-the-company" litigation. With a credible argument to be made and their business lines at risk, investment advisor are likely to find litigation a worthwhile option.

Investment advisor may not be alone in challenging the risk retention regime, as industry trade groups have also taken up the legal argument against the Agencies' proposals.[10] Therefore, unless the Agencies craft an exception, adjustment or exception for CLO risk retention, we expect to see one or more challenges to regulatory authority brought before the courts.

The Impact of a Litigation Loss

What if a court held that the Agencies did overstep their authority by applying the risk retention rules to CLOs? Such an outcome could affect not only CLOs, but potentially other classes of asset-backed securities as well. In other words, a court ruling adverse to the Agencies carries the risk that managed CLOs would not be subject to risk retention in any form, as well as other unknown risks, which may be even more crippling to the Agencies' ability to impose risk retention. We believe the Agencies understand these dynamics and will issue a more workable alternative for CLOs. In doing so, the Agencies would not only avoid a court fight, but would retain oversight over not only CLOs but other primary targets of the risk retention legislation, such as CDOs.

9 A complete list of and the full text of the comment letters submitted to the SEC are available at http://www.sec.gov/comments/s7-14-11/s71411.shtml.

10 See, for example, *The Loan Syndications and Trading Association Comment Letter*, submitted October 30, 2013 (available at http://www.sec.gov/comments/s7-14-11/s71411-477.pdf); the *Structured Finance Industry Group Comment Letter*, submitted October 30, 2013 (available at http://www.sec.gov/comments/s7-14-11/s71411-488.pdf); and *The American Bar Association Comment Letter*, submitted November 12, 2013 (available at http://www.sec.gov/comments/s7-14-11/s71411-496.pdf).

2. Beyond the Legal Challenge

Aside from avoiding the risks of litigation, as noted in the overview, there are several other reasons why the Agencies would elect to modify the proposed risk retention framework to provide something workable for CLOs.

CLO Performance

With the passage of time, originate-to-distribute consumer debt securitizations have been identified as the primary source of problems in the securitization market leading into the financial crisis. For example, poor CDO performance has its origins in the underlying residential mortgage bonds, which were backed by mortgages originated by institutions that did not retain any risk of repayment. In comparison, the assets backing a CLO are syndicated bank loans that have undergone diligence by the credit committees of the banks making the loans and are frequently retained, at least in part, by the banks that originally make such loans. The higher origination standards of such assets and the related transparency have translated to better performance as compared to the mortgages originated for distribution.

The positive performance of the CLO securities could steal a bit of the Agencies' thunder. Do investors need protection from a security that performed relatively well during the credit crisis? In addition, the positive performance of CLOs also supports the theory (with hindsight of course) that Congress intended to regulate other types of securitizations, where the performance record is much worse. When making a cost-benefit analysis of whether to risk a legal battle, the Agencies' resolve may be weakened by the facts we now know about the CLO market.

The Agencies Know More

When the Agencies drafted the Initial Proposal and the Re-Proposal, they correctly focused their efforts on where the problems in the financial crisis were the greatest. Nuances of the specific asset types were lost during the Agencies' gargantuan task of producing coherent regulation. However, since the Initial Proposal and subsequent Re-Proposal, the Agencies have had the time and opportunity to digest a great deal of information provided by the CLO industry, including all the comment letters to the Initial Proposal and the Re-Proposal, and should now be in a much better position to distinguish a CLO securitization from other types of securitization. Becoming educated on the differences between the types of securitizations in the market allows the Agencies to understand important technical distinctions which should make them comfortable that exemptions, exceptions and adjustments are warranted for CLOs under the Dodd-Frank Act.

The Unknown Unknowns

Perhaps the greatest risks in regulating CLOs are the unknowns. While regulators almost always face this uncertainty in proposing new rules, often the risk comes in the face of a more noble purpose. Here, the risk comes with little, if any, upside.

CLOs are a significant source of funding for corporate borrowers that drive the US economy. Without CLOs to purchase commercial loans, will these companies see a significant increase to their cost of funding, assuming credit even remains available to them? If CLOs are unavailable to purchase commercial loans, it seems likely that the availability of credit will suffer. To what extent will it suffer? It is difficult to say with certainty, but there is a risk of consequences detrimental to corporate borrowers and thus to the economy as a whole.

The Agencies acknowledged that the standard risk retention option will have unwelcome effects on CLO issuance and competition.[11] Congress requires the Agencies to perform a cost-benefit analysis to support their rules and, based on the premise that CLOs do not suffer from the same problems endemic to originate-to-distribute securitizations, the Agencies may have difficulty justifying that the benefits of the regulation as currently proposed outweigh the costs.

3. Moving Forward: Regulation and Exemption, Exception or Adjustment

Under the currently proposed regulatory scheme, the risks are high for both the regulators and the regulated. On one hand, the Agencies have a strong desire to fulfill the obligation delegated to them under the Dodd-Frank Act and impose risk retention with respect to each class of asset-backed security. On the other hand, CLO investment advisor without significant capital face a severe limitation upon, or even elimination of, their businesses. In our view, the natural solution is to gravitate toward a lower-risk solution for both sides.

11 See Re-Proposal, at 57962.

Following two rounds of proposed rules and comment letters, we believe that the foundation for a workable solution for CLOs has already been laid out for the Agencies. First, the Agencies needed to recognize the challenges posed by applying risk retention to CLOs, and we believe they did so in the Re-Proposal. By defending their interpretation of the statute, the Agencies acknowledged the risk that their position could be challenged. Rather than pursue that risky path, the Agencies may now conclude that CLOs are distinct from originate-to-distribute securitizations such as CDOs and allow for an alternative solution for CLOs. The Agencies already started down this path in the Re-Proposal when they suggested a separate risk retention regime for CLOs, even if the regime as proposed was not viable.

We believe the Agencies will take this last step when they issue the forthcoming final rules, and that it will come in the form of a revised risk retention alternative for CLOs. Using the tools provided in the Dodd-Frank Act, that alternative could come in the form of an exemption, exception or amendment.[12] By taking this path, the Agencies will parry the risk of litigation while also maintaining CLOs under their regulatory umbrella. Rules adopted today may always be amended in the future, and it will be significantly more difficult for the CLO industry to challenge regulatory authority following years of precedential oversight. Whether or not the final rule includes an exception for CLOs or a modified form of risk retention as proposed by many of the industry commenters, if the Agencies can come up with a workable regulatory framework, they and the market will each be able to claim a successful outcome.

For the Agencies, a victory is maintaining the ability to regulate the CLO market in the event that the market is not sufficiently self-regulated. For the CLO investment advisor, maintaining their ability to run viable businesses will also be a significant victory. We are looking for a win-win. A bowl game for everyone—just like college football.

12 See *White & Case Comment Letter #2*.