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U.S. RISK RETENTION RULES: WHAT CONSTITUTES AN OPEN-MARKET CLO?

The authors discuss the LSTA case and argue that a new CLO that would otherwise qualify as an open-market CLO should not be deemed a balance-sheet CLO solely because it acquired certain assets from an existing account rather than in open-market transactions. They close with five factors that should make it more likely for a new CLO to qualify as open-market.

By Deborah Festa and Andrew Keller *

On February 9, 2018, the U.S. Court of Appeals for the D.C. Circuit issued a decision holding that the U.S. Risk Retention Rules¹ do not apply to managers of open-market CLOs (the “LSTA Case”). As a result, collateral managers of open-market CLOs no longer need to retain (or cause any of their affiliates to retain) a 5% interest in the credit risk of the CLOs that they manage. The D.C.

Circuit, however, did not discuss in detail the parameters of what constitutes an open-market CLO compared with a balance sheet CLO. There is more room for uncertainty here than may originally appear. In transactions where a CLO issuer (“New CLO”) acquires assets not solely on the open market, but also from an existing CLO, warehouse vehicle, investment fund, or separately managed account (“Existing Account”) such New CLO could be deemed a balance sheet CLO and therefore its manager would need to retain a Required Retention Interest (as defined below) under the Risk Retention Rules. This article will discuss and analyze in what circumstances a New CLO that would otherwise qualify as an open-market CLO may be deemed to be a balance sheet CLO as a result of having acquired some of its assets from an Existing Account.

¹ The final rules published by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Department of Housing and Urban Development, Federal Housing Finance Agency, Office of the Comptroller of the Currency and Securities and Exchange Commission (collectively, the “Agencies”) entitled “Credit Risk Retention” on December 24, 2014, implementing the requirements of Section 941 of the Dodd-Frank Act, codified at 17 C.F.R. Part 246 (the “Risk Retention Rules” or the “Rules”).

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