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.*

INSIDE THIS ISSUE