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Securities Regulation Daily Wrap Up, TOP STORY—D.D.C.: 'Skin in the game' rules for CLOs upheld, (Dec. 27, 2016)

Securities Regulation Daily Wrap Up

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By Mark S. Nelson, J.D.

A D.C. District Court judge has upheld the SEC's and federal banking agencies' final joint credit risk retention rules, saying the agencies' implementation of these Dodd-Frank Act provisions met the requirements of the Administrative Procedure Act and were entitled to *Chevron* deference. The petition for review challenging the agencies' definition of "securitizer" was originally filed in the D.C. Circuit, but that court determined it lacked jurisdiction and instead transferred the case to the district court. Briefs completed in the circuit court formed the basis for the district court's cross-summary judgment decision issued two days before the December 24, 2016 compliance date (*The Loan Syndications and Trading Association v. SEC*, December 22, 2016, Walton, R.).

Congress enacted Dodd-Frank Act Section 941 to amend the Exchange Act in order to address asset-backed securities practices that, at least partly, contributed to the Great Recession. With respect to collateralized loan obligations, a subset of collateralized debt obligations, the SEC, along five other federal banking agencies, adopted final credit risk retention rules that did not exempt open market CLOs. These CLOs securitize assets bought on the secondary market (as compared to balance sheet CLOs, which securitize assets held by one institution). The LSTA claimed the final rules stretched the definition of "securitizer," inaptly used fair value in calculating risk retention, and failed to provide exemptive relief.

"Securitizer" includes CLOs. As an initial matter, the court determined that *Chevron* applies to the agencies' interpretation of "securitizer" despite the LSTA's objections and D.C. Circuit law worries because the circuit precedent cited allows for *Chevron* analysis where multiple agencies with "overlapping expertise" jointly adopt rules and Congress expected those agencies to "speak with the force of law." Put another way, the agencies here would speak as one in a single rulemaking. That conclusion led to an application of the *Chevron* two-step analysis that ultimately persuaded the court to uphold the agencies' definition of "securitizer."

Judge Walton first held that *Chevron* step one was satisfied because the Dodd-Frank Act provision at issue was either silent or ambiguous. The court noted the broad statutory delegation of authority to regulators as exemplified by the use of key phrases in the statute: "directly or indirectly;" the presence of the disjunctive "or;" and the general purpose of the Dodd-Frank Act in seeking to prevent a recurrence of market practices that led to the Great Recession. The court also noted the similarity between an old definition of "sponsor" and the new definition of "securitizer," which it said further backed the agencies' view.

The LSTA had argued that the Dodd-Frank Act sought to curb practices associated with the originate-to-distribute model of securitization and not practices associated with open market CLOs. Commenters on the proposed rules noted that the latter types of CLOs were more transparent, earned performance fees, and had other significant differences from loans more closely tied to the Great Recession. But the final rules rejected this view and instead found leveraged loans, including CLOs, to be much more akin to loans that typically use the originate-to-distribute model.

The LSTA also had argued that the statutory term "transfer" should be read to exclude CLO mangers, who act as agents, but do not own or possess the assets they recommend to CLO issuers. But the court instead observed that a "concept" of "indirect transfer" without ownership better explains ties between different parts of the statute regarding "selling or transferring assets" and the phrase "either directly or indirectly." Also, the court said Congress could have explicitly exempted CLO mangers if it had wanted to.

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Chevron's step two likewise tipped in favor of the agencies. In concluding that the final rules reasonably interpreted the Dodd-Frank Act, the court found the statutory definition of "securitizer" did not contain extraneous text merely because the definition could be met by reference to its different prongs. Moreover, the court agreed with the agencies that open market CLO managers are in the best position to monitor assets for risk while reiterating its doubts about the LSTA's "ownership" theory.

Fair value component. The LSTA also saw a problem with the agencies' use of fair value in determining risk retention. The Dodd-Frank Act requires regulators to adopt rules that require securitizers "…to retain an economic interest in a portion of the credit risk…" The LSTA read this language as being focused on "credit risk" and barring the use of fair value. The agencies instead devised vertical, horizontal, and combined methods of risk retention. While the LSTA and the agencies agreed that the vertical mode was appropriate, they were at odds over the horizontal residual method, which incorporated the challenged fair value calculation.

The court concluded that the agencies' had sufficiently mulled the available options and reasonably adopted the horizontal method incorporating fair value. That finding was bolstered by the lack of a statutory definition of "credit risk" and judicial "reluctan[ce]" to presume the agencies were barred from adopting solutions on which Congress was silent. The court explained that the vertical option was set exactly at the minimum five percent required risk retention, while the non-mandatory horizontal and combination options provided flexibility consistent with market practices.

Lack of exemption. The LSTA further argued that the agencies' had erred by not exempting open market CLO managers. The Dodd-Frank Act allows the agencies to jointly exempt certain market participants if doing so will "ensure high quality underwriting standards" and "encourage appropriate risk taking management practices."

The court concluded that the agencies' followed their statutory directive and reasonably explained the final rules when they rejected industry requests for exemptions based on the inherent features of CLOs. Moreover, the court, citing portions of the D.C. Circuit's conflict minerals decision (see last paragraph at page 16 describing the SEC's Congressional mandate) noted that the agencies had sufficiently considered the costs and benefits of not including an exemption for CLOs. The case disputing the SEC's conflict minerals rule had a protracted history in the D.C. Circuit and, as the district court noted, was partially overruled (see page 8) by a later decision in a case against a different federal agency.

The case is No. 16-652.

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