Congressional Research Service
Informing the legislative debate since 1914

Legal Sidebar

The Half Trillion Dollar Ruling: Latest Dodd-Frank Case Narrows "Skin-in-the-Game" Rule

February 14, 2018

Last week, the U.S. Court of Appeals for the D.C. Circuit (D.C. Circuit) held that the Dodd-Frank Wall Street Reform and Consumer Protection Act's (Dodd-Frank's) risk-retention requirements—which one of the bill's co-authors has described as "the single most important part" of the Act—do not apply to investment managers of collateralized loan obligations (CLOs). The total value of outstanding CLOs is estimated to be roughly $500 billion, and CLO managers represent the largest buyers of leveraged loans in the United States. The D.C. Circuit held that CLO managers do not qualify as "securitizers" within the meaning of Dodd-Frank's risk-retention provision and accordingly invalidated the risk-retention rules for CLO managers adopted by the Securities and Exchange Commission (SEC) and the Federal Reserve Board of Governors (Federal Reserve). This Sidebar discusses the background of Dodd-Frank's risk-retention requirements, the court's decision, and the legal implications of the decision as Congress considers financial regulatory reform.

Securitization, Dodd-Frank Section 941, and the Credit-Risk Retention Rule

Securitization refers to a process by which certain assets—such as mortgages, corporate loans, and credit card receivables—are pooled so that they can be repackaged into interest-bearing securities. Often, the securitization process involves a financial institution transferring assets to a "special purpose vehicle" (SPV) that issues those securities to third-party investors. CLOs—securities backed by commercial loans—are one prominent example of a product that results from securitization, representing nearly one-quarter of leveraged lending (that is, lending to companies with large amounts of outstanding debt) in the United States.

Many commentators regard securitization as a valuable means of transferring risk that increases the liquidity of financial markets. However, others contend that when financial institutions securitize the loans they originate rather than holding them on their own books, they lack sufficient incentives to ensure that the loans can be repaid. Several of these observers argue that the "originate-to-distribute" model of lending promoted by securitization was "a root cause" of the 2008 financial crisis. According to these observers, financial institutions originated and purchased low-quality mortgages and packaged them into securities in the lead-up to the crisis in order to collect securitization fees, knowing that they would not ultimately bear the risk that the mortgages would default. As discussed, CLOs are composed of corporate loans, not mortgages. According to some commentators, CLOs performed considerably better than mortgage-backed securities during the financial crisis.

In response to concerns about the "originate-to-distribute" model, Congress enacted Section 941 of Dodd-Frank in 2010. Section 941 directed certain federal financial regulators to prescribe requirements that any "securitizer" of an asset-backed security must "retain" at least five percent of the credit risk for any asset that the securitizer "transfers, sells, or conveys" to a third party. Proponents of this rule reasoned that requiring securitizers to "retain a material amount of risk" was necessary to ensure that "they have 'skin in the game,'" and that their economic interests are "align[ed] . . . with those of investors in asset-backed securities." Section 941 defines a "securitizer" as (1) "an issuer of an asset-backed security," or (2) "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."

In 2014, the relevant financial regulators responded to Section 941's directive by promulgating a final rule imposing risk-retention requirements for a variety of asset-backed securities. However, only the SEC and the Federal Reserve ultimately codified risk-retention requirements for CLOs. In promulgating the rule, the SEC and the Federal Reserve imposed risk-retention requirements on managers of "open-market CLOs." In contrast to companies that create CLOs with loans that they originate or hold on their own books (so-called "balance-sheet CLOs"), managers of open-market CLOs direct the activities of SPVs that purchase loans and issue securities, but do not originate loans or hold loans on their own books at any point in the securitization process. The agencies reasoned that open-market CLO managers qualify as "securitizers" under Section 941 because they "indirectly transfer[]" assets to SPVs that issue CLOs by instructing SPVs to acquire particular loans. As a result, the final risk-retention rule required CLO managers or their majority-owned affiliates to acquire a five percent interest in the CLOs they manage.

Loan Syndications and Trading Association v. SEC

After the SEC and the Federal Reserve promulgated the final credit-risk retention rule, a trade association representing CLO managers challenged the agencies' determination that CLO managers qualified as "securitizers" under Section 941. In December 2016, the U.S. District Court for the District of Columbia rejected the trade association's argument and granted summary judgment in the agencies' favor. Last week, however, the D.C. Circuit reversed the district court and struck down the risk-retention rules for CLO managers.

The D.C. Circuit reasoned that CLO managers do not qualify as "securitizers" under Dodd-Frank because they do not "transfer" loans at any point in the securitization process. The court explained that because CLO managers never hold securitized loans on their own books (but instead direct separate entities to purchase loans), they do not "transfer" loans within the ordinary meaning of that term. In order for an entity to "transfer" an asset, the court reasoned, it must have "control" over the asset "via possession or ownership." Because CLO managers never possess or own the assets that they instruct SPVs to purchase, the court concluded that they do not "transfer" those assets within the meaning of Section 941. Similarly, the court explained that because CLO managers never hold loans themselves, they cannot "retain" a portion of their credit risk.

In arriving at this conclusion, the court rejected the agencies' argument that a third party can "transfer" loans by causing a transfer between two other parties—that is, by directing SPVs to purchase loans. Such an interpretation, the court explained, would justify including many parties that merely play a role in the securitization process, including brokers, lawyers, and non-CLO investment managers, contrary to Congress's intent. The court also rejected the agencies' argument that an entity can "retain" credit risk it did not previously possess, explaining that "it is an astonishing stretch of language to read a mandate to 'retain' to apply to one who would never hold the item at all apart from the mandate."

The D.C. Circuit also rejected the argument that its interpretation of Section 941 renders the credit-risk retention rule open to easy evasion. In pressing this argument, the agencies contended that interpreting "transfer" to require ownership or possession of an asset would allow *any* securitizer to evade risk-retention requirements by hiring a third-party manager to direct an SPV to purchase pre-approved assets.

The court rejected this argument, reasoning that (1) this possible "loophole" is largely a product of the idiosyncratic way in which the agencies had defined certain terms, which resulted in SPVs being excluded from the definition of a "securitizer," and (2) the agencies' feared hypotheticals are unlikely to materialize. In addressing the agencies' hypotheticals, the court explained that financial institutions that utilize securitization to "get 'bad assets' off their balance sheets" remain covered by both Dodd-Frank and the credit-risk retention rule because, "'*by transferring*' its assets," an institution "can be required to *retain* credit risks that it is *already holding*." The court also noted that re-securitized asset-backed securities (that is, asset-backed securities composed of other asset-backed securities) are unlikely to escape regulation, as many of the primary securitizations underlying such securities are subject to the risk-retention rule.

Implications of the Court's Decision

The D.C. Circuit's decision may have important implications for the structure of financial markets and financial regulatory reform. According to one estimate, because only the largest CLO managers could feasibly meet Dodd-Frank's risk-retention requirements, the agencies' rule "threaten[ed] to reduce the CLO market by as much as 60 to 90%." The agencies similarly "acknowledge[d]" that imposing risk-retention requirements on CLO managers "could result in fewer CLO issuances and less competition in [the CLO] market," but contended that the rule's benefits exceeded its costs because, among other things, "other entities, such as hedge funds and loan mutual funds, also purchase commercial loans." By contrast, some commentators contend that "[i]nitial concerns that risk retention would limit [CLO] issuance [have] proved unfounded" in light of a significant increase in CLO volume last year. Nevertheless, the court's decision may forestall changes in asset markets that could have resulted from the sustained application of risk-retention requirements to CLO managers.

The court's decision may also influence the shape of financial regulatory reform. Several Members of Congress and the Trump Administration have indicated that reforming Dodd-Frank is among their top legislative priorities. The Financial CHOICE Act, which passed the House of Representatives in June 2017, would repeal Dodd-Frank's risk-retention requirements altogether, except with respect to residential mortgage-backed securities. By contrast, the Treasury Department's reform proposal recommends more limited changes to Dodd-Frank's risk-retention requirements, including an exemption for CLO managers. While the D.C. Circuit's decision likely renders such an exemption unnecessary, the litigation over the rule will remain of interest should the agencies seek rehearing *en banc* or file a petition for a writ of certiorari with the Supreme Court.

The D.C. Circuit's decision will go into effect in 45 days, unless the agencies file a petition for *en banc* review by the entire court.

Author Information

Jay B. Sykes
Legislative Attorney

Disclaimer