KIRKLAND & ELLIS

KIRKLAND **ALERT**

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Risk Retention Reverberations

How Far Do the Effects of the LSTA Case Extend?

I. Introduction

A recent federal appellate court decision on a narrow question of statutory interpretation is likely to have broad implications for the securitization market. Unquestionably, the ramifications are greatest for collateral managers of open-market collateralized loan obligations. But we think it will significantly affect other securitization market participants. In particular, we believe that a range of investment funds and their external managers will benefit from this ruling.

The court decision is likely to benefit credit-focused funds, private equity funds, hedge funds and other investment funds and their external managers, as well as the CLO market.

The decision in the case, *Loan Syndications & Trading Association v. SEC*,[1] addressed the Dodd-Frank Act's provisions for credit risk retention upon the issuance of asset-backed securities ("ABS"). The LSTA brought the case on behalf of collateral managers ("CLO managers") of open-market collateralized loan obligations ("open-market CLOs"). The implications for CLOs, credit-focused funds, private equity funds, hedge funds and other investment funds and their external managers, and other market participants, include the following:

- In open-market CLOs and a few other ABS issuances, neither the manager nor any other person should be forced to be the "sponsor" of the ABS, with the result that no party should be required to hold a retained interest in the ABS. We refer to this result as "unsponsored status" (as discussed here for CLO managers and here for managers of other funds)

- Where an externally advised investment fund acquires and securitizes financial assets in circumstances that do not qualify for unsponsored status, the fund itself — rather than the external manager — should be considered the "sponsor" of the ABS. This "fund as sponsor" result eliminates the headaches and considerable costs that arose from the focus on the manager as the sponsor; it will fit the investment approach more comfortably for the fund to retain that 5% interest (as discussed here).

- Open-market CLO managers who were deterred by the cost of the risk retention rules could get back in the game, perhaps increasing overall CLO issuance volume and expanding overall demand for leveraged loans (as discussed here).

The case has recently reached a key milestone that all but ensures its continued vitality. The regulatory agencies who wrote the credit risk retention rules declined to appeal within the specified time period, and the decision has now gone into effect. As a result, we think it is timely to analyze the decision and its impact.

Regulation RR defined "sponsor" as "a person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."

II. Background on Risk Retention and the LSTA Case

Dodd-Frank, Reg RR, Securitizers and Sponsors

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, passed in the wake of the financial crisis, called for many new rules regulating the issuance of ABS. One of the most significant of these was the credit risk retention rule, under which "securitizers" of ABS were generally required to retain 5% of the credit risk of securitized assets.

Section 941(b) of Dodd-Frank defined a securitizer as:

(A) an issuer of an asset-backed security; or

(B) 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.

Section 941(b) further directed several banking, housing and securities regulatory agencies to jointly develop rules that would require securitizers to retain an economic interest in a portion of the credit risk for any asset that the securitizer "transfers, sells, or conveys" to a third party through the issuance of ABS. Two of those agencies were the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission, and each codified the rules as Regulation RR (which we'll shorten to "Reg RR").

In crafting Reg RR, the agencies categorized "a person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity" as the "sponsor," and they imposed the obligation to comply with Reg RR on the sponsor. This language closely followed clause (B) from the statutory definition of securitizer quoted above.

Although the statutory definition of securitizer included two references to the issuer of the ABS, the agencies in two ways excluded references to the issuer from the Reg RR definition of sponsor. First, the agencies noted that several existing ABS regulations define the "issuer" as the party that transfers the assets being securitized directly to the issuing entity — a role conventionally known in securitization circles as the "depositor" — and concluded that the depositor often either is, or is controlled by, the sponsor, and therefore did not need to be separately identified as a retention party. Second, the agencies substituted "issuing entity" for "issuer" at the tail end of the "sponsor" definition that otherwise followed clause (B) of the securitizer definition.

But the agencies then sought to interpret their definition of sponsor expansively. Although the language of the Dodd-Frank and Reg RR definitions each seemed to require the securitizer or sponsor to be a transferor of assets, the agencies focused instead on the phrase "organize and initiate an ABS transaction." Several passages within the explanatory preamble that preceded the actual rule text in the adopting release posited that it was appropriate to pin the sponsor label on the party that made the underwriting or asset selection decisions, even if that party did not itself transfer any assets into the transaction. The agencies reasoned that phrase "directly or indirectly" in the definition allowed them to treat such a party as the sponsor.

In Reg RR's explanatory preamble, the agencies posited that the sponsor was the asset selection decision-maker, not the asset transferor.

Reg RR imposed on the sponsor the obligation of assuring compliance with the risk retention rules. In general, Reg RR called for the sponsor, or a "majority-owned affiliate" of the sponsor, to retain an interest of at least 5% in each ABS offering effected by the sponsor. That interest could be horizontal (the most subordinate 5%), vertical (5% of each class of ABS) or L-shaped (a combination of horizontal and vertical adding up to 5% of the total interests).

Ironically, the language at issue was, in fact, language that the SEC had written in the first place. Back in 2005, when the SEC initially put in place Regulation AB (the SEC rule that governs public offerings of ABS), it adopted what is now a familiar definition:

> *Sponsor* means the 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 issuing entity.

However, the SEC made no effort whatsoever in the process of proposing and adopting Regulation AB to construe this term in the expansive fashion that it later sought to use in Reg RR. Rather, the SEC's goal when defining the sponsor in Regulation AB seemed to be to restrict, rather than expand, those parties who could qualify as sponsors. In particular, the SEC was at pains in Regulation AB to exclude actively managed transactions like CLOs from its scope. For example, the Regulation AB definition of "asset-backed security" expressly limits the designation to situations where the issuing entity "passively" owns its pool of assets.

Open-Market CLOs and the LSTA Case

The interpretation given to "sponsor" in the preamble to Reg RR was, in significant measure, directed at open-market CLO managers. That focus was due to the substantial efforts that the CLO industry, led by the Loan Syndications and Trading Association, had made to exempt CLO managers from the scope of Reg RR.

In an open-market CLO, the CLO manager directs the CLO issuing entity to acquire its assets, which are leveraged loans, directly from third parties in open-market purchases. The funds for the purchases are supplied to the issuing entity by third-party investors, and (in the absence of the risk retention rules) the CLO manager's interests are limited to servicing and performance fees. Although the CLO manager does not itself transfer any assets to the CLO issuing entity, its asset selection activities are what led the agencies to deem it the sponsor, and therefore the party that should be responsible for complying with Reg RR.

The CLO industry objected strenuously to the agencies' interpretation, arguing that risk retention should not be required of open-market CLO managers on the basis that the managers do not transfer assets to the issuing entity. They also pointed out that these managers are not in the business of owning assets themselves and that this requirement would likely put many smaller managers out of business, as they could not afford to hold the requisite retained interests. Shortly after Reg RR was finalized, the LSTA filed suit against the Fed and the SEC, seeking relief for CLO managers.

The *LSTA* court observed that the agencies' interpretation "turns 'retain' a credit risk into 'obtain' a credit risk."

The courts generally extend considerable deference to regulators' interpretations of statutes; a "reasonable agency interpretation" will prevail over a challenge. As a result, the LSTA's argument was considered a long shot by most observers. And, indeed, the LSTA lost in federal district court, as the judge deferred to the agencies' interpretation and upheld the treatment of CLO managers as sponsors.

The D.C. Circuit Decision

On appeal, the LSTA prevailed. A three-judge panel — all appointed by Republican presidents — of the U.S. Court of Appeals for the District of Columbia Circuit (the "D.C. Circuit") unanimously disagreed with the agencies' interpretation of the Dodd-Frank definition. The court said that "to be covered by clause (B) of [the statutory definition of securitizer], the party must actually be a transferor, relinquishing ownership or control of assets to an issuer."

The court emphasized Congress's choice of the words "transferring or selling" in the statutory definition and observed that the agencies' interpretation "turns '*retain*' a credit risk into '*obtain*' a credit risk." The court noted that "CLO managers neither originate loans nor hold them as assets at any point. Rather, like mutual fund or other asset managers, CLO managers only give directions to an SPV and receive compensation and management fees contingent on the performance of the asset pool over time."

After reaching the foregoing conclusions, the court then turned to the "special argument" advanced in the agencies' brief that limiting risk retention to transferors would "'create a loophole that would allow securitizers of other types of transactions to structure around their risk retention obligation.'" Although the court noted twice that a pure policy concern cannot sustain an unreasonable regulatory interpretation of a statute, the court nonetheless proceeded with an analysis of the agencies' position. Despite the the arguably gratuitous nature of the court's commentary on this policy issue, the analysis is probative when seeking to apply this decision beyond the CLO industry, and we review that discussion here.

III. The Impact of the LSTA Case

A lot of questions have arisen regarding the LSTA case and the effect of the decision on CLOs and CLO managers, other investment funds and their external managers, the market for leveraged loans, and securitization structuring in general. There are no easy answers, but we think there is value in a careful consideration of the questions raised by this case.

A. Where the Agencies and the Case Might Go From Here

The D.C. Circuit has made it very clear that risk retention can only be imposed upon a party that fits the Section 941(b) definition of "securitizer."

Is the decision currently in effect?

Yes, the decision is now in effect. The time for appeal of the decision to the D.C. Circuit for a rehearing by the same panel or *en banc* has passed. On April 5, 2018, the district court implemented the D.C. Circuit's instructions, vacated the earlier district court decision in favor of the agencies and ordered summary judgment in favor of the LSTA.

The agencies do still have until May 10 to submit a petition for a writ of *certiorari* from the Supreme Court. However, that seems an unlikely course, inasmuch as a party seeking Supreme Court review typically seeks to demonstrate that it has first exhausted all other courses of review before. Further, there does not seem to be any factor here that would make a compelling reason for the Supreme Court to accept a petition, such as a split in authority among the various circuit courts. But the agencies have thus far made no public comment about their intentions, so the possibility of a petition cannot be entirely ruled out.

Could the agencies revise the definition of sponsor to achieve their desired treatment?

The D.C. Circuit has made it very clear that risk retention can only be imposed upon a party that fits the Section 941(b) definition of "securitizer."

That definition has two parts. Clause (B) was the focus of the litigation, and the D.C. Circuit rejected the agencies' effort to treat non-transferor CLO managers as being within the scope of that clause.

That leaves clause (A), which covers an "issuer" of ABS. The agencies chose not to include the concept of an issuer in their Reg RR definition of sponsor. The agencies noted that the issuer, in other longstanding regulations governing ABS, is the "depositor." For example, in Regulation AB, the depositor is defined as the party "who receives or purchases and transfers or sells the pool assets to the issuing entity." Under Regulation AB, it is this party, rather than the issuing entity, that is entitled to effect a "shelf registration" of ABS on Form SF-3 — a point that has some significance in the consideration of the impacts of the *LSTA* ruling, as we discuss here.

The D.C. Circuit took the agencies to task for ignoring what it called the "commonsense" view that the issuer should be the entity that actually issues the securities, which in ABS parlance is the issuing entity. But the court ultimately acknowledged that the issuing entity in a standard open-market CLO is owned entirely by investors, and that requiring it to hold the risk retention would not accomplish Dodd-Frank's goal.

As a result, we do not see how it would be feasible for the agencies to try to re-define "issuer" to pick up a CLO manager or other external manager. Short of Congress revisiting and revising the statute, there does not appear to be a viable way for the agencies to get to that desired interpretation.

But it strikes us that the agencies could conceivably draw unsponsored ABS offerings back into Reg RR with an approach modeled loosely on the "B-piece buyer" provisions for commercial mortgage-backed securities ("CMBS") that already exist in Reg RR. Those rules permit no more than two "third-party purchasers" to acquire the most subordinate horizontal interest in the CMBS offering in satisfaction of the risk retention requirement, so long as each third-party purchaser independently re-underwrites each purchased asset, honors with the transfer restrictions on the acquired interest and complies with several other restrictions. Although the B-piece buyer rules are drafted within the existing "sponsor" concept (by permitting the sponsor to delegate its retention obligation to B-piece buyers), the agencies might be able to justify that sort of arrangement under the "issuer" wing of the Dodd-Frank definition of securitizer. While such an approach would not capture the CLO manager directly, it would allow the agencies to restore a measure of "skin in the game" to what would otherwise be exempt transactions.

The agencies could conceivably draw unsponsored ABS offerings back into Reg RR with an approach modeled on the "B-piece buyer" provisions for CMBS.

At present, one would think that the agencies do not have much appetite to engage in another round of rule writing. But one can only speculate at this point, as the agencies are not saying anything publicly. In the meantime, we would expect the agencies to keep a watchful eye on the securitization market, as they try to determine whether there is a surge in companies that restructure their asset acquisition and securitization methodologies to achieve unsponsored status. If they detect significant activity in that realm, they might just become motivated to take further action of some sort.

B. Effects on the CLO Market

Will any person need to hold a retained interest under Reg RR in an open-market CLO?

If the CLO issuing entity purchases all of its assets directly from third parties, so that no assets are transferred into the issuing entity by the CLO manager or an affiliate, then the CLO manager will not be deemed to be the sponsor.

The upshot is "unsponsored status" for the offering, as no one else would fit the definition of sponsor. Inasmuch as Reg RR imposes the compliance obligation on the sponsor, that means that no person involved in such a transaction would be required to hold a retained interest or otherwise comply with Reg RR.

How will this decision affect "dual compliant" CLO structures?

An interesting question arises with respect to so-called "dual compliant" structures. A CLO seeking dual compliant status has risk retention arrangements to satisfy both Reg RR and the separate risk retention rules adopted by the European Union, in order to facilitate the sale of CLO securities in both the U.S. and the EU.

Under the risk retention rules adopted by the EU, EU investors may not invest in a securitization unless an "originator" (or a sponsor or original lender, but CLO managers do not currently fit in those roles as defined by the EU) holds a retained interest equal to 5%. To be an originator, the CLO manager needs to own, and then transfer into the issuing entity, a small portion of the assets — typically 5% to 10% of the total amount. Such a CLO manager is commonly referred to as a "manager-originator."

It seems to us that this kind of activity, even though at a low level, could push a manager-originator back into the scope of the Reg RR sponsor definition. That definition covers a party that "organizes and initiates" an ABS transaction "by selling or transferring assets" to the issuing entity; it has no numerical threshold or *de minimis* exception. Given that the manager-originator otherwise is engaged in organizing and initiating the transaction, the additional fact of transferring in a small portion of the assets could be enough to tilt the balance toward sponsor status under Reg RR.

As the EU rules will continue to require the holding of a retained interest of at least 5%, CLO managers who want to take advantage of the LSTA ruling will presumably elect to avoid marketing to EU investors. But CLO managers who wish to reach that investor base will need to continue to comply with the EU rules.

Will some CLO managers continue to retain interests in funds they manage?

Under Reg RR, a sponsor can hold its retained interest either directly or through a "majority-owned affiliate." Affiliate status can be achieved either through ownership of more than 50% of an entity, or through ownership of "any other controlling financial interest in an entity as determined under GAAP."

As it happens, GAAP will permit sponsors to set up funds to hold retained interests where the sponsor holds an economic stake that could be as low as 10%, but in which the sponsor otherwise controlled the decision-making. As a result, the sponsor is able to consolidate the fund under the accounting rules for variable interest entities, making it a majority-owned affiliate.

CLO managers with risk retention funds, as well as CLO managers who have enough of their own capital to hold retained interests directly, will henceforth have the choice of either continuing to use those funding sources to retain interests in future CLOs (without being subject to the transfer limitations, disclosure requirements and other restrictions inherent in Reg RR) or instead letting third-party investors acquire those erstwhile retained interests.

It is too early to know how this will turn out. One wonders whether ABS investors care enough about risk retention to reward risk-holding managers, and whether ABS investors distinguish between retaining managers who hold the entirety of their retained interests and retaining sponsors who, by dint of their risk retention funds, really only hold 10% or so of the retained interests. This will be interesting to watch.

One wonders whether ABS investors care enough about risk retention to reward risk-holding managers.

What does this decision mean for balance sheet CLOs and their managers?

The term "balance sheet CLO" refers to a transaction in which a lender that owns leveraged loans for its own account (a "balance sheet lender") subsequently transfers those loans into an SPV and effects an ABS offering. The balance sheet lender is typically a finance company or investment fund that is in the business of making middle-market leveraged loans, and it uses the CLO as a means of leveraging its investment capital. Further differentiating itself from an open-market CLO, the balance sheet lender may hold the equity in the SPV.

Inasmuch as the balance sheet lender is transferring its loans to an SPV to effect the transaction, it will not qualify for unsponsored status. However, for those balance sheet lenders that are investment funds with external managers, the LSTA ruling will allow use of the "fund as sponsor" approach, thus avoiding the problems that arose from the agencies' focus on managers as sponsors.

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Will this decision bring more CLO managers into the market? Will it increase CLO issuance volume and overall demand for leveraged loans?

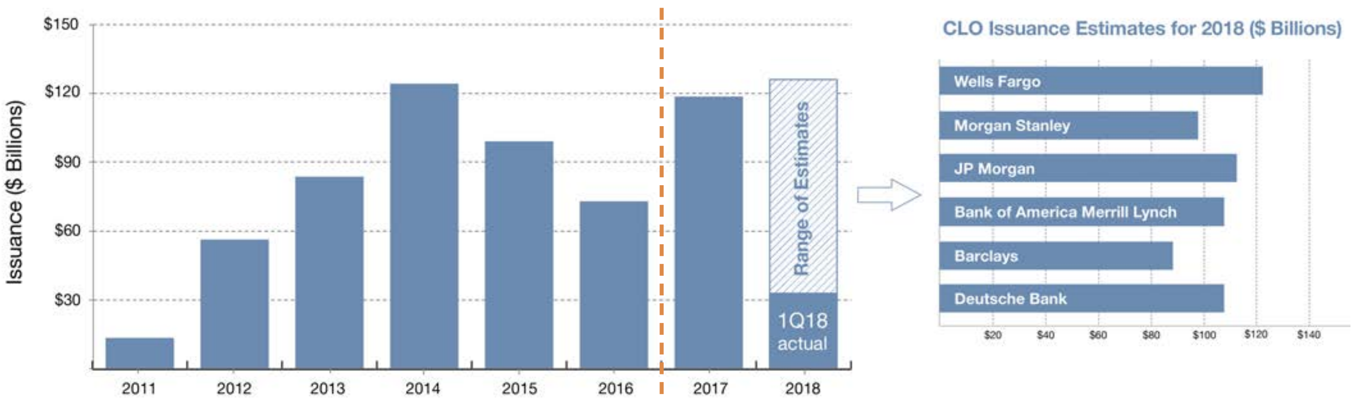
Popular opinion is that the *LSTA* decision will bring some CLO managers into the market who were sitting out, or limiting their new issue volume, due to the cost of obtaining capital to hold retained interests.

Interestingly, the SEC addressed the concern about an adverse impact on CLO managers in the cost-benefit section of the adopting release. The SEC acknowledged that less well-capitalized managers might not be able to afford to hold retained interests, and estimated that Reg RR would "impact current levels of capital formation by CLOs by 37 percent." That is a striking admission; one would think that regulators would exhibit more concern about such an extraordinary impact on an existing market.

However, it is not clear that the actual impact of Reg RR was that severe, if indeed it was adverse at all. The SEC made that estimate in September 2014; Figure 1 shows U.S. CLO issuance from 2011 through 2018 year-to-date, along with estimates for overall 2018 volume.

Figure 1: U.S. CLO Issuance

The orange line indicates when Reg RR went into effect.



Source: Thomson Reuters LPC

Among the notable takeaways from this data:

- Although CLO issuance volume declined in each of 2015 and 2016 from the prior year, those declines would not seem attributable to Reg RR, because Reg RR did not become effective for CLOs until December 24, 2016.

- CLO issuance volume soared in 2017, notwithstanding that Reg RR became effective just before the start of the year — or, indeed, maybe because Reg RR became effective and investors liked that development.

It almost goes without saying that many factors are going to influence CLO issuance volume. CLO managers who do have access to the capital needed to fund risk retention can increase the number and size of transactions they issue. A favorable economic outlook, or a favorable reaction to the presence of risk retention, can induce CLO investors to buy more bonds, or to buy those bonds at tighter spreads. On the other hand, shrinking spreads in the leveraged loan market can reduce the arbitrage opportunity for CLO managers unless there is a corresponding drop in spreads demanded by CLO investors.

Meanwhile, leveraged lending has also grown dramatically, accompanied by a substantial tightening of spreads, as shown in Figures 2 and 3. In addition, the percentage of leveraged loans falling into the "covenant-lite" category has continued to increase. All of these metrics seem to indicate a robust leveraged loan market at present.

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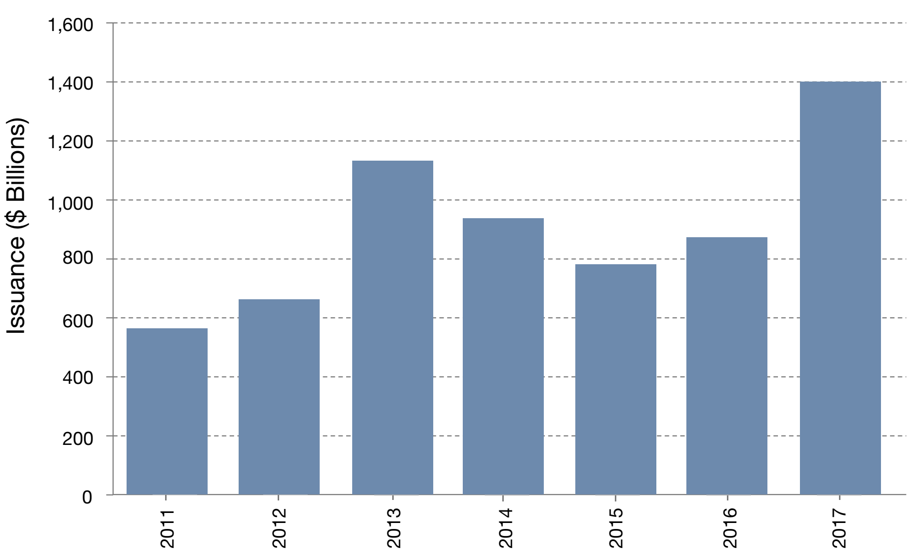
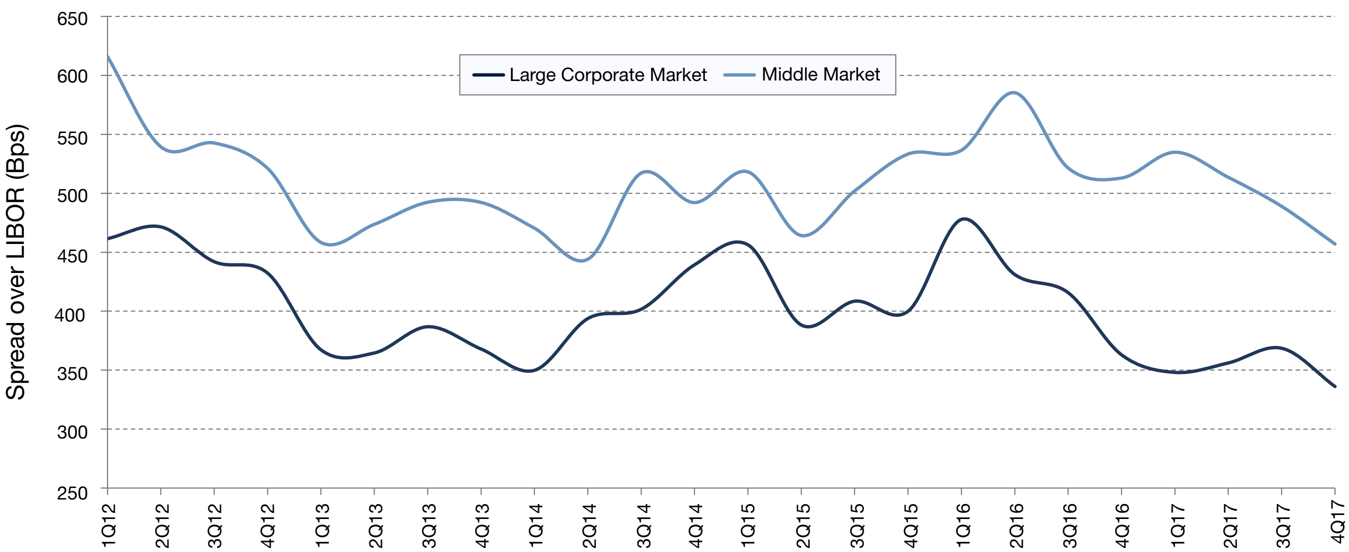
Figure 2: U.S. Leveraged Loan Issuance

Leveraged lending jumped 60% to $1.4 trillion in 2017 to set a new record. Volume was 24% higher than the previous high point ($1.1 trillion) recorded in 2013.



Source: Thomson Reuters LPC

Figure 3: Primary Market Institutional First-Lien Leveraged Loan Spreads



Source: Thomson Reuters LPC

With all of these influences, it would seem to be very hard to isolate the impact of the LSTA decision on CLO issuance volume or, even more tangentially, leveraged loan volumes.

C. Impacts on Other Types of Investment Funds and Their External Managers

Why were external managers of investment funds other than open-market CLOs covered as "sponsors" under Reg RR?

The agencies expressed the view in the adopting release's preamble that every ABS offering has a sponsor. There is always some party that "organizes and initiates" an ABS offering, and the agencies sought to use this interpretation to identify that party.

Although the preamble's most extensive comments outlining the agency's interpretation of "sponsor" came in a discussion of CLOs, there were other passages discussing the term that did not mention CLOs. Further, the rationale applied equally to other investment funds that effected ABS offerings with assets that they had acquired at the direction of external managers.

Is this concern about the manager being a sponsor relevant when an operating portfolio company effects an ABS offering?

No, this "external manager as sponsor" concern did not previously, and still does not, arise in the case of ABS issued by a typical "operating" portfolio company of an investment fund — and we use the concept of an "operating" portfolio company to distinguish it from a special purpose vehicle ("SPV") with no employees or other operations that is established solely for the purpose of acquiring and securitizing the assets. When the portfolio company is itself an operating entity that has its own personnel that make the underwriting or asset selection decisions, then there is no reason to look to the external manager of the investment fund that owns the portfolio company. The portfolio company would have been the sponsor under the agencies' interpretation and, assuming it transfers the securitized assets into the issuing entity, the portfolio company will still be the sponsor notwithstanding the *LSTA* decision.

Relatively few ABS offerings outside of the CLO sector share the confluence of structural elements that will allow open-market CLOs to avoid risk retention.

Does this ruling mean that an investment fund can achieve "unsponsored status" when it effects an ABS offering, so that no risk retention will be necessary?

Not in most cases — absent a significant restructuring of the way assets are acquired and ABS offerings are effected by most investment funds. The answer to this question depends on how the assets to be securitized were acquired by the investment fund, and on how the ABS offering is structured.

Open-market CLOs have a combination of structural features that are not often present in other types of ABS offerings:

- the assets are originated independently of the CLO manager
- the securitized assets are acquired directly into the issuing entity
- each securitized asset is typically acquired in a separate transaction
- the securitized assets are acquired from many different third-party sellers who have no involvement in the ABS offering

These features are integral to the ABS offering attaining unsponsored status, because there is no party that is "organizing and initiating" the ABS offering by "transferring assets … to the issuing entity." The CLO issuing entity buys some 100 to 250 assets, generally in separate purchases from third-party sellers who have no other stake or role in the ABS offering.

In our experience, relatively few ABS offerings outside of the CLO sector share this confluence of structural elements. Here are various factors present in many ABS offerings by investment funds that would seem to undermine the position that no person qualifies as the sponsor:

Falling Short of the Open-Market CLO Model

Typical Fund Feature	Why feature may fall outside of the LSTA rationale
Some funds, such as senior or mezzanine credit funds, originate the assets themselves	Such a fund owns the assets initially. As the fund itself would not likely fit applicable rating agency criteria to be a bankruptcy-remote SPV, the fund will need to transfer the assets to such an SPV, thus effecting a transfer that will draw it squarely into the sponsor category.
The fund acquires assets in secondary transactions, either directly or into a subsidiary, but the owner then transfers the securitized assets to an SPV for the ABS offering	As with the direct originators discussed in the prior example, the transferor role causes the fund or its subsidiary to become a sponsor under Reg RR.
The issuing entity acquires the assets directly, but all or substantially all of the assets are acquired in one transaction, or a series of related transactions, from a single seller or set of related sellers	Even though no transfer occurs from the fund's external manager to the issuing entity, when the assets to be securitized are acquired in bulk in a single transaction or series of related transactions, we think a significant risk exists that the seller of the assets itself might be deemed to be the sponsor. This risk would seem particularly acute if the issuing entity in the ABS offering will have recourse to the seller for breaches of representations, disclosure deficiencies or other problems related to the assets.

There are, though, some companies that have effected securitizations with transaction structures and asset acquisition methodologies that closely parallel the CLO model. Examples include companies in the business of acquiring and securitizing cellular towers, easements underlying cellular towers and billboard assets. Those companies typically have SPVs purchase the assets directly (and often from a multitude of sellers) and the SPVs continue to hold the assets without any further transfers to effect the securitization.

As it happens, many companies utilizing this type of structure are able to conclude for other reasons that their securitizations do not constitute asset-backed securities within the meaning of the Dodd-Frank Act. That conclusion provides them with an alternative basis to avoid Reg RR. Nonetheless, the prospect of a second basis for avoiding Reg RR may well be comforting.

There may also be other players who are currently sourcing financial assets in secondary transactions and effecting ABS offerings who could, without great difficulty, mimic the open-market CLO model. For example, a fund manager that buys marketplace loans on the secondary market from a variety of originators might be able to take advantage of this ruling.

Can external managers of investment funds other than open-market CLOs rely on this ruling to achieve "fund as sponsor" status?

External managers of credit funds, hedge funds, private equity funds, mutual funds, REITs and other sorts of investment funds should be able to rely on this decision to avoid sponsor status when their funds effect ABS offerings. So long as those external managers are not transferring assets into the ABS offering, they should not be tagged as sponsors.

So long as external managers of investment funds are not transferring assets into ABS offerings, they should not be tagged as sponsors.

In most cases, the investment fund itself will be the sponsor of the ABS offering, because the investment fund will have transferred the securitized assets to the issuing entity. The benefit of this "fund as sponsor" status is that the fund, as the vehicle established and capitalized to make investments, is the logical entity to hold the retained 5% interest in the ABS. The manager was established for the purpose of providing advice, not for the purpose of making investments.

External managers that encountered this issue prior to the *LSTA* decision had considered, and sometimes effected, a variety of steps to cause the investment fund itself, rather than the external manager, to be treated as the sponsor based on the SEC's "decision-maker" criteria. Actions such as the "dual hatting" of employees, under which the manager's personnel are also employed and paid directly by the entity actually acquiring the assets, were taken to bolster the argument that the underwriting or asset selection decisions were being made by the acquiring entity rather than the external manager. Those types of steps should no longer be necessary.

Were the agencies right when they argued that this decision could create a "loophole" that would allow "easy evasion" of Reg RR?

The agencies might have had a point, although we think they did not make the most convincing argument.

The agencies argued in the preamble of the adopting release that limiting risk retention to transferors would "make it feasible for many sponsors to evade risk retention by hiring a third-party manager to 'select' assets for purchase by the issuing entity that have been pre-approved by the sponsor." To buttress this argument, on appeal the agencies gave two examples of evasive behavior.

The agencies' first example involved a bank with "bad assets" that would seek out a third-party manager to direct an issuing entity to acquire the bad assets and securitize them. Although the agencies evidently feared that the bank would be able to avoid sponsor status by claiming that it did not "organize and initiate" the transaction, the court (rightly, in our view) had no trouble concluding that the bank in such an example would easily be categorized as the sponsor, given its role as transferor of the assets to the third-party-managed issuing entity.

The agencies' second example was that a revival might occur of the so-called "CDO-squared" market, in which asset managers would acquire pieces of a variety of outstanding ABS issuances and re-securitize them. The court dismissed this fear for a variety of reasons:

- CLO managers are not direct or indirect agents of the originators of the leveraged loans
- CLO managers already have "skin in the game" by means of their fee arrangements
- An individual CLO acquires relatively few loans
- CLOs in fact performed well during the financial crisis

As we noted in the prior Q&A, there are some other companies that use the same kind of business model as open-market CLOs, and they should get the same benefit from the *LSTA* ruling as do CLO managers. We discuss in the next Q&A whether others might restructure to use this same business model.

Can an investment fund or other finance business restructure its business model to achieve unsponsored status in future ABS offerings?

We have heard the suggestion made that "just about any finance business" could be re-configured along the lines of the open-market CLO model to avoid Reg RR. This thinking holds that, by switching to the business model discussed in the second preceding Q&A — in which assets are acquired directly into SPVs that subsequently become issuing entities in ABS offerings (with no assets being transferred into a new issuing entity) — the finance business could achieve unsponsored status for its ABS offerings. We call this approach the "SPV acquisition model."

Consider, for example, one of the longest-standing consumer finance businesses: retail automotive finance. The current business model in this industry is for the finance company to purchase retail installment sales contracts individually from dealers (after the finance company underwrites the contract), hold those contracts until it is ready for an ABS offering, then select the pool to securitize and transfer the pool to the issuing entity.

The thinking goes that the finance company could achieve unsponsored status by setting up SPVs at the outset, and then having those SPVs acquire contracts from the dealers. When it came time to do an ABS offering, no transfer of assets would be necessary — the acquiring SPV could just issue ABS notes itself, and avoid any requirement for risk retention.

While the benefit of avoiding Reg RR makes a reconfiguration to an SPV acquisition model worthy of some consideration, we think there are a lot of costs and other adverse consequences that need to be evaluated, as shown in the table below.

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Obstacles to Restructuring to the SPV Acquisition Model

Feature	Problems
Economic Impact of Reg RR	Many finance companies routinely retain the equity interest in their ABS offerings, and that equity interest is typically at least the size required by Reg RR. These companies do not consider the retention requirement to be an additional or unanticipated deployment of capital, so they do not have a significant economic incentive to convert.
Shelf Registration & Reg AB	Frequent issuers register their ABS on Form SF-3 in order to be able to sell ABS "off the shelf" in public offerings at any time. But registration Form SF-3 is only available to a "depositor," which (as discussed above) is a party that "transfers or sells the pool assets to the issuing entity." Further, Regulation AB requires disclosure regarding both the depositor and the sponsor in a registration statement. If a finance business wants to take the position that there is no transferor (and therefore no depositor or sponsor) under Reg RR, it would be hard-pressed to take the simultaneous position that there is a transferor for purposes of registering ABS on Form SF-3.
Converting the Contract Acquisition Method	The process of converting the process of acquiring a contract to one in which the dealer would sell to an SPV (or, in most cases, to several different SPVs over the course of a few years) would be expensive and confusing to dealers. Auto lessors learned this lesson when they created titling trusts in the 1990s, a process that required a long lead time and a lot of dealer education.
Role in Originating the Contracts	Although the auto dealer technically originates each contract, it does so based on the finance company's underwriting. That type of upfront involvement by the finance company in the origination of the contract is at odds with the open-market CLO model; the LSTA court several times cited the lack of involvement by CLO managers in the loan origination process as a relevant factor.
Pool Composition	Many finance companies want to securitize a pool of contracts that have been originated over several quarters, if not several years. In addition, they also want to securitize just those contracts that are performing and that have not been modified. A difficulty of the SPV acquisition model is that, inevitably, some set of the contracts held by the SPV will have been amended or become delinquent or defaulted. If the SPV includes those assets in the securitized pool, its pool data will look markedly worse. On the other hand, if the SPV sells the non-performing contracts back to the finance company, an argument could be made that such a "reverse transfer" is sufficient to make the finance company a sponsor.

While there are benefits to the SPV acquisition model, both the costs of reconfiguration and the ancillary adverse consequences we have described will likely keep this approach from becoming a trend.

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