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You Can Fight City Hall

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It seemed like a one-in-a-million shot at the time.

In October 2014, the LSTA filed a lawsuit against the SEC and the Federal Reserve Board, claiming that CLOs should not be covered under Dodd-Frank's risk retention rules. These rules, arising from the credit crisis, required parties that securitized assets to retain at least 5% equity in those vehicles.

The LSTA, the loan industry's advocacy organization, argued (among other things) that CLO managers, unlike sellers of student loans or home mortgages, already had economic interests in their vehicles. Additional "skin in the game," they said, was not required.

On Friday DC Circuit's Court of Appeals agreed. In a 17-page ruling, the Court decreed that "given the nature of the transactions performed by CLO managers, the language of the statute invoked by the agencies does not encompass their activities."

Much of the finding reads like a text in advanced semantics. The nuances of terms such as "retain," "transfer," and "securitizer" are thoroughly analyzed. The nature of collateralized loan obligations is examined relative to other securitized assets. And the loan syndication process is reviewed with attention to how loans are distributed, who buyers and sellers are, and why this differs from what triggered the Great Recession.

In essence the Court confirmed the arguments industry participants, including this columnist, had made for years about the virtues of the asset class. Unlike subprime mortgages, for example, which were packaged and sold ("transferred") by bankers who did not hold them, CLOs are an integral part of a loan manager's tool kit.

Indeed the success or failure of that manager is directly linked to the performance of those vehicles. As the LSTA had argued originally, managers "purchase" loans that comprise CLOs on the open market, not just "transfer" them. That puts CLOs in a different risk category than other consumer-related securitizations.

The Court further underlined the disparity between the asset classes by noting the historic underwriting standards of leveraged loans. "[This] reduce[s] the likelihood that such financing will generate anything like the decline in underwriting standards that the more famous ABS market is thought to have brought about."

The opinion continues. "Perhaps for these reasons, CLOs weathered the financial crises relatively well. In contrast to 435 ABS collateralized debt obligations that defaulted, no more than six CLOs defaulted during the crisis, and all six included features atypical for CLOs and were eventually cured."

Finally we recognize the retired executive director, Bram Smith, under whose leadership the LSTA went toe-to-toe with the agencies. As their counsel, Elliott Ganz, said, "We feel deeply gratified that our perseverance on this issue paid off."