Middle Market CLO Relief

September 20, 2018 (updated September 21, 2018) - The SEC recently issued a no-action letter to Dechert on behalf of its client, Golub Capital that could have important ramifications for the issuance of middle market balance sheet CLOs issued through Business Development Corporations (BDCs). The SEC agreed that it would not take enforcement action against Golub's BDCs if they engage in a series of transactions (described in detail in Dechert's incoming letter to the SEC) the effect of which would be to allow the BDCs to transfer their loans to affiliated CLOs while allowing the affiliated CLO manager to transfer the risk retention interest to the BDC such that the BDCs rather than the CLO manager will hold the risk retention for the CLOs. The no-action letter raises a bunch of questions so let's dive in (and stay for the fascinating postscript).

Why are we still talking about risk retention? Didn't it go away for CLOs? The CLOs in question are "balance sheet" CLOs rather than "open market CLOs" whereby the BDCs originate the loans and then transfer them to the CLOs as a financing tool. These types of CLOs are still subject to risk retention.

Why is it important that the risk retention be held by the BDC rather than the manager and why is the BDC allowed to hold the risk retention? Under the risk retention rules, the CLO manager is the "sponsor" and is obligated in the first instance to hold the retention. Because managers are typically thinly capitalized, it is usually advantageous to have other permissible parties (like a majority owned affiliate) hold the retention. The BDC is permitted to hold the retention because the risk retention rules permit the sponsor to transfer all or a portion of the retention interest to an "originator" or a majority owned affiliate of the originator under certain circumstances (which would apply in these cases).

How would the transfers in question here work? Boiled down to its basics, the BDC would transfer some of the loans it originated to the CLO manager and the CLO manager would transfer those loans to the CLO. In consideration for those loans, the CLO would issue securities representing the risk retention interest to the CLO manager who would then transfer the retention interest back to the BDC (in consideration for the loans that were initially transferred by the BDC to the CLO manager).

Would these transfers be a problem in the absence of no action relief? The Golub Capital BDCs are BDCs as defined by the Investment Company Act of 1940 (the "1940 Act"). The 1940 Act restricts certain affiliates of a BDC, acting as principals, from selling or purchasing securities from or to such BDC. Absent relief from the SEC, the acquisition and subsequent transfer by the manager of the loans and the acquisition and subsequent transfer of the retention interests from the manager to the BDCs, undertaken solely to comply with risk retention, would likely have been characterized as prohibited principal transactions. With the issuance of the no-action letter, it is possible that middle market CLO issuance might increase, with other BDCs following the roadmap set out by Golub.

Postscript. Was the no-action letter even necessary? Mayer Brown poses that question in an interesting memo. While welcoming the clarity the no-action letter brings to BDC sponsored CLOs, they submit that the relief was necessary only because the SEC CorpFin staff erroneously determined that a BDC could not be a "sponsor" of its own externally managed CLO. They then provocatively wonder whether, if the BDC is not a sponsor, is anyone? After the LSTA's victory in its risk retention litigation, without the round tripping of loans and retention interests described in the no-action letter, it is not clear that the CLO manager is the sponsor, notwithstanding that it is a balance sheet CLO.

Asset Securitization Report has published a very thorough explanation of the no-action letter and its context available here.