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Legal Update

The Recent *Golub Capital BDC* No-Action Letter: Certainly Welcome, But Was It Really Necessary?

The September 7, 2018 *Golub Capital BDC* no-action letter (*Golub* letter, (https://www.sec.gov/divisions/investment/noaction/2018/golub-capital-bdc-090718-17d1.htm) issued by the Division of Investment Management (IM) of the US Securities and Exchange Commission (SEC) is certainly welcome relief for externally managed business development companies (BDCs) that use on-balance sheet collateralized loan obligation (CLO) transactions as long-term financing for their small- and medium-enterprise loan portfolios. However, the *Golub* letter raises some interesting questions, which we explore below.

The potential conflicts between the requirements of the Credit Risk Retention rule (CRR Rule)[1] and the prohibitions under section 57(a) and rule 17d-1 of the Investment Company Act of 1940 (ICA) had cast a long shadow over the US middle market CLO space[2] for some time; although middle market CLO (MM CLO) issuance has picked up this year.[3]

As described in the related incoming letter (https://www.sec.gov/divisions/investment/noaction/2018/golub-capital-bdc-090718-17d1-incoming.pdf), the conflicts between the prohibitions under the ICA and the requirements to comply with the CRR Rule arise when, as appears from the *Golub* letter, the staff of the Division of Corporation Finance (CorpFin) of the SEC have determined that the related BDC cannot be a "sponsor" and that, as the manager of the related CLO, the adviser is the "sponsor" of such CLO and, as such, the entity that must comply with the CRR Rule. In order to comply (and to allocate the required retention obligation to the BDC as the "originator" as permitted under the CRR Rule), the adviser must acquire the required eligible retention interest from the CLO and then transfer it to the BDC. Absent the relief granted by the *Golub* letter, this acquisition and transfer would violate section 57(a) and rule 17d-1. Importantly, the *Golub* letter disclaims any view regarding compliance with the CRR Rule.

But was the relief necessary at all? It is apparently required because the SEC CorpFin staff determined that the BDC could not be a "sponsor."[4] While the adopting release for the CRR Rule was reasonably clear that "sponsors" must be active participants in the related origination and initiation activities critical to the determination that an entity is a "sponsor,"[5] why is it the case that this must be the adviser for a BDC that is externally

managed rather than the BDC itself? Why aren't the activities of the BDC's adviser that make it the "sponsor" under the view of the SEC CorpFin staff[6] to be attributed to the BDC under traditional principal/agent principles? Of course, an adviser's "managerial assistance" activities are to be so attributed to the BDC for the purpose of satisfying the related statutory requirement for the BDC. Similarly, why couldn't the adviser "dual-hat" some employees as BDC employees so that such activities are by the BDC directly?[7]

Also, because the decision by the Court of Appeals for the DC Circuit in the LSTA case[8] requires a "sponsor" for purposes of the CRR Rule to hold title to the underlying loans at some point, in the absence of the intermediate purchaser position assumed by the adviser in the fact pattern described in the *Golub* letter's incoming letter, it is not clear that the adviser would be a CRR Rule "sponsor" (even where the CLO is not an "open market CLO" under that decision).

Putting the court's reasoning in the LSTA decision together with the CorpFin staff position that the BDC is not itself a CRR Rule "sponsor," is any party in a MM CLO involving an externally managed BDC required to retain risk?

While the granted relief in the *Golub* letter is a clear path to compliance with the CRR Rule, it is not an exclusive one. There are other alternative

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[1] Credit Risk Retention, 79 Fed. Reg. 77602.

[2] *See*, for example, "*LPC: Conflicting regulations hamper CLO risk retention*," Reuters, July 27, 2018.

[3] According to recent Wells Fargo research, primary MM CLO issuance through August 16, 2018 was around $9.4 billion (compared to $8.3 billion for the comparable period last year).

[4] More accurately, the SEC "concurred" in Golub's determination. Why Golub would have so determined is not clear from the incoming letter.

[5] *See*, for example, the CRR Rule at 77609.

[6] As affirmed by a recent statement (https://www.sec.gov/news/public-statement/statement-clayton-091318) of SEC Chair Jay Clayton, the views of the SEC CorpFin staff are not binding on the SEC and do not have the force or effect of law.

[7] With a corresponding reduction in any advisory fee for any compensation paid by the BDC to such employees.

[8] *The Loan Syndications and Trading Association v. Securities and Exchange Commission and Board of Governors of the Federal Reserve System*, No 17-5004, Decided February 9, 2018 (the LSTA Case).

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