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CLO Group Client Alert:
SEC Staff Grants Limited Relief from Compliance with US Risk Retention Rules in the Context of Certain CLO Refinancings

On July 17, 2015, the SEC staff (the "Staff") issued a no-action letter (the "Letter") granting limited relief from compliance with the risk retention requirements of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Final Rules") for certain collateralized loan obligation transactions ("CLOs") that are refinanced following the effective date of the Final Rules on December 24, 2016 (the "Effective Date"). The Letter was addressed to Crescent Capital Group LP ("Crescent Capital"), which manages a CLO that priced prior to the December 24, 2014 publication of the Final Rules.

WHAT THE LETTER SAYS

Generally, as described in our prior Client Alert, Final Risk Retention Rules – Implications for US & European Collateralized Loan Obligations, the Final Rules require a CLO manager or its majority-owned affiliate to acquire and retain, unhedged, an eligible five percent interest in securities issued in a CLO transaction, and do not exempt or otherwise "grandfather" any post-Effective Date issuance of securities by CLOs existing prior to the Effective Date.

Crescent Capital argued in its request for no-action relief that because the CLO it managed was priced prior to publication of the Final Rules, the CLO's refinancing feature was not structured to accommodate risk retention and neither Crescent Capital nor the investors in the CLO expected that the risk retention obligation would apply with respect to a refinancing of the CLO.

In the Letter, the Staff conditioned its relief on the following conditions, and included the customary admonishment that any different facts or conditions might require a different conclusion:

- The refinancing will be completed (*i.e.*, by the issuance of the relevant refinanced notes) within four years after the original closing date of the CLO transaction.

- The interest rate applicable to the refinanced notes will be lower than the interest rate of the original notes.

- Other than the reduction of the interest rate of the original notes, after giving effect to a refinancing:

    - the CLO entity's capital structure will be unchanged;

    - the principal amount of the refinanced notes after a refinancing and the original notes after a refinancing will be the same;

    - the priority of right of payment of the refinanced notes and the original notes will be the same;

    - the voting and other consent rights of the refinanced notes and the original notes will be the same; and

    - the stated maturity of the refinanced notes and the original notes will be the same.

- The CLO entity's investment criteria will not change as a result of the refinancing.

- No securitization of additional assets will be effected by a refinancing (*i.e.*, proceeds from the issuance of the refinanced notes will be used only for the redemption of the original notes), it being understood that the CLO manager will continue to actively manage the collateral obligations on the CLO entity's behalf.

- No additional subordinated interests will be issued in connection with a refinancing.

- Refinancing will not cause the identity of the holders of subordinated interests to change.

- Refinancing of different classes of secured notes may occur on different dates; however, each class of secured notes will be subject to only one refinancing and the supplemental indenture executed in connection with refinancing each class will prohibit any further refinancing of the refinanced notes.

- The offering document for the refinanced notes will, among other things:
    - include a prominent statement (*e.g.*, on the cover of the offering document) that the sponsor is not retaining a risk retention interest contemplated by the Final Rules in connection with a refinancing or the refinanced notes;
    - describe the interest rates of the refinanced notes and confirm that all other legal and economic terms of the refinanced notes will be the same as the original notes; and
    - include a statement in a section entitled "Credit Risk Retention" to the effect that reliance on the no-action letter contemplated hereby does not preclude the availability of any applicable private rights of actions for any violation of the federal securities laws.

WHAT THE LETTER MEANS FOR CLO MANAGERS

Although helpful, the relief granted in the Letter is not a panacea. Any CLO priced on or after December 24, 2014, or that otherwise does not meet the above criteria, is not eligible to qualify the CLO manager for relief from the Final Rules in the context of a refinancing. The CLO manager of any such ineligible CLO that is refinanced on or after the Effective Date will therefore need to comply with the Final Rules at the time of the refinancing. Many questions remain concerning the precise requirements for such compliance, including, by way of example, (i) whether it would suffice for the CLO manager or its majority-owned affiliate to acquire five percent of only the new notes issued in the refinancing; (ii) whether, and how, a CLO manager's or its affiliate's investment in the original CLO notes would be taken into account in determining the CLO manager's compliance at the time of refinancing, and (iii) whether the CLO manager can satisfy its retention obligation at the time of refinancing by acquiring none of the new notes issued in the refinancing, but instead acquiring in a secondary transaction a position in the CLO's subordinated notes equivalent to five percent of the new notes issued in the refinancing.

The ability to direct a refinancing is a material selling point for many CLO equity investors given the relatively long life of a CLO and the gradual overall contraction of spreads on CLO liabilities that the market has seen over the past couple of years. Sponsors structuring CLOs since the date the Final Rules were released have routinely conditioned equity investors' ability to direct a refinancing on the receipt of the CLO manager's prior consent. This consent feature protects CLO managers from having to forfeit their CLO management rights in a scenario where the equity directs a

refinancing and the CLO manager is unable to finance its required risk retention position. Given that it is now clear that CLOs priced in 2015 and 2016 will not be eligible for relief from compliance with the Final Rules if refinanced on or after the Effective Date, coupled with the fact that traditional two-year non-call periods can only be shortened so much (*i.e.*, to expire prior to the Effective Date), CLO managers structuring transactions today are under more pressure than ever to demonstrate to their investors that they will have the financial wherewithal to comply with the Final Rules after the Effective Date and to remain eligible to continue to manage those CLOs.

CLO managers that do not have ready access to sufficient capital to comply with the Final Rules are pursuing a variety of options, including raising debt and equity financing directly at the CLO manager level or through majority-owned affiliates, and exploring other business combination strategies with well-capitalized partners. Vast differences across collateral management platforms concerning structure, regulation, investor base, and other important factors mean that each CLO manager will require a solution tailored to its particular circumstances and needs.

CLO GROUP

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