Current Issues Facing CLO Managers

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This Note summarizes ten issues for CLO managers and their legal counsel to consider as they structure new CLOs in the face of evolving market and regulatory conditions. These include US and EU risk retention rules, the Volcker Rule and FATCA US withholding tax considerations.

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The US market for collateralized loan obligations (CLOs) has suffered in recent years, the victim of guilt by association with its distant acronymed cousins, especially collateralized debt obligations (CDOs), which were backed by other securities collateralized by subprime home mortgages and other poorly underwritten consumer debt.

Recently, however, that perception has begun to reverse. Strong performance by CLOs issued from 2005 to 2007 are providing returns in the 20%-plus range. Tighter spreads on senior liabilities, primary loan issuances with wider spreads and slowly emerging clarity on the regulatory front have contributed to a slow but steady resurgence of CLO origination activity over the past two years along with continued interest in CLO manager acquisition opportunities.

New issuance in 2011 surpassed the $12 billion mark and is projected by some analysts to reach $20 billion in 2012. In addition, consolidation in the CLO manager sector continues to augment substantially the assets under management of several major advisers, and to provide opportunities for new synergies to develop among fixed income portfolio managers.

This Note sets out ten issues facing CLO managers and their advisers as they work to structure new CLOs in the face of evolving market and regulatory conditions.

REGISTRATION UNDER THE INVESTMENT ADVISERS ACT OF 1940

Most CLO managers previously relied on the private adviser exemption from registration with the SEC as an adviser under the Investment Advisers Act of 1940 (Advisers Act). This exemption was repealed by the Dodd-Frank Act. The narrow remaining exemptions from registration adopted in the SEC's final rules are now no longer available to most CLO managers.

As a result, existing CLO managers were required to register with the SEC by March 30, 2012, and portfolio management groups considering managing CLOs in the future must register as well. Registration applications to the SEC, which require careful attention to prepare, are generally processed within 45 days of receipt.

ADVISERS ACT COMPLIANCE POLICIES AND PROCEDURES

As SEC-registered advisers, CLO managers must adopt, implement and annually review for adequacy and effectiveness written policies and procedures reasonably designed to prevent violations of the Advisers Act and administered by a chief compliance officer. The SEC staff have expressed the view that "off the shelf" procedures not specifically tailored to an adviser's business or that fail to address risks presented by current market conditions or to take into account relevant contractual obligations are inadequate. The SEC staff have also expressed the view that valuation procedures, for example, should, at a minimum:

- Take into account contractual obligations under specific CLO indentures and variances in those requirements across an adviser's platform.
- Establish a valuation committee whose compensation is not directly based on the performance of the CLOs under management.
- Appoint a pricing manager to obtain market values for the CLO assets at regular intervals.
- Prescribe a sound procedure for valuing assets for which a pricing service bid price value and sufficient independent broker-dealer quotes are unavailable.
- Provide for valuation back-testing.

FATCA REQUIREMENTS

Beginning in 2014, the Foreign Account Tax Compliance Act (FATCA) will impose a 30% withholding tax on "withholdable payments" made to foreign financial institutions (FFIs), which includes CLOs, unless an FFI enters into an FFI agreement with the IRS to do all of the following:

- Obtain information from debt and equity holders necessary to determine if the holder qualifies as a "US account."
- Comply with verification and due diligence procedures required to identify US accounts.
- Report certain information with respect to US accounts on an annual basis to the IRS and comply with requests by the IRS for additional information with respect to any US account.

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- Attempt to obtain a waiver in any case where foreign law would prevent the reporting of information required with respect to any US account, and close the account if the waiver cannot be obtained.
- Starting in 2017, deduct and withhold 30% of any "foreign passthru payment" made to a "recalcitrant holder" that does not provide the required information or another FFI that has not entered into an FFI agreement or that elects withholding in lieu of compliance with the FATCA information reporting regime. However, it is currently unclear what kinds of payments will be treated as "foreign passthru payments" for this purpose.

The date on which FATCA withholding will begin has been extended and phased-in to permit affected institutions to make appropriate changes to their systems, and FATCA "grandfathering" rules apply to debt obligations issued and outstanding on or before January 1, 2013.

However, existing CLOs may be unable to comply with FATCA and enter into an FFI agreement or provide the required information to the IRS because of their legal structures. A non-compliant CLO may be:

- Subject to FATCA withholding on interest and principal payments it receives as well as sale proceeds on non-grandfathered US debt obligations that it owns.
- Required to withhold on payments it makes after 2016 with respect to non-grandfathered obligations it has issued.

It is worth noting that grandfathered debt obligations that are "materially modified" after January 1, 2013 can lose their grandfathered status under FATCA. Because of these difficulties, trade organizations and others have written comment letters to the IRS requesting a variety of FATCA exemptions for existing CLOs but no real relief has been granted yet. Further, subordinated obligations issued by the CLO that are not "debt" for US federal income tax purpose would not be grandfathered under currently proposed rules.

For these reasons, a collateral manager structuring any new CLO will need to:

- Revise its standard documentation, fairly extensively, to require investors to provide the necessary information.
- Ensure that key documents can be amended without excessive difficulty if necessary to address future developments in the FATCA regime (in particular, changes to the "foreign passthru payment" withholding regime).
- Include appropriate remedies for FATCA non-compliance (such as forced sale provisions).
- Appropriately revise disclosures and risk factors in offering materials to disclose the impact of the new FATCA regime.
- Develop a FATCA compliance plan with the indenture trustee to manage FATCA information collection and reporting to the IRS.

For more informations about FATCA, see *Practice Note, What's Market: FATCA Provisions in Loan Agreements (http://us.practicallaw.com/7-502-0730)* and *Articles, FATCA: sweeping international tax obligations (http://us.practicallaw.com/6-518-7061)* and *Impact of FATCA on Foreign Funds (http://us.practicallaw.com/2-518-6799)*.

CONFLICTS REVIEW

An extended comment period has expired for rules proposed by the SEC that would prohibit collateral managers of CLOs, among others, from engaging in transactions that would involve or result in certain material conflicts of interest with a CLO's investors for a period extending from one year following the closing of the CLO (see *Legal Update, SEC Proposes ABS Conflict of Interest Prohibition under Dodd-Frank (http://us.practicallaw.com/1-508-3141)*).

While the contours of the proposed rules remain subject to further definition, the proposal suggests that a transaction would involve or result in a "material conflict" for the purposes of the rules if the collateral manager would benefit directly or indirectly from either:

- The actual, anticipated or potential:
  - adverse performance of the asset pool supporting or referenced by the CLO;
  - loss of principal, monetary default or early amortization event on the CLO; or
  - decline in the market value of the relevant CLO.

  Each of these is referred to in the rules as a "short transaction."
- Fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration, as a result of allowing a third party, directly or indirectly, to structure the CLO or select assets underlying the CLO in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction, as described above.

The proposal suggests a deeper focus than ever will be required by CLO sponsors and collateral managers on conflicts analysis and related disclosure to ensure compliance with existing SEC regulations as well as the anticipated final conflicts rules. Such parties and their counsel should consider the utility of conflicts management procedures, which may include important roles for advisory committees and independent directors. For more information on the proposed ABS conflict of interest rules, see *Practice Note, Summary of the Dodd-Frank Act: Securitization: ABS Conflict of Interest Rules (http://us.practicallaw.com/9-502-8508)*.

US RISK RETENTION

The SEC and several other federal regulators have proposed rules that would require the sponsors of securitization transactions, including CLOs, to retain for the life of the CLO at least 5% of the credit risk of any asset that the sponsor transfers, sells, or conveys to a third party through the issuance of the CLO (see *Practice Note, Securitization: US Transaction Parties and Documents: The*

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Sponsor (http://us.practicallaw.com/9-501-7345)). Options for obtaining the requisite credit risk exposure, among others, include retention of:

- At least 5% of each issued class of CLO notes.
- An amount of notes of the most subordinated tranche equal to 5% of the par value of all of the CLO's issued notes.
- An L-shaped option combining both of the above in equal dollar amounts.

The proposed rules explicitly state that CLO managers generally are "sponsors" for purposes of the risk retention rules. However, that conclusion and the related assumptions in the proposed rules have been challenged in numerous comment letters.

The extended comment period for these controversial proposals expired in August 2011, leaving the CLO industry in anticipation of further clarity on the scope and contours of the rules, and the viability of certain exemptions for CLOs proposed by leading industry groups and market participants. Unless an exemption is granted, the universe of US CLO sponsors will likely be reduced to those with the financial ability to retain the requisite credit risk in each new CLO. The risk retention requirement will become effective for CLOs two years after final rules are adopted.

For more detailed information on the proposed risk retention rules, including a discussion of the comment letters on the application of the rules to CLOs, see *Practice Note, ABS Risk Retention under Dodd-Frank (http://us.practicallaw.com/7-517-5982)*.

EU RISK RETENTION

Article 122a of the EU Capital Requirements Directive requires European credit institutions, including most EU banks, that invest in securitization vehicles, including US CLOs, to adhere to new requirements in order to avoid prohibitively high regulatory capital charges. Similar legislation is being enacted in relation to European insurers and fund managers. Affected institutions must ensure that the original lenders, originators and sponsors of any CLO in which it proposes to invest will retain a material net economic interest of at least 5% in the securitized assets. Collateral managers that have the capacity and willingness to deploy their own balance sheets, as opposed to the assets from their managed funds, to meet the 5% retention requirement will enjoy a competitive advantage. But the new legislation severely restricts the ability of European institutional investors to purchase CLO securities and, as a practical matter, has meant that currently, the majority of US CLO transactions either:

- Are not marketed in Europe.
- Constitute balance sheet CLOs in relation to which the originator retains the necessary 5% exposure.

US CLOs generally are not Article 122a compliant and include in their disclosure materials a risk factor to that effect. Article 122a has posed a particular problem for European banks active in the US CLO market, as their US branches and subsidiaries often fall under its restrictions, which may prevent them from investing in US CLOs and providing related services, such as hedging, that they previously provided in connection with their arrangement of US CLOs.

THE VOLCKER RULE

Section 619 of Dodd-Frank, popularly known as the Volcker Rule, would prohibit insured depository institutions, bank holding companies (BHCs) and their subsidiaries and affiliates from engaging in many proprietary trading activities and from investing in and sponsoring certain private funds and other investment vehicles. While certain technical details remain to be clarified, several features of the proposed rules suggest that the final rules will not impede the issuance of basic CLOs. Highly controversial, the proposed rules continue to be the subject of intense debate in Congress and in financial markets worldwide.

Regulators have issued a release clarifying that the compliance date for the Volcker Rule will not occur until July 21, 2014 (see *Legal Update, Agencies Clarify Volcker Rule Implementation Date (http://us.practicallaw.com/7-519-0685)*) to permit banks to bring their activities and investments in line with the rule. The Federal Reserve also has discretion to allow individual banks up to three one-year extensions of that period. For detailed information on the proposed CLO exemption from the Volcker Rule, see *Practice Note, Summary of the Dodd-Frank Act: Securitization: The Volcker Rule and CLO Exemption (http://us.practicallaw.com/9-502-8508)*. For more information on the Volcker Rule generally, see *Practice Note, Summary of the Dodd-Frank Act: The Volcker Rule (http://us.practicallaw.com/6-502-7553)*.

"AMEND-TO-EXTENDS"

Borrowers on debt obligations included in CLO portfolios often look to extend the maturity dates of their obligations through a variety of mechanisms and techniques, commonly involving an amendment to their loan documents (known as amend-to-extends or amend & extends). As a result of this trend, collateral managers are learning to live with increased pressure on their rating agency driven tests, such as those that set a maximum par-weighted average on the remaining lives of the assets in a CLO, and to navigate complex indenture requirements to accommodate these extensions. Collateral managers are increasingly consulting their legal and tax advisors to ascertain their rights and obligations in the context of these modifications to the assets in their portfolios, including whether compliance with standard "purchase" requirements, such as meeting portfolio profile test requirements, is necessary. These kinds of amendments may also raise tax concerns if they could be construed, in substance, as originations of new loans. For more information on amend & extends, see *Practice Notes, What's Market: Amend & Extends (http://us.practicallaw.com/9-385-9683)* and *Amend & Extends: When Non-pro Rata is the Best Way (http://us.practicallaw.com/8-386-4388)*.

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LOAN WORKOUTS

Restructuring the terms of a loan held in a CLO's portfolio can cause the CLO to be deemed to have acquired assets that could cause the CLO to be engaging in a US trade or business. This could have an adverse impact on the tax status of the CLO. Problematic assets include interests in companies that own real property or interests in limited liability companies or other "pass through entities" that are US operating companies. Careful analysis of existing transaction documentation and evolving rating agency guidance is required for the creation of "blocker" subsidiaries to address these issues.

NEW DISCLOSURE REQUIREMENTS

Rule 17g-5 under the Securities Exchange Act of 1934 requires, among other things, that a credit rating agency registered with the SEC that is being paid by a CLO arranger to rate a CLO managed by that manager maintain a password-protected website for the CLO in order to manage conflicts. The rating agency must provide free, unlimited access to the website to other registered rating agencies, identifying the information currently used to determine or monitor the credit ratings for that CLO, and to allow other rating agencies to rate and monitor the CLO on an unsolicited basis.

In practice, a negotiation ensues among the issuer, the collateral manager, the placement agent, the trustee and the accountants to allocate responsibility for posting information to the website, both pre-closing and post-closing, and to appropriately assign risk among such parties. CLO arrangers also should consider disclosing potential risks associated with unsolicited ratings. For more information on Rule 17g-5, see *Practice Note, Summary of the Dodd-Frank Act: Securitization: Rating Agency Conflict Disclosure and Unsolicited ABS Ratings (http://us.practicallaw.com/9-502-8508).*

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