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Current Issues in the CLO Market: As of February 2017

Schulte Roth & Zabel LLP

Craig Stein

Paul N. Watterson, Jr.

I. Introduction

In 2016, new issuances of U.S. CLOs[1] were down from approximately $99 billion in 2015 to approximately $70 billion.[2] The major themes for U.S. CLOs in 2016 were: (i) structuring that gave investors in the subordinated notes confidence that they would be able to refinance the senior notes after December 24, 2016 (the date the U.S. risk retention rule[3] became effective); (ii) risk retention "solutions" that will be used in new-issue CLOs that close after the U.S. risk retention rule became effective; (iii) refinancings and "resets" of CLOs for which the non-call period had passed; and (iv) continuing uncertainty (and apprehension) about how the EU's risk retention requirements[4] would be modified as part of the "STS" process.

We expect the following major developments in the U.S. CLO market in 2017: (i) refinancings of CLOs in a manner that is exempt from the U.S. risk retention rule; (ii) refinancings of CLOs in a manner that complies with the U.S. risk retention rule; (iii) implementation of risk retention "solutions" for new-issue CLOs in order to comply with the U.S. risk retention rule; (iv) adaptation of those risk retention solutions by managers to make their new issue CLOs "dual compliant"; (v) adaptation of warehousing structures to comply with risk retention requirements; (vi) for non-U.S. managers "sponsoring" Euro CLOs, making the painful choice between complying with the U.S. risk retention rule or observing the marketing and other restrictions necessary to qualify for the extraterritorial exemption; and (vii) further modification of the U.S. and EU risk retention requirements.

II. Developments in 2016

A. Structuring of new issue U.S. CLOs

Although the U.S. risk retention rule did not become effective until December 24, 2016, most new-issue CLOs that closed in 2016 nonetheless were structured to give investors in the subordinated notes a high degree of confidence that they would be able to exercise the "refinancing option". Although CLOs that issued notes prior to December 24, 2016 were "grandfathered" from the U.S. risk retention rule, a refinancing of such notes that occurs on or after December 24, 2016 will constitute a new "securitisation transaction", which requires CLO managers, as sponsors, to comply with the rule unless the requirements of one of the no-action letters discussed below are satisfied.

In some U.S. CLOs in 2016, the CLO manager retained subordinated notes sufficient to qualify as an eligible horizontal residual interest in the CLO. Since the U.S. risk retention rule was not yet effective, CLO managers did not provide the required disclosures to investors about the assumptions and methodology used to calculate the fair value of the notes in order to demonstrate that the manager held subordinated notes with a fair value at least equal to five per cent of the fair value of all of the CLO notes. Now that the rule is in effect, if a CLO refinances notes issued *prior to* the rule's effective date, the manager would need to calculate the fair value of the refinancing securities and of the subordinated notes that it was retaining and disclose this information to investors in the refinancing.

In other 2016 CLOs, the manager (or a "majority-owned affiliate" of the manager) purchased a five per cent "vertical interest" in each class of notes. This will not be sufficient to comply with the U.S. risk retention rule at the time of a subsequent refinancing, because some of these notes will be redeemed in the refinancing and the manager (or a majority-owned affiliate ("MOA")) must purchase five per cent of each class of refinancing notes issued in the refinancing. However, this purchase at the original closing gave subordinated note investors comfort that the manager would roll its investment into the refinancing notes, and in some cases the manager committed to do so.

The indentures for some 2016 CLOs provided that if a majority of the subordinated notes proposed to refinance the CLO's senior notes but the manager did not consent to the refinancing, its management fees would be reduced, thereby reducing the impact on the subordinated noteholders of the CLO's inability to consummate the refinancing. These provisions give an incentive to the CLO manager to comply with the U.S. risk retention rule at the time of a refinancing.

B. Development of risk retention "solutions"

In 2016, many CLO managers developed risk retention "solutions" that will be used in new issue CLOs that close in 2017 and thereafter. The three main solutions have become known as majority-owned affiliates ("MOAs"), capitalised majority-owned affiliates ("CMOAs") and capitalised management vehicles ("CMVs").

For many years CLO managers have formed private investment funds to invest in CLOs for which they are the collateral manager. Investments in a CLO by such a private investment fund will not satisfy the risk retention obligations of the CLO manager unless the private investment fund qualifies as a majority-owned affiliate of the CLO manager. A "majority-owned affiliate" is a term defined in the U.S. risk retention rule (but, unfortunately, this term is not used

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in the EU risk retention regime), and generally means that the CLO manager (or a consolidated affiliate) must own more than 50 per cent of the equity of the fund or a "controlling financial interest" in the fund (or the fund must own a majority of the equity or a controlling financial interest in the manager). The determination of whether or not there is a controlling financial interest is an accounting conclusion under GAAP. Ownership of less than a majority of the equity can be sufficient for this purpose if the CLO manager (or its consolidated affiliate) controls the major economic decisions of the fund and contributes 10 to 20 per cent of the fund's capital. As a result, an MOA may raise 80 to 90 per cent of its capital from third-party investors. An MOA may either hold an eligible horizontal residual interest in the CLO (i.e., the CLO's subordinated notes) or an eligible vertical interest in all classes of the CLO's notes (or a combination of the two), and MOAs which hold vertical interests often borrow on a "recourse" basis to finance the investment.

CLO managers (and their affiliates) also form private investment funds to invest in risk retention securities of CLOs managed by unaffiliated CLO managers. This is similar to a "fund of funds" in that the fund invests in MOAs formed by unaffiliated CLO managers, and may also invest through a majority-owned affiliate formed by the fund's manager in CLOs managed by the fund's manager (or its affiliate). These funds also may invest in the CMVs described below.

Several CLO managers formed new management companies (i.e., CMVs) that will both manage CLOs and invest in the risk retention securities issued by those CLOs. Unlike MOAs, there is no accounting requirement that the legacy manager make a minimum capital contribution to a CMV (or own a majority of its equity) or that it have "control" over major economic decisions by the CMV. The new CLO management companies are capitalised in a number of ways, including by equity alone or by a combination of debt and equity. In order to qualify as a "sponsor" which may hold the requisite risk retention interest, the new management company must be the entity that "organises and initiates" the CLO[5] and cannot be "an entity that … only purchases assets at the direction of an independent asset or investment manager, only pre-approves the purchase of assets before selection, or only approves the purchase of assets after such purchase has been made".[6] Therefore, the new CLO management company should have sufficient economic substance and its own directors, officers and/or employees who will make the investment decisions. Some of these directors, officers and/or employees may be "dual" employees of the existing manager or "seconded" from the legacy manager. The new management companies should pay their own expenses, including their employees' salaries. They often have services agreements with the legacy manager to provide administrative, back-office, research, loan settlement and middle-office services. However, the services agreement with the existing manager should not delegate the investment management decisions for the CLO to the legacy manager. The new management company must register as an investment adviser with the SEC.

CMOAs qualify as MOAs because the legacy CLO manager (or its consolidated affiliate) has a majority equity interest or a "controlling financial interest" in the CMOA. However, a CMOA is not an investment fund, but (like a CMV) is a new investment manager which will manage CLOs. A CMOA may fail to qualify as the "sponsor" of a CLO under the U.S. risk retention rule because, unlike a CMV, it relies too heavily on the investment management resources of the legacy CLO manager; however, even if the legacy CLO manager is the sponsor of the CLO, the CMOA is a majority-owned affiliate of the legacy CLO manager and, therefore, is eligible to hold the risk retention interest in the CLO. As the collateral manager for the CLO, a CMOA (like a CMV) may also satisfy the EU risk retention rules by holding the risk retention interest and also "originating" at least five per cent of the loans for the CLO prior to the closing date. This is significant, because the EU regime does not permit an MOA that is not the CLO manager to hold the risk retention interest unless it meets the more rigorous requirements for a non-manager "originator". Such loan origination activities may increase the capitalisation needed by the CMOA to support its business. A CMOA may be a "relying adviser", which does not register as an investment adviser with the SEC, but instead relies on the prior registration of the legacy manager. It may receive significant services from the legacy manager.

C. Refinancings and "resets" of CLOs

After a two-year non-call period, the holders of a majority of the principal amount of the subordinated notes typically have the right to direct a refinancing of a U.S. CLO's senior notes. In a refinancing, the CLO issues new securities (or a loan) that have a lower interest rate or spread than the original CLO notes and uses the proceeds to redeem the original senior notes.

In 2016, many CLOs (that closed in 2014 and earlier) were eligible for refinancing. Because a refinancing by a CLO on or after December 24, 2016 will trigger an obligation to comply with the U.S. risk retention rule, holders of subordinated notes were keen to exercise their refinancing right prior to that date. Some CLOs that issued notes in 2015 even shortened their non-call periods to enable the holders of the subordinated notes to direct a refinancing prior to the effective date of the U.S. risk retention rule. In addition, many CLOs effectuated a "reset" in 2016 prior to the effective date of the U.S. risk retention rule. A "reset" is a refinancing that also extends the non-call period and reinvestment period, and makes other material changes to the CLO indenture to reflect current market terms. As a result, notes issued in refinancings and resets comprised a majority of the notes issued by U.S. CLOs during the fourth quarter.

D. Continuing uncertainty (and apprehension) about how EU risk retention requirements will be modified as part of the STS process

In December 2016, the European Parliament's Committee on Economic and Monetary Affairs ("ECON") adopted a compromise draft to the proposed framework for simple, transparent and standardised ("STS") securitisations ("STS Regulation"). The original proposal of the STS Regulation was published by the European Commission in September 2015 and was intended to reduce regulatory capital requirements applicable to EU financial institutions investing in STS securitisations. A number of provisions of the draft STS Regulation, most importantly, those governing risk retention, apply to all types of securitisations. Facing proposals from members of Parliament to increase risk retention from five to 20 per cent, a compromise was reached at the end of last year to change the required level of risk retention to between five to 10 per cent depending on the method of holding the risk retention piece (e.g., 10 per cent for a vertical interest), while leaving open the possibility of future increases in both horizontal and vertical risk retention requirements up to as much as 20 per cent.

Another key provision of the compromise draft is that at least one of the originator, sponsor or original lender must be a "regulated entity" or another type of qualifying financial institution. A "regulated entity" is defined as an EU-regulated bank, investment firm or insurance firm. Therefore, the current proposal may exclude CLO managers that are not regulated in the EU as investment firms from acting as the retention holder.

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The compromise draft adopted by ECON must now go through the trilogue process in 2017 with representatives of the European Parliament, the European Commission and the Council attempting to reach consensus on the final draft of the STS Regulation.

III. Developments in 2017

A. Refinancings of CLOs

Immediately after the effective date of the U.S. risk retention rule, many CLO managers began the process of refinancing CLO notes that priced prior to December 24, 2014. In the Crescent no-action letter[7] the staff of the U.S. Securities and Exchange Commission (the "SEC") concluded that such CLOs could refinance each class of their senior notes once after December 23, 2016 without complying with the U.S. risk retention rule if the refinancing met the conditions in the letter. Such refinancings have accounted for a significant portion of the new issue activity in the first quarter of 2017. The refinancing must meet the following conditions, among others, to qualify: (i) it must be completed within four years after the original closing date of the CLO; (ii) after giving effect to the refinancing, the capital structure will be unchanged, the principal amount of the refinanced notes after the refinancing and the original notes after the refinancing will be the same, the priority of payments 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; (iii) the investment criteria of the CLO will not change as a result of the refinancing; and (iv) no securitisation of additional assets will be effected by the refinancing. As a result, while refinancings may rely on the no-action letter, "resets" will not be able to rely on the letter.

In the Sancus Capital no-action letter,[8] the SEC staff concluded in September 2016 that a CLO could use the auction procedure described in the letter to reset the spread over LIBOR, on any class of senior notes, periodically after the original issuance date (and thereby reduce the interest rate on the notes) after December 23, 2016, without triggering a requirement for the manager to comply with the U.S. risk retention rule. The CLO must satisfy the conditions in the letter, many of which relate to the reverse Dutch auction procedures and how (and by whom) they are implemented. Essentially this auction procedure would have the same result as a refinancing of a class of notes (i.e., a reduction in the interest rate on that class of notes). The CLO would need to provide for the auction procedure in its note offering documents in order for it to comply with one of the conditions in the no-action letter.

Refinancings of CLOs that cannot meet the conditions in the Crescent no-action letter or the Sancus no-action letter and all resets of CLOs must comply with the U.S. risk retention rule. CLO managers (or their MOAs) may comply by purchasing five per cent of each class of the new securities issued in the refinancing. Alternatively, the CLO could issue additional subordinated notes to the manager (or its MOA) which, together with the subordinated notes purchased by the manager at the original closing, have a fair value equal to five per cent of the fair value of the securities issued in the refinancing. CLO managers that comply by retaining or acquiring an eligible horizontal residual interest will be required to provide the required disclosures on the estimated fair value in the preliminary offering circular (or in a separate disclosure) to investors at a reasonable time prior to the sale of the refinancing notes and information on the fair value as of the date of issuance at a reasonable time after the closing for the refinancing notes.

B. Implementation of risk retention "solutions" for new issue U.S. CLOs

MOAs, CMOAs and CMVs which have completed their first round of funding are beginning to invest in CLOs which they manage or, in the case of an MOA, which are managed by affiliates.

These new investment and management entities need to implement governance and management procedures that satisfy their specific accounting and regulatory requirements. In order for the accounting firm to reach the necessary conclusion under GAAP (that there is a controlling financial interest) most important decisions for a typical MOA must be made by the legacy manager or its consolidated affiliate, and there will be little participation by investors in decision-making; in this respect the typical MOA is similar to investment funds which invest in subordinated notes of a CLO. On the other hand, a CMV is likely to implement governance and management procedures that involve a significant amount of independent decision-making by the CMV, and may involve investor participation in the governing board (or at least in a limited partner advisory committee). Many CMVs have their own portfolio management staff and/or independent directors (who are not affiliated with the legacy manager), which helps to establish that the CMV is the "sponsor" under the U.S. risk retention rule. That is not to say that the CMV does not have extensive economic and legal relationships with the legacy manager. These relationships often include agreements under which the legacy manager and its affiliates provide a broad range of services (other than discretionary investment management services) to the CMV, and the CMV and the legacy manager may share "dual employees". A CMOA is likely to have even more extensive support and services agreements with the legacy manager, and these agreements may include the legacy manager providing investment management services to the CMOA. A CMOA is less likely to have its own employees who are not also "dual" employees of the legacy manager. The activities of a CMV or an MOA, particularly if it also receives collateral management fees from the CLO, can result in U.S. tax issues for non-U.S. investors and for tax-exempt U.S. investors. Careful tax structuring in the design of the CMV or the MOA may mitigate these tax concerns.

C. Adaptation of those risk retention solutions by managers to achieve "dual compliance"

The differences in the U.S. and the EU risk retention regimes make "dual compliance" problematic, but nonetheless many CMVs and MOAs, especially CMOAs, are designed not only to comply with the U.S. requirements but, when marketing to European investors is important, the EU requirements as well. Most CMVs and CMOAs have not obtained the MiFiD authorisation necessary to qualify as a sponsor under the EU risk retention regime. However, under current EU risk retention requirements, because a CMV or CMOA is the collateral manager for the CLO, it may hold the risk retention interest so long as it "originates" a portion of the loan portfolio for the CLO. The percentage of the loan portfolio that the collateral manager must originate has not been specified by the regulators, but in market practice it has been at least five per cent of the portfolio. To qualify as an "originator" under the EU risk retention rules, the collateral manager is required to sell the loans to the CLO after it has taken the credit risk or market risk (or both) of the loans for a period of time. Although an MOA (that is not a CMOA) also can qualify to hold the risk retention interest by originating a portion of the loan portfolio for the CLO, the requirements under the EU regime are much greater when the originator is not also the collateral manager for the CLO; among other things, the MOA must originate more than

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50 per cent of the CLO's portfolio and this requirement remains in effect after the CLO closing. Once a CMV or an MOA qualifies as an "originator" under the EU regime, it may hold either a horizontal or a vertical interest in order to satisfy risk retention requirements. The face amount of notes acquired by the manager or an MOA must take into account the differences in the calculation of the required risk retention interest under the EU risk retention rule and the U.S. risk retention rule, particularly for horizontal residual interests.

D. Warehouse facilities

CLOs utilise warehouse financing to accumulate a loan portfolio prior to the issuance of the CLO notes. Although the U.S. risk retention rule does not specifically address warehousing transactions, it would apply to a warehouse transaction if it is a "securitisation transaction". The hallmark of a "securitisation transaction" is that it involves the offer and sale of asset-backed securities. "Asset-backed security" is defined as a fixed-income or other security collateralised by any type of self-liquidating financial asset (including a loan) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including, among other things, a collateralised debt obligation.[9] Warehouse facilities which take the form of a revolving credit agreement with a bank are less likely to be characterised as an "asset-backed security", because traditional loans have rarely been viewed as securities and the revolving credits utilised in CLO warehousing do not have the characteristics which have infrequently caused courts to determine that a loan is a security. During the warehouse phase the CLO manager and/or third party investors will typically invest in preference shares, a subordinated loan or subordinated notes issued by the CLO. It is necessary to analyse whether this first-loss equity is an "asset-backed security", in which case the warehouse financing is likely to be a "securitisation transaction" and both the first-loss equity and the revolving credit loan are likely to be "ABS interests" for which risk retention is applicable. Preference shares and similar securities are not ABS interests if they were issued to evidence ownership of the CLO (or warehousing company) and are not "primarily dependent on the cash flows of the collateral held by the issuing entity".[10] The risk that the U.S. risk retention rule will be triggered by a warehouse transaction can be mitigated by documentation of the warehouse on terms that make it less likely that the revolving credit facility (or total return swap or other senior facility) or the first-loss security are asset-backed securities.

E. Adaptation of Euro CLOs to the U.S. risk retention rule

Just as CLO managers domiciled in the U.S. are required to adapt their transactions to the EU risk retention rules if they wish to market U.S. CLO notes to European investors, CLO managers domiciled in Europe now need to adapt their transactions to the U.S. risk retention rule if they wish to market Euro CLO notes to U.S. investors. The U.S. risk retention rule states that it is not applicable to securitisations in which neither the issuing entity nor the sponsor is domiciled in the United States, provided that certain conditions are satisfied. One of those conditions is that no more than 10 per cent of the dollar value (or equivalent in Euro if the CLO notes are so denominated) of all classes of ABS interests issued in the CLO are sold or transferred to or for the account or benefit of U.S. persons. A non-U.S. manager planning to market a Euro CLO must now choose whether to comply with these marketing and other restrictions or to hold a risk retention interest that satisfies the U.S. risk retention rule.

F. Legislative action

The results of the trilogue process may change both the amount of required risk retention and which entities will be eligible to hold risk retention securities. At the same time significant changes in the U.S. risk retention rule (or in the statute on which it is grounded) may be in the offing. In March 2016, HR 4166 (which is sometimes referred to as the Qualified CLO (the "QCLO") bill) passed the House Financial Services Committee 42-15, with 10 Democrats supporting the bill. It would reduce the risk retention requirements for "qualified" CLOs, which meet six requirements: (i) quality of assets; (ii) portfolio diversification; (iii) minimum capital structure; (iv) alignment of interests; (v) reporting and disclosure; and (vi) manager regulation. The risk retention requirement for a QCLO would be reduced to five per cent of the equity of the CLO, as opposed to equity which has a fair value equal to five per cent of the fair value of the securities issued by the CLO. If a CLO does not meet these restrictions, the CLO manager could still retain an eligible vertical interest or eligible horizontal residual interest under the existing rule. This legislative initiative has been supported by the LSTA, which has also brought litigation challenging the application of the U.S. risk retention rule to CLOs, which to date has not been successful.[11]

In 2017, Republicans control the House, the Senate and the Presidency. Since the QCLO bill passed the House Financial Services Committee with bipartisan support, there is hope that it will be reintroduced and pass the full House. If it then was approved by the Senate, most commentators believe that President Trump would sign it. However, President Trump and many Republican Congressmen have supported a broader effort to repeal much of the Dodd-Frank Act (pursuant to which the U.S. risk retention rule was adopted), and the QCLO bill may be superseded or delayed by this broader legislative effort.

CLO industry participants expect new issuances in 2017 (excluding refinancings and resets) to be flat as the industry adapts to the imposition of the U.S. risk retention rules and the ever-changing EU risk retention rules. Market forces will need to cooperate as well; there is a current shortage of loan collateral and liability spreads still need to further tighten to continue the current pace of new issuances. But the CLO market has proven resilient over recent years, having flourished through the financial crisis and adjusted to the more burdensome regulatory environment.

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Endnotes

1. In this article, CLOs which invest primarily in loans to U.S. obligors are referred to as "U.S. CLOs", and CLOs which invest primarily in loans to European obligors are referred to as "Euro CLOs".
2. http://cloi.creditflux.com. These amounts exclude notes issued in refinancings and resets.
3. The final rules implementing the credit risk retention requirements of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, entitled "Credit Risk Retention", 79 Fed. Reg. 77602 (Dec. 24, 2014).
4. ARTICLES 404-410 OF REGULATION (EU) NO 575/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, 2013 O.J. L 176/1, as supplemented by COMMISSION DELEGATED REGULATION (EU) No 625/2014 of 13 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council by way of regulatory technical standards specifying the requirements for investor, sponsor, original lenders and originator institutions relating to exposures to transferred credit risk; 2013 O.J. L 174/16, Chapter 3 Section 5 of the EU Commission Delegated Regulation (EU) 231/2013; and Articles 254- 257 of Delegated Regulation (EU) No 2015/35 of 10 October 2014.
5. Credit Risk Retention, *supra note* 3, at 77742.
6. Credit Risk Retention, *supra note* 3, at 77609.
7. Crescent Capital LP, SEC No-Action Letter (July 17, 2015).
8. Sancus Capital Management LP, SEC No-Action Letter (Sept. 1, 2016).
9. Securities Exchange Act, 15USC Sec. 78c., (a)(79) (2012).
10. Credit Risk Retention, *supra note* 3, at 77740.
11. *The Loan Syndications and Trading Assn v. Securities and Exchange Commission et al.* No. 16-652, 2016 WL 7408834 (D.D.C Dec. 22, 2016).

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