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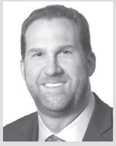
U.S. and EU CLOs: Market Trends and Recent Regulatory Developments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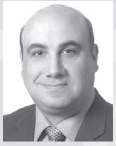
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Introduction

2021 was a banner year for CLOs in the United States and Europe. New issuance was approximately $186.7 billion in the United States and €39 billion in Europe. Although the CLO market had a slow start in 2022, primarily (at least anecdotally) due to the transition from the London Interbank Offered Rate ("LIBOR") to the Secured Overnight Financing Rate ("SOFR"), some forecasters were still predicting between $155 to $160 billion of new issuance for U.S. CLOs for the year. European issuance was expected to be around €37 billion. However, inflation and rising interest rates created volatility in the market and the war in Ukraine brought an unexpected shock to the market. Supply chain issues continuing from the COVID-19 pandemic were also exacerbated by the war. Analysts have now adjusted their expectations downward. As a result, some CLOs in the United States have been offered with shorter non-call periods and shorter reinvestment periods. We also heard about interest in static CLOs.

This chapter discusses current market trends and legal and regulatory developments that are affecting the CLO market.

U.S. CLOs Transition from LIBOR to SOFR

Financial markets continued their transition from LIBOR to alternative reference rates, which has been ongoing since the United Kingdom's Financial Conduct Authority (the "FCA") announced in 2017 that it did not intend to sustain LIBOR after 2021. On March 5, 2021, the FCA announced that all LIBOR settings would either cease to be provided by any administrator, or no longer be representative, immediately after December 31, 2021 for all GBP, EUR, CHF and JPY LIBOR settings and one-week and two-month USD LIBOR settings, and immediately after June 30, 2023 for the remaining USD LIBOR settings, including one-month and three-month USD LIBOR, thereby allowing an additional 18 months for certain USD LIBOR settings to continue. Notwithstanding the additional 18-month continuation for certain USD LIBOR settings, the U.S. banking regulators released statements that (i) encouraged banks to cease entering into new contracts that use USD LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021, (ii) indicated that new contracts entered into before December 31, 2021 should either utilize a reference rate other than USD LIBOR or have robust fallback language that includes a clearly defined alternative reference rate after the discontinuation of USD LIBOR, and (iii) explained that extending the publication of certain USD LIBOR tenors until June 30, 2023 would allow most legacy USD LIBOR contracts to mature before LIBOR begins experiencing disruptions. The FCA's announcement coincided with a March 5, 2021 announcement from ICE Benchmark Administration ("ICE"), the administrator of LIBOR, indicating that, absent FCA intervention or further panel bank support, it could not publish USD LIBOR tenors on a representative basis on or after June 30, 2023. Although LIBOR rates may be published using a changed methodology (also known as a "synthetic" basis), the FCA stated that these rates would not be representative of the prior LIBOR rates, and should be used only, if at all, for the purposes of difficult legacy contracts.

The Federal Reserve Bank of New York has been publishing SOFR, which is the alternative rate favored by the Alternative Reference Rates Committee ("ARRC") convened by the Federal Reserve Board and the Federal Reserve Bank of New York for purposes of determining an alternative reference rate. On July 29, 2021, the ARRC announced its formal recommendation of forward-looking SOFR term rates produced by the CME Group ("CME's Term SOFR").

The ARRC announced on March 8, 2021 that the announcements by the FCA and ICE on March 5, 2021 constitute a "benchmark transition event" under the ARRC's recommended fallback terms for new issuances of LIBOR-based floating rate securities and securitizations. Consequently, for most legacy CLOs that implemented the ARRC's suggested fallback language in the past few years, a "Benchmark Transition Event" occurred with respect to LIBOR for the CLO issuer's securities; however, for most of these CLOs a "Benchmark Replacement Date" has not yet occurred. The Benchmark Replacement Date is expected to be June 30, 2023, which means that, absent a further change in cessation date by the FCA, the transition from LIBOR to an alternative reference rate for a legacy CLO issuer's securities will become effective on or after June 30, 2023.

Taking into account the bank regulators' recommendations to cease use of LIBOR by December 31, 2021, the CLO market began to see transactions that were scheduled to close towards the end of 2021, or that priced in 2021 with a closing date scheduled in early 2022, being priced with reference rates based on SOFR (or CME's Term SOFR). Because LIBOR is an unsecured rate, and because SOFR is a secured rate, initially these transactions were priced to include a credit spread adjustment ("CSA") in addition to any applicable pricing spreads to indicate the amount of the total spread that accounted for the perceived difference between the LIBOR and SOFR reference rates. It is of note that the CSA priced into these transactions was in most cases not the same as the fixed spread adjustment calculated and announced by the International Swaps and Derivatives Association, Inc. ("ISDA"). For example, for notes that pay quarterly, the CSA priced into these CLO transactions was typically in the range of 10 to 15 basis points, where the ISDA spread adjustment for a USD three-month tenor is 26.161 basis points. In any event, relatively quickly, the CLO market began to price SOFR transactions without the CSA.

In summary, although 2022 started off slowly as market participants worked through the transition to SOFR-based rates, the CLO market quickly adjusted. New CLOs issuing floating rate notes in 2022 are typically using CME's Term SOFR instead of LIBOR as the interest reference rate for floating rate notes, and the pricing spread is typically a single figure with no CSA.

Jurisdiction of U.S. CLO Issuers

Earlier this year, with effect from March 13, 2022, the Cayman Islands were included in the European Union's list of jurisdictions that have strategic deficiencies in their regimes on anti-money laundering and counter-terrorist financing (the "EU AML/CFT List"). This impacts CLOs and other securitizations as, under Article 4 of the EU Securitization Regulation, there is a prohibition on securitization special purpose entities being established in a third country that is listed as a high-risk third country that has strategic deficiencies in its regime on anti-money laundering and counter terrorist financing. As such, not only would EU sponsors and originators be prevented from issuing securitizations out of the Cayman Islands, but, by extension, EU investors would also be prevented from investing in securitizations that involve Cayman vehicles.

Not all the consequences of this are completely clear and there are a number of questions being raised, for example:

- Is it possible to devise workarounds through building double special-purpose-vehicle ("SPV") structures which include a Cayman vehicle but with another vehicle interposed between investors? On its face, this is almost certainly a non-starter. EU legislation takes a purposive approach and it is as important to follow the spirit of the rules as it is to obey the letter. However, channeling EU cash via a non-Cayman entity to an ultimate non-Cayman destination could be acceptable in a structure where non-EU cash is routed via or to a Cayman entity. The devil, as always, is in the details.
- Would EU investors be required to divest themselves of existing holdings in Cayman securitizations? It seems reasonable to take the view that this would be a step too far. It would turn EU investors into forced sellers placing them at a disadvantage and exposing them to mark-to-market losses. It would be surprising if the European Union sought to penalize EU investors in this way when they had done nothing wrong when they made the original investment.
- Are EU investors permitted to acquire new positions in Cayman securitizations that were issued prior to the "blacklisting"? This is debatable, but we understand the favored view to be that this is not permitted. Under the EU Securitization Regulation, the Article 5 due diligence obligations apply prior to an EU institutional investor holding a position in a securitization. Therefore, prior to making the investment would seem to be the key time to make the determination with regard to the factual situation at that time and not to look back to the original issue date.
- What is the position in relation to refinancings? Given that a noteholder has the option of being repaid on the refinancing date and is not obliged to roll into the new issuance, if issuers are looking for EU money to be rolled into any refinanced CLO, they likely will have to replace any original Cayman issuer with an issuer domiciled in another permitted jurisdiction.

The EU AML/CFT List is reviewed and amended from time to time, but it is uncertain as to how long it will be before the Cayman Islands are removed from the EU AML/CFT List. Therefore, CLOs that intend to sell their securities to European investors and comply with the EU Securitization Regulation are now being established in jurisdictions other than the Cayman Islands, such as Bermuda and Jersey, and in some cases in the United States.

It should be noted that post-Brexit, although the UK Securitization Regulation includes a similar prohibition to that in Article 4 of the EU Securitization Regulation, it is not as extensive. Consequently, the addition of the Cayman Islands to the EU AML/CFT List has no jurisdiction over UK institutional investors. However, many UK investors from a reputational perspective may be deterred from investing in Cayman securitizations as a result.

Proposed U.S. Regulations that May Affect CLO Managers

In February 2022, the United States Securities and Exchange Commission (the "SEC"), in what some market participants consider to be a potentially disruptive event for managers of CLOs in the United States, issued a proposed rule (the "Proposal") that would require registered (under the U.S. Investment Advisers Act of 1940) investment advisers to private funds to comply with new proposed requirements relating to reporting, record-keeping and disclosure, among other things, and would prohibit certain sales practices, conflicts of interest and compensation arrangements. The term "collateralized loan obligation" is not used in the Proposal and an initial reading of the Proposal leads one to believe that it is primarily directed at managers of hedge funds and private equity funds. However, because most CLOs rely on Section 3(c)(7) of the Investment Company Act of 1940 (the "ICA") for an exemption from registration as an investment company under the ICA, CLOs therefore fall within the definition of "private fund" as used in the Proposal. Although the Proposal applies to investment advisers as opposed to the private funds directly, the Proposal is viewed as disruptive to CLOs because, among other things: (i) practically all portfolio managers and collateral managers to U.S. CLOs are registered investment advisers and, therefore, the Proposal applies to all such managers; and (ii) many of the Proposal's requirements purport to address issues with practices in the private funds market that will affect the CLO space, even though the practices in the private funds market are markedly different from practices in the CLO space.

As a high-level summary, among other things, the Proposal would: (i) require quarterly statements that include information regarding fees, expenses and performance to be distributed 45 days after each calendar quarter to private fund investors (but, given that CLOs provide monthly reports and payment date reports with asset, liability, collection and expense level detail, these quarterly reports would add no value for CLOs); (ii) require mandatory audits of financial statements of the private funds annually and upon liquidation (but CLOs do not deliver financial statements; they provide detailed reporting of assets, liabilities, collections and expenses, and typically accountants are engaged to perform agreed-upon procedures on the reports); (iii) require an adviser to obtain a fairness opinion in connection with certain adviser-led secondary transactions, which, even though adviser-led secondary transactions are rare in the

CLO context, does not make sense for a CLO transaction where investors have access to direct information about the underlying assets of the CLO; (iv) prohibit fees for unperformed services, prohibit pass-through of certain expenses and reduce tax claw-backs, each of which is conceptually not applicable to a CLO as the senior, subordinated and incentive fee structure is typically built into the indenture or trust deed for a CLO and expense reimbursement is set forth in the management agreement (and expenses are typically capped at the top of the waterfall structure and only uncapped after payments to the rated securities); (v) limit the ability of the adviser to receive reimbursement or exculpation for certain types of misconduct, including negligence (most CLO managers allow willful misconduct and bad faith as reasons for removal for "cause," but would consider negligence to be inadvertent and not something that should rise to that level); and (vi) require more detailed disclosure of side letter arrangements relating to fees and additional information disclosure, which could be viewed as regulating *investors* in CLOs, as opposed to simply regulating investment adviser activity.

Perhaps most important as currently drafted, there is no "grandfathering" under the Proposal and therefore advisers to CLOs and private funds would be obligated to comply with the proposed rules, to the extent they are adopted in final form, with respect to any CLO transactions or other private funds that they manage within one year after the effective date of the final rule. The expectation of market participants is that the cost of retroactive compliance would be significant.

At the time of this writing, the SEC is considering comments received on the Proposal. The Proposal has not been finalized, but prior history of SEC rulemaking suggests that the SEC will not accept many changes to their proposals. The CLO industry is hopeful that some parts of the Proposal will be revised favorably for managers of CLOs, but there is no certainty that this will occur.

The Rise of CLO Equity Funds

In an effort to support their CLO platforms, many U.S. CLO managers are forming private investment funds to raise capital to invest in the equity (and often the below investment grade notes) of the CLOs that they manage. U.S. CLO managers have recognized that bringing equity to the table enables them to obtain better execution of their CLOs. Raising capital to purchase the equity in multiple CLOs enables U.S. CLO managers to come to market with their deals faster and more efficiently. In addition, they are able to save arranger fees since the arrangers do not need to place the equity. CLO equity funds may also be structured to assist U.S. CLO managers with complying with EU and UK risk retention regulations.

Amendments to Luxembourg Securitization Law

Luxembourg has now opened its doors to being an issuer jurisdiction for managed CLO transactions due to amendments made on February 9, 2022 to the Luxembourg Securitization Law. Previously, a Luxembourg securitization vehicle (or a third party on its behalf) could not actively manage its assets, meaning that although it may have been possible to have static securitizations, it was not an attractive jurisdiction for actively managed deals. The new law permits such active management, meaning that Luxembourg now has the potential to rival Ireland as an issuer jurisdiction for European CLOs, especially with the exit of CLOs from the Netherlands due to Dutch tax authorities imposing VAT on management fees payable by Dutch CLOs.

In addition, the amendments allow Luxembourg securitization vehicles to raise finance from borrowing under loans (not just from the issuance of securities), to grant security to secure the obligations of a third party and to be in the form of partnerships.

ESG and CLOs

Over the last few years, there has been an increased focus on Environmental, Social and Governance ("ESG") considerations in finance transactions. This is not completely new but does at least partly coincide with COP26, the Glasgow Climate Change Conference, the "#MeToo" and "Black Lives Matter" movements, and the global population living through the COVID-19 pandemic. This elevation of ESG, and a desire to live in a fair and just society, in the public consciousness undoubtedly feeds into the way that some securitization transactions are being structured, the assets they are acquiring and how and by whom they are financed.

There has been some debate over what merits a transaction being classified as ESG, amid concerns over "greenwashing." For example, can you look to any of: (i) what the proceeds of the financing are applied toward; (ii) the assets on which the financing is secured; (iii) the ESG credentials of the issuer or borrower; or (iv) the returns generated for investors and what they will be applied towards? On the one hand, the net should not be cast so wide that being classified as ESG becomes worthless; however, on the other hand, if the ESG label is too narrowly bestowed, then an opportunity to stimulate the market and promote ESG considerations will be missed.

In the European-managed arbitrage CLO space, negative screening has been prevalent, with it now commonplace for the eligibility criteria to exclude obligors in industries related to fossil fuels, gambling, tobacco, pornography and weapons of mass destruction. Other transactions have introduced ESG scoring and tests. Across the board, ESG reporting is now commonplace. There have been some transactions that have gone even further, with portfolios made up exclusively of healthcare, renewables, clean water/sanitation and micro-finance loans. The United States broadly syndicated CLO market has primarily seen only negative screening similar to the European market, but has generally not included positive ESG attributes.

Investor appetite is certainly strong for ESG, but it could aid some sectors if more stimulus could be made available, for example, in the form of more beneficial regulatory capital treatment, advantageous tax relief or financing support or guarantees from state-backed institutions. Nonetheless, ESG seems very much here to stay.

United Kingdom and European Union Divergence

As a result of Brexit, divergence between the UK and EU regulatory regimes is now becoming a reality. For example, we mention elsewhere in this chapter that the "blacklisting" by the European Union of the Cayman Islands as a jurisdiction for securitizations has not been mirrored by the introduction of a corresponding prohibition for UK securitizations.

In addition, it is also worth noting that when the European Union finally brings into force regulatory technical standards providing more detailed guidance on the risk retention requirements, these will not apply in the United Kingdom. A final draft of these EU regulatory technical standards was published on April 12, 2022, which included provisions concerning the securitization of non-performing exposures, recognizing synthetic excess spread as a form of risk retention, guidance on when an entity shall not be considered to be established or operating for the sole purpose of securitizing exposures, clarification on the circumstances when the risk retainer entity can transfer or sell the retained interest, and contemplating the authorization of resecuritizations for legitimate purposes.

Indeed, the United Kingdom could introduce guidance, in the form of binding technical standards, which is different and potentially at odds with that published in the European Union. From the beginning of April 2022, reporting by UK securitization issuers, originators and sponsors has been required to be in the form of the FCA templates, as opposed to the European Securities and Markets Authority ("ESMA") ones developed for the EU Securitization Regulation. Although there is currently little difference between the two sets of templates, this could very much change in the future. The United Kingdom does not require UK investors in a non-UK securitization to be provided with reporting in the form of the UK templates, but, rather, it is sufficient if the information provided is "substantially the same" as would have been provided for a UK securitization. Unfortunately, this flexibility is not explicitly present under the EU Securitization Regulation for EU investors, which has created a lack of certainty as to whether EU investors can be exposed to transactions that do not provide reporting on ESMA templates.

Ultimately, going forward, if a securitization wants access to both EU and UK investors then it will need to aspire to satisfy both regimes. It could be expected that a less bureaucratic UK regime may seek to exploit its ability to legislate and regulate in a more nimble and potentially market-friendly fashion to the advantage of UK market participants. It is important to be aware that the possibility for divergence applies not only to the direct regulation of securitizations but across the board to other areas, such as ESG and sanctions, all of which will likely impact the financial markets either directly or indirectly.

Conclusion

It is certainly not a dull time to be involved in the CLO market on either side of the Atlantic, or even further afield. Without doubt, the market has taken the brunt of some headwinds during the first part of this year but its underlying condition is robust and of good health. No doubt structures will continue to evolve due to market, legal and regulatory developments, while CLOs continue to be a product that has already repeatedly weathered the storms and demonstrated its resilience time and time again.

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