International
Comparative
Legal Guides

Practical cross-border insights into securitisation

Securitisation
2023

16th Edition

Contributing Editor:
Rupert Wall
Sidley Austin LLP

ICLG.com

Expert Analysis Chapters

Q&A Chapters

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


Craig Stein


Phillip Azzollini


Daniel Oshinsky


Martin Sharkey

Schulte Roth & Zabel LLP

Introduction

Rising inflation, supply chain issues, war in Ukraine and concerns about a possible economic recession made 2022 a turbulent year for collateralized loan obligations ("CLOs") in the United States and Europe. New issuance was approximately $112 billion in the United States and €24.5 billion in Europe. Although CLO managers are hopeful of increased investor demand in 2023, the CLO market will be challenged by ongoing uncertainty around the global economy, marked by high inflation and higher interest rates, and regulatory developments. This chapter discusses current market trends and legal and regulatory developments that are affecting the CLO market.

U.S. CLOs Continue to Transition from LIBOR to SOFR; U.S. Congress Enacts the Adjustable Interest Rate (LIBOR) Act

Financial markets continued their transition from LIBOR (formerly known as the London Interbank Offered Rate, and referred to herein as "LIBOR") to alternative reference rates. The United Kingdom's Financial Conduct Authority ("FCA") announced in 2017 that it would not sustain LIBOR after 2021. This deadline was extended to June 30, 2023 for U.S. dollar LIBOR ("USD LIBOR") settings other than one week and two months. The Federal Reserve Bank of New York has been publishing the Secured Overnight Financing Rate ("SOFR"), which is the alternate rate favored by the Alternative Reference Rates Committee ("ARRC") convened by the Federal Reserve Board and the Federal Reserve Bank of New York. In response to the anticipated cessation and/or non-representativeness of USD LIBOR, and statements made in 2021 by U.S. banking regulators, the FCA, ICE Benchmark Administration ("IBA"), the administrator of LIBOR, and the ARRC, including the ARRC's announcement in July 2021 of its formal recommendation of forward-looking SOFR term rates produced by the CME Group ("CME Term SOFR"), 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 Term SOFR. Because LIBOR is an unsecured rate and SOFR is a secured rate, the earliest transactions that used SOFR as a reference rate were priced to include a credit spread adjustment ("CSA") in addition to any applicable pricing spreads to express the amount of the total spread that accounted for the perceived difference between LIBOR and SOFR reference rates. It is of note that the CSA priced into these transactions was in many cases not the fixed spread adjustment calculated and announced by the International Swaps and Derivatives Association, Inc. ("ISDA") and recommended by the ARRC for cash products (other than consumer products). 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, whereas the ISDA spread adjustment for a U.S. dollar three-month tenor is 26.161 basis points. Relatively quickly, the CLO market began to price SOFR transactions without presenting the CSA separately from the applicable pricing spread, as presumably any applicable CSA was factored into the pricing spread. This pricing trend continued for the CLO market for the remainder of 2022 and into 2023.

In 2023, CLO issuers that pay interest based on a USD LIBOR-based reference rate will have to transition to a replacement reference rate, and in most cases a replacement will be required to be identified by June 30, 2023. For CLO transactions that were newly issued in 2022, the reference rate is typically CME Term SOFR, so those transactions should not be affected.

However, many CLO transactions that were issued in the period after the FCA made its announcement in 2017 either did not have fallback language, or included language that, in many cases, required certain holders in the capital structure to agree on a replacement rate. The ARRC published proposed fallback language for securitizations in mid-2019, and many CLOs that priced from late 2019 to the end of 2021, including CLO transactions that refinanced/reset during that period, adopted the proposed ARRC fallback language (often at the insistence of debt investors). The ARRC announced in March 2021 that earlier statements by the FCA and IBA constituted a "benchmark transition event" under the ARRC's recommended fallback terms for new issuances of LIBOR-based floating rate securities and securitizations. Therefore, for legacy CLOs that used the ARRC's recommended fallback terms, a "benchmark transition event" occurred with respect to LIBOR in March 2021, but a "benchmark replacement date" had not yet occurred. The benchmark replacement date is expected to be the first London banking day after June 30, 2023, and therefore the transition from a USD LIBOR rate to an alternative reference rate for these CLO issuers' securities will become effective on or after June 30, 2023.

For CLOs that did not incorporate ARRC fallback language and included terms that required certain parties to agree upon a replacement rate, the issue of how and when a new rate may be implemented requires an analysis of the contract language. For some CLO indentures, it may not be practical for the applicable parties to agree. Moreover, some indentures refer to replacement rates or fixed spread adjustments recommended by organizations that have not recommended a specific replacement rate or spread adjustment. Therefore, many CLO indentures are likely to fall into the category of contracts with fallback terms that do not clearly define a replacement or that do not provide a practicable means of determining a benchmark, ultimately requiring an alternative means of establishing a replacement rate.

In March 2022, the United States Congress enacted the Adjustable Interest Rate (LIBOR) Act ("LIBOR Act"). The purpose of the LIBOR Act is, among other things, to set forth rules to address transitions from USD LIBOR-based rates following the cessation of USD LIBOR in contracts subject to U.S. law that lack clearly defined or practicable replacement benchmarks. The Board of Governors of the Federal Reserve ("Board") was tasked by Congress to draft rules to implement the LIBOR Act. The final rule ("Final Fed Rule")[1] became effective on February 27, 2023.

The LIBOR Act defines a LIBOR contract broadly to include any obligation or asset that uses the overnight, one-month, three-month, six-month or 12-month tenors of USD LIBOR as a benchmark, and defines fallback provisions to mean the terms in a LIBOR contract for determining a benchmark replacement, including terms relating to the date on which the benchmark replacement becomes effective.[2]

The LIBOR Act distinguishes among different categories of LIBOR contracts.[3]

If a contract contains fallback provisions identifying a specific benchmark replacement that is not based in any way on any USD LIBOR values (except to account for the difference between LIBOR and the benchmark replacement), and does not require any person (other than a benchmark administrator) to conduct a poll, survey or inquiries for quotes concerning interbank lending or deposit rates,[4] then these LIBOR contracts are expected to transition as provided by their fallback provisions.[5] The LIBOR Act and the Final Fed Rule do not address these contracts.

If a LIBOR contract (i) contains no fallback provisions, or (ii) has fallback provisions that do not identify a determining person and that; (A) identify a benchmark that is based in any way on USD LIBOR values (except to account for the differences between LIBOR and the benchmark replacement), such as "last published LIBOR"; or (B) require that a person (other than a benchmark administrator) conduct a poll, survey or inquiries for quotes or information concerning interbank lending or deposit rates, then the LIBOR Act provides that the benchmark replacement on the LIBOR replacement date will be the Board-selected benchmark replacement (which is required to be based on SOFR and include the tenor spread adjustments required under the LIBOR Act). References to USD LIBOR in these LIBOR contracts will, by operation of law, be replaced by the Board-selected benchmark replacement on the LIBOR replacement date.[6] The LIBOR Act provides a series of statutory protections, including that no person shall be subject to any claim or cause of action in law or equity or request for equitable relief, or have liability for damages, arising out of the use of the Board-selected benchmark replacement as a benchmark replacement for the LIBOR contracts.[7]

The final category of LIBOR contracts are those that contain fallback provisions authorizing a determining person to determine a benchmark replacement. How the LIBOR Act applies to these contracts depends on the determination, if any, made by the determining person. Where a determining person does not select a benchmark replacement by the LIBOR replacement date or the latest date for selecting a benchmark replacement according to the terms of the LIBOR contract (whichever is earlier), the LIBOR Act provides that the benchmark replacement for such LIBOR contract will be, by operation of law, the Board-selected benchmark replacement on and after the LIBOR replacement date. If the determining person selects the Board-selected benchmark replacement as the benchmark replacement, then under the LIBOR Act that selection shall be (i) irrevocable, (ii) made by the earlier of the LIBOR replacement date and the latest date for selecting a benchmark replacement under the terms of the LIBOR contract, and (iii) used in any determinations of the benchmark under or with respect to the LIBOR contract occurring on and after the LIBOR replacement date.[8]

Although the LIBOR Act does not require a determining person to select the Board-selected benchmark replacement as the benchmark replacement for a LIBOR contract, the LIBOR Act provides a series of statutory protections for any determining person who does so, including that a determining person shall generally not be subject to any claim or cause of action in law or equity or request for equitable relief, or have liability for damages, arising out of the selection of the Board-selected benchmark replacement as a benchmark replacement.[9] The Final Fed Rule clarified that the term "determining person" refers to a person with the sole authority, right or obligation, including on a temporary basis, to determine the benchmark replacement, rather than a group, irrespective of whether the person's authority, right or obligation is based on a contingency specified in the LIBOR contract or by its governing law (so the determining person qualifies as a determining person even before LIBOR becomes unavailable or unrepresentative).[10]

In addition, where the Board-selected benchmark replacement becomes the benchmark replacement for a LIBOR contract (either by operation of law or through the selection of a determining person), the LIBOR Act allows for benchmark replacement conforming changes as further detailed in the Final Fed Rule, whether determined by the Board or a calculating person, to become an integral part of the LIBOR contract and the determination, implementation and performance of benchmark replacement conforming changes are subject to statutory protections under the LIBOR Act.

The Board-selected benchmark replacement for cash transactions such as CLOs that reference one-, three-, six- or 12-month LIBOR is CME Term SOFR plus the applicable tenor spread adjustments specified in the LIBOR Act (and in the Final Fed Rule).[11] For CLO transactions, which tend to pay interest on either a one-month or three-month basis, the most relevant tenor spread adjustments included as part of the Board-selected benchmark replacements are (i) for one-month LIBOR, 0.11448 percent, and (ii) for three-month LIBOR, 0.26161 percent.[12]

On April 3, 2023, the FCA announced that it would require the IBA to publish a "synthetic" LIBOR for one-month, three-month and six-month tenors for a limited period after June 30, 2023 until September 30, 2024. The FCA indicated that this is intended as a temporary measure to assist with the transition of legacy contracts and is not permitted for use in new contracts on and after July 1, 2023. The synthetic rate will be CME Term SOFR plus the ISDA spread adjustments for the relevant tenors. The LIBOR Act does address synthetic LIBOR by, among other things, indicating that it is not the Board-selected benchmark replacement and, therefore, although it may be an equivalent rate for the applicable tenors, the selection of synthetic LIBOR as a replacement rate would not receive the same safe harbor protections as the selection of the Board-selected benchmark replacements.

In addition to LIBOR contracts that have a non-LIBOR based fallback, the LIBOR Act is not applicable to LIBOR contracts that the parties have agreed in writing shall not be subject to the LIBOR Act and is not applicable to a LIBOR contract where a determining person does not elect to use the Board-selected benchmark replacement as permitted in the Final Fed Rule.

Accordingly, for CLOs currently paying interest based on USD LIBOR, there is an expectation that by June 30, 2023, most such CLOs will either: (i) transition to fallback rates as specified in their underlying indentures where the applicable fallback provisions specify a benchmark replacement not based on USD LIBOR (or, in certain circumstances where the documentation allows for certain parties to agree to a replacement rate, and such parties do agree upon the replacement rate, then as agreed by the applicable parties); or (ii) transition to Board-selected benchmark replacement rates as provided under the Final Fed Rule, whether by operation of law or as selected by a sole determining person.

Proposed Private Fund Rules

On February 9, 2022, the Securities and Exchange Commission ("SEC") proposed certain rules and amendments under the Investment Advisers Act of 1940, as amended ("Advisers Act") to enhance the regulation of private fund advisers ("Proposed Private Fund Rules") that, if adopted in their current form, would affect investment advisers, including managers of CLOs, by, among other things: (i) requiring such investment advisers to comply with additional reporting and compliance obligations; (ii) prohibiting certain business practices; (iii) prohibiting certain types of preferential treatment offered by such investment advisers to certain (but not all) investors in a CLO, including, among other things, the provision of information regarding portfolio holdings of the CLO or of a substantially similar pool of assets; and (iv) prohibiting other forms of preferential treatment for certain (but not all) investors without providing sufficiently detailed written disclosures about such preferential treatment to prospective and current investors. Section 202(a)(29) of the Advisers Act defines the term "private fund" as an issuer that would be an investment company under the Investment Company Act but for the exemption provided under Sections 3(c)(1) or 3(c)(7) thereunder. Because CLOs overwhelmingly rely on Section 3(c)(7) of the Investment Company Act, most CLOs will be considered a "private fund" within the meaning of the Proposed Private Fund Rules, and the CLO managers would be required to comply with the enhanced obligations under the Proposed Private Fund Rules. The costs of complying with certain of the reporting and compliance obligations under the Proposed Private Fund Rules could be substantial, and it is unclear if the costs of preparing such reports would be borne by the CLO issuer or the CLO manager. If the CLO issuer is responsible for such expenses, it would reduce amounts available for distribution to the holders of the CLO securities and would have an impact on the returns to the equity investors. In addition, if the CLO manager was prohibited from discussing the underlying portfolio of loans with investors, or if certain types of side letters were prohibited absent highly specific disclosure, it could result in a reduction of the quality and quantity of information provided to holders of the CLO securities, and could have a negative effect on a CLO manager's ability to manage CLO transactions.

There is no "grandfathering" under the Proposed Private Fund Rules, and therefore the CLO manager would also be obligated to comply with the Proposed Private Fund Rules with respect to existing CLO transactions within one year after the effective date of the final rule. At the time of writing, it is unclear if the Proposed Private Fund Rules will be adopted in the form proposed, or at all, and if adopted in any form, when such Proposed Private Fund Rules would take effect. The comment period for the Proposed Private Fund Rules closed in June 2022, and the SEC is currently considering comments received, including comments relating to the effect on CLO transactions and possible allowances proposed for CLO transactions. It is unclear if the SEC will consider amendments to the Proposed Private Fund Rules to reduce the potential impact on CLO managers and/or CLO transactions.

SEC's New Marketing Rule

On and after November 4, 2022, all investment advisers registered with the SEC must comply with Rule 206(4)-1 ("Marketing Rule") under the Advisers Act in connection with marketing advisory services to investors, including the marketing of CLOs. The SEC adopted a two-prong definition of "advertisement" to regulate the advertising and marketing practices of investment advisers to private fund investors, which includes CLOs. The first prong covers any direct or indirect communication an investment adviser makes itself to more than one person (or to one or more persons if the communication includes hypothetical performance). The second prong covers third-party communications, any "endorsement" or any "testimonial" for which an investment adviser provides compensation, directly or indirectly.

Any direct communication made by the CLO manager to a prospective CLO investor soliciting their investment in a CLO constitutes "advertising" under the Marketing Rule. In addition, solicitation activities of a CLO placement agent, if the CLO placement agent is engaged by the SEC-registered CLO manager to market a CLO, will also constitute "advertising" under the Marketing Rule. An "endorsement" is any statement by a person other than a current client or investor in a CLO managed by the CLO manager that: (i) indicates approval, support or recommendation of the CLO manager or describes that person's experience with the CLO manager; (ii) directly or indirectly solicits any current or prospective investor to be an investor in a CLO advised by the CLO manager; or (iii) refers any current or prospective investor to be an investor in a CLO advised by the CLO manager.

While the first prong of the definition of advertisement explicitly excludes one-on-one communications and extemporaneous, live, oral communications, the second prong of the definition does not exclude oral or one-on-one communications. Therefore, any form of statement by a placement agent to a prospective investor (whether oral or written) may be an endorsement if the statement is considered a solicitation or referral to invest in a CLO or indicates approval, support or recommendation of the CLO manager.

The Marketing Rule does exclude from both prongs of the definition of advertisement "any information contained in a statutory or regulatory notice filing or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing or other required communication." Therefore, an offering memorandum that only includes: (i) the material terms, objectives and risks of the CLO; and (ii) information mandated by statute and regulation, should not be treated as an advertisement. However, if the offering memorandum contains information related to the performance of the CLO, the offering memorandum may constitute an endorsement.

The Marketing Rule's definition of advertisement only includes endorsements for which compensation was paid by the CLO manager, directly or indirectly. A typical CLO engagement letter will in almost all cases provide for compensation to be paid to the CLO placement agent for an endorsement by the CLO placement agent under the Marketing Rule.

Based on the foregoing, the typical marketing of CLOs is required to comply with the Marketing Rule. The Marketing Rule specifies required disclosure for advertisements that are or include endorsements. A CLO manager must disclose, or must reasonably believe that the person giving the endorsement is disclosing the following at the time the endorsement is disseminated, clearly and prominently: (i) that the endorsement was given by a person other than a current investor; (ii) that compensation was provided for the endorsement; and (iii) a brief statement of any material conflicts of interest on the part of the person giving the endorsement resulting from the CLO manager's relationship with such person.

The Marketing Rule prohibits a CLO manager from directly or indirectly compensating a person for an endorsement if the CLO manager knows, or in the exercise of reasonable care should know, such person is an "ineligible person" at the time the endorsement is disseminated. If the CLO placement agent is an SEC-registered broker-dealer this prohibition does not apply, unless the broker-dealer is subject to "statutory disqualification."

The Marketing Rule requires a CLO manager to exercise oversight over any person compensated to provide an endorsement. The CLO manager must have a reasonable basis for believing that the endorsement complies with the requirements of the Marketing Rule and a written agreement with any person giving an endorsement that describes the scope of the agreed-upon activities and the terms of the compensation for those activities.

CLO managers and CLO placement agents have worked together to ensure that CLO marketing activities satisfy the requirements of the Marketing Rule. CLO managers have implemented policies and procedures that are designed to prevent violating the Marketing Rule. The CLO market has taken a broad view on what types of communications constitute "endorsements." CLO managers and CLO placement agents are ensuring that existing and new engagement letters contain provisions that provide the CLO manager with sufficient oversight of any communications by the CLO placement agent with prospective CLO investors and that the required disclosures will be provided to prospective investors. In addition, CLO managers are obtaining assurances that the CLO placement agent is not an ineligible person and is not subject to statutory disqualification.

SEC's Proposed Revisions to Custody Rule

The SEC has proposed revisions to the Custody Rule. If the rule is adopted as proposed, it would impose significant costs and burdens on CLO managers and would completely alter the relationship with CLO custodians. CLO custodians would be required to accept significantly more liability and be subject to strict rules. The proposed rule might require the CLO manager to engage an independent accountant to review every trade and report discrepancies to the SEC in close to real time. CLO managers would have to maintain client assets with a "qualified custodian." The qualified custodian must have "possession and control" of the assets of the CLO and would be required to participate in any change of beneficial ownership of the assets of the CLO. The CLO manager would be required to enter into a written agreement with the custodian and obtain reasonable assurances concerning nine enumerated provisions that address safeguarding of the assets of the CLO, including a requirement that the qualified custodian indemnify the CLO for losses resulting from the custodian's own negligence. Currently, CLOs have a gross negligence standard for custodians. The proposed rule would require CLO managers to engage an auditor to verify the assets of the CLO by undertaking an annual surprise examination.

Comments to the proposed rule are due on or before May 8, 2023.

Uptiering

In late 2022, provisions were added to new issuance CLO documentation to permit investment in uptier financing. In an "uptiering" transaction, certain existing lenders to the borrower provide the same borrower with a new senior facility, which ranks senior to the existing facility. The new facility frequently consists of an exchange of at least a portion of the debt under the existing facility for debt under the new facility, with an additional loan of new money.

CLO documentation has previously addressed liability management transactions in various ways, including through the concepts of Collateral Enhancement Obligations, Bankruptcy Exchanges, Corporate Rescue Loans, Restructured Obligations and Loss Mitigation Obligations. Some in the market have queried whether the introduction of a new concept of "Uptier Priming Debt" really adds anything new that was not already sufficiently covered by pre-existing concepts.

Uptier Priming Debt is defined as a CLO providing to a borrower new money financing that is senior to the original debt, or exchanging the borrower's existing debt for new senior debt. The CLO will treat the new asset as a performing asset if it satisfies the eligibility criteria (subject to certain carve-outs, for example, for rating and maturity date requirements) and concentration limits.

As the "Uptier Priming Debt" concept overlaps somewhat with other distressed debt concepts used in CLOs, care should be taken to the treatment and demarcation of this debt within the CLO documentation as it potentially falls within more than one definition with different resulting consequences.

SEC Securitization Conflicts of Interest Proposal

In January 2023, the SEC issued proposed Rule 192, "Prohibition Against Conflicts of Interest in Certain Securitizations," to prohibit conflict of interest transactions in connection with the issuance of asset-backed securities.[13] Rule 192 is a re-proposal and revision to a rule that was first proposed by the SEC in 2011 (and did not advance after the comment period), in accordance with Section 27B of the Securities Act of 1933, which was added by the Dodd-Frank Act in response to certain of the more problematic transactions that occurred in the lead up to the 2007–2008 global financial crises. In particular, the statute is intended to prevent a participant assembling an asset-backed security offering from profiting from the securities' failure.

The new rule would prohibit specified participants in a securitization, as well as their affiliates and subsidiaries, from engaging directly or indirectly in certain conflicted transactions, subject to certain specified exceptions. The release accompanying the proposed rule poses many questions for comment.[14] The broad reach of the rule has raised concern in the CLO market.

The prohibition

The rule prohibits a "securitization participant," directly or indirectly, from engaging in any transaction that would involve or result in any "material conflict of interest" between the securitization participant and an investor in the asset-backed security. The prohibition applies for a period commencing on the date the participant has reached, or taken substantial steps to reach, an agreement to become a securitization participant with respect to an asset-backed security, and ending on the date that is one year after the date of the first closing of the sale of such asset-backed security.

A "material conflict of interest" is identified in the proposed rule as a "conflicted transaction," which is defined as any of three categories of transactions, if "there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision, including a decision whether to retain the asset-backed security." The three specified categories are: (i) a short sale of the asset-backed security; (ii) the purchase of a credit default swap ("CDS") or other credit derivative if the securitization participant may receive payments upon the occurrence of specified credit events relating to the asset-backed security; and (iii) the purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction through which the securitization participant would benefit from the actual, anticipated or potential (A) adverse performance of the underlying asset pool, (B) loss of principal, monetary default, or early amortization event on the asset-backed security, or (C) a decline in the market value of the asset-backed security. Clause (iii) amounts to a catch-all clause, which may bring many types of related transactions under the scope of the rule. This, together with the "indirect" application of the prohibition, and the rather vague "reasonable investor" standard, has raised concerns that it will be costly to administer the rule.

The last provision of the proposed rule is an "anti-circumvention clause." It provides that if a securitization participant engages in a transaction that circumvents the prohibition on engaging in any material conflict of interest, the transaction will be deemed to violate the rule. This is an additional "catch-all" provision. Notably, the wording of the rule is not based on intent or reasonable expectation, but arguably only the effect. Further, disclosure or consent by investors is not an exception.

Securitization participants

The rule defines "securitization participants" as an underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security, or an affiliate or subsidiary. The rule further defines these categories. An arranger, placement agent or initial purchaser under a typical CLO transaction will clearly be covered by the rule.

The rule defines a "sponsor" in two ways. First, a sponsor is any person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, directly or indirectly, to the entity that issues the asset-backed security. This is consistent with the definition of "sponsor" under Regulation AB (which applies to the SEC's risk retention rule). However, the rule also defines a sponsor as any person that has a contractual right to, or does in fact, direct or cause the direction of the structure, design or assembly of an asset-backed security or the composition of the pool of assets. This would encompass the collateral manager and, where applicable, the sponsoring fund for a CLO, which goes further than the Regulation AB definition of sponsor.[15]

As noted, securitization participants also include any affiliate or subsidiary of the other specified categories. This is the clause that will likely be most concerning for arrangers and sponsors of CLOs – especially large organizations that may have different divisions – that operate independently and may be involved in various trading activities. The release accompanying the proposed rule notes that the SEC did not include the use of information barriers as an exception for affiliates and subsidiaries. On the other hand, the release asks for comment whether an exception utilizing information barriers could be implemented in a way consistent with the statute.

Exceptions

The proposed rule does provide certain specified carve-outs from "securitization participants," including a person that "performs only administrative, legal, due diligence, custodial, or ministerial acts." The SEC's release states it expects accountants, attorneys and credit rating agencies, as well as trustees and other contractual service providers, to typically fall within this exclusion.[16]

The proposed rule also provides three exceptions to its prohibition on conflicted transactions, but each subject to conditions. Firstly, risk-mitigating hedging activities are permitted, but only if designed to mitigate specific identifiable risks. The hedging must be recalibrated on an ongoing basis to make sure the participant will not benefit from an adverse event, and must be subject to a compliance program. The second exception is for purchases and sales of securities pursuant to commitments to provide liquidity for the securities. The third exception is for *bona fide* market-making activities in either the applicable asset-backed securities or the underlying assets. This exception only applies if the participant routinely engages in this activity and stands ready to quote, purchase or sell the assets. Further, the participant's market-making activities must be designed to not exceed, on an ongoing basis, the reasonably expected near-term demands of clients, customers and counterparties. There is a prohibition on compensation that would incentivize conflicted transactions. The participant must be licensed and a compliance program must be implemented.

Conclusion

The SEC in its release acknowledged that markets have evolved since the enactment of Section 27B under Dodd-Frank and does not cite new instances of abuse. Nevertheless, the SEC states that it believes securitizations remain susceptible to abuse through conflicted transactions.[17] The proposal is certain to garner comment from CLO and other industry participants that are concerned about the broad scope of the rule if implemented in its current form.

ESMA Template Reporting

To the consternation of the securitization market, the European Commission ("Commission"), on October 10, 2022, provided the European Parliament with a report on the functioning of the EU Securitization Regulation. In this report, the Commission concluded that EU institutional investors in non-EU securitizations (*i.e.*, transactions that involve no EU originator, CLO manager or issuer) are not meeting their verification obligations if the reporting requirements stipulated by the Securitization Regulation, notably the use of European Securities and Markets Authority ("ESMA") templates, are not complied with.

Previously a grey area, the market practice that developed had been not to use the ESMA templates and to disclose this in the offering documents, with the onus placed upon investors then to decide whether or not they may invest in a transaction.

Since the publication of the Commission's report, EU investors are largely requiring the documentation to include a commitment for reporting to be provided in the format prescribed by the ESMA templates as a condition to them investing in such transactions. Non-EU securitization issuers and originators seem to have accepted this in many transactions, although it is also likely that the requirement may have dissuaded some issuers and originators from targeting the EU investor base.

In addition, the Securitization Regulation prescribes certain disclosures to be made prior to pricing. This includes the provision of transaction documentation to investors. In Europe, this has been done in draft form with such documentation stated to be subject to amendment and finalization prior to closing. Since the Commission's report, EU investors have also sought similar pre-pricing disclosures for non-EU transactions.

For pre-October 2022 transactions, there is a question as to whether there will be any grandfathering. As this circumstance is not a change in law, but rather the Commission providing its interpretation of the existing law, the Commission may view grandfathering as inappropriate. In effect, this likely means that EU investors will not be able to acquire new positions in non-compliant pre-October 2022 securitizations, impacting liquidity in those positions. However, for any EU investors who already held positions in non-compliant pre-October 2022 securitizations, it is unlikely that they will face any immediate sanctions as they will have acquired the positions in good faith and based on what was then a reasonable interpretation of the Securitization Regulation. As it is not in the EU's interests to compel a fire sale that would result in losses to EU financial institutions, we believe regulators will be accommodating when it comes to timing and requirements for exiting any non-compliant positions.

Furthermore, the Commission has invited ESMA to revisit its existing disclosure templates, including considering removal of fields that are unnecessary or technically difficult to complete, and aligning the templates more closely to investors' needs. As part of this, ESMA should consider whether loan-by-loan information is useful and proportionate to investors' needs for all securitizations. The Commission also invited ESMA to propose a more simplified form of reporting template for private securitizations (*i.e.*, those for which there is no Prospectus Regulation Prospectus), which currently is the status of most non-EU securitizations.

Any future simplification by ESMA of the reporting templates would only have prospective effect. The Commission did not suggest that EU investors may wait for ESMA to produce new streamlined templates before implementing the reporting for non-EU transactions.

However, industry bodies have raised concerns with European Supervisory Authorities ("ESAs"), including ESMA, that this puts EU investors in a very difficult position. A clear response is expected eventually, and there is the possibility that a temporary and targeted forbearance may be provided by regulators to EU investors. However, no forbearance should be presumed until there is a formal response from the ESAs.

U.K. and EU Divergence

We expect the European Union and the United Kingdom to further diverge in their regulation of securitizations. Since Brexit, the European Union has amended the Securitization Regulation to address non-performing exposures and synthetic securitizations and has also published a final draft technical standards on the risk retention requirements for securitizations, without any corresponding changes being made to the U.K. legislation.

In the United Kingdom, the Securitization (Amendment) (EU Exit) Regulations 2019 has made clear that non-U.K. investment firms can act as sponsor risk retainers, whereas in the EU legislation it is unclear whether a non-EU investment firm qualifies. In addition, with reference to the above discussion on ESMA templates, the U.K. legislation explicitly provides that U.K. investors may invest in non-U.K. securitizations that do not report on U.K. reporting templates, as long as they make available information that is substantially the same as that which would have been made available for U.K. securitizations. In December 2022, the U.K. government announced proposals (the Edinburgh Reforms) to reform the U.K. framework for securitization. This will revoke the EU law surrounding the regulation of securitization, which was retained following Brexit, and replace it with new domestic laws. Legislation would set out the scope and core elements of the regulatory framework for securitization, empowering the U.K. regulators, the FCA and Prudential Regulation Authority to introduce the more detailed rules around the regulation of securitization, which these regulators will enforce. In particular, reforms will focus on:

- certain risk retention provisions, for example in relation to (i) transferring the risk retention manager, and (ii) risk retention in securitizations of non-performing exposures;
- the definitions of public and private securitization, as well as the disclosure requirements for certain securitizations, to ensure they are appropriate;
- due diligence requirements for institutional investors when investing in non-U.K. securitizations, to provide greater clarity on what is required; and
- the definition of institutional investor as it relates to certain unauthorized non-U.K. alternative investment fund managers who are currently in scope of due diligence requirements, so that these requirements do not act as a disincentive to firms from seeking investors in the United Kingdom, and to address extraterritorial supervision and enforcement problems.

In addition, we understand that there is an intent to introduce a regime to recognize equivalent simple, transparent and standardized ("STS") securitizations issued by entities established outside the United Kingdom.

Conclusion

The CLO market took some headwinds in 2022 and financing conditions are expected to remain tight and volatile in 2023; however, the underlying condition of the CLO market remains robust. Although structures will continue to evolve due to market, legal and regulatory developments, CLOs continue to be a product that has weathered storms and demonstrated resilience.

Endnotes

1. See the Board's adopting release for Rule 253 (the "Adopting Release"), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20221216a1.pdf (last visited March 22, 2023).
2. See the Adopting Release, supra note 1, at 7–8.
3. This article pertains to CLO transactions and, therefore, does not address or consider LIBOR contracts that are consumer loans.
4. See the Adopting Release, supra note 1, at 8.
5. See the Adopting Release, supra note 1, at 8.
6. See the Adopting Release, supra note 1, at 8–9.
7. See the Adopting Release, supra note 1, at 8–9.
8. See the Adopting Release, supra note 1, at 8–9.
9. See the Adopting Release, supra note 1, at 8–9.
10. See the Adopting Release, supra note 1, at 17–19.
11. See the Adopting Release, supra note 1, at 38–39.
12. See the Adopting Release, supra note 1, at 72.
13. See https://www.sec.gov/news/press-release/2023-17 (last visited March 22, 2023).
14. Comment letters are due on March 27, 2023.
15. Notably, in February 2018, the D.C. circuit court of appeals ruled that the collateral manager of an "open market" collateralized loan obligation transaction is not a "sponsor" within the meaning of the Dodd-Frank risk retention requirements.
16. See the SEC's release ("SEC Release"), https://www.sec.gov/rules/proposed/2023/33-11151.pdf (last visited March 22, 2023) at 34. Other carve-outs are provided under the proposed rule for the United States or an agency of the United States providing a guaranty related to an asset-backed security, as well as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.
17. See the SEC Release, supra note 16, at 7.

Acknowledgment

The authors would like to acknowledge the assistance, in the preparation of this chapter, of Sunho (Sam) Shin, associate in the Finance & Derivatives Group at Schulte Roth & Zabel.

Craig Stein is a partner and co-head of Schulte Roth & Zabel's Finance & Derivatives Group. His practice focuses on structured finance and asset-backed transactions, with a primary focus on CLOs, and swaps and other derivative products. He represents issuers, underwriters, collateral managers and portfolio purchasers in public and private structured financings. Craig has been recognized in this area by *Chambers USA* and *The Legal 500 United States*. He is a sought-after speaker at industry events and authors numerous articles on advanced financial products. He earned his J.D., *cum laude*, from University of Pennsylvania Law School and his B.A., *cum laude*, from Colgate University.

Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
USA

Tel: +1 212 756 2390
Email: craig.stein@srz.com
URL: www.srz.com

Phillip Azzollini is a partner in Schulte Roth & Zabel's Finance & Derivatives Group. His practice focuses on private offerings of collateralized loan obligation securities and on warehouse financing transactions, including the representation of issuers, placement agents and portfolio managers. Phil has been recognized as a leading lawyer by *Chambers Global*, *Chambers USA* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*. He earned his J.D. from Fordham University School of Law and his B.B.A., *cum laude*, from Pace University.

Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
USA

Tel: +1 212 756 2285
Email: phillip.azzollini@srz.com
URL: www.srz.com

Daniel Oshinsky is a partner in Schulte Roth & Zabel's Finance & Derivatives Group. He represents hedge funds, private equity funds, asset managers, specialty finance companies and investment banks in a wide range of financing transactions. Dan focuses his practice on middle market and broadly syndicated CLOs, fund finance, ABL facilities and structured credits. He has been recognized as a leader in his field by *The Legal 500 United States* and *New York Super Lawyers*. Daniel earned his J.D. from New York University School of Law and his B.A., *magna cum laude*, from Yeshiva University.

Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
USA

Tel: +1 212 756 2111
Email: daniel.oshinsky@srz.com
URL: www.srz.com

Martin Sharkey is a partner in Schulte Roth & Zabel's Finance & Derivatives Group. He focuses his practice on providing strategic counsel for CLO managers, investors, and arrangers. He advises CLO managers on multi-currency, arbitrage, balance sheet, market value and ESG CLOs. Martin has been recognized as a leading lawyer by *The Legal 500 United Kingdom* and *Thomson Reuters*. He is a frequent speaker at industry events and writes on topics concerning developments in the CLO market and ESG financing. Martin earned his LLB from King's College London.

Schulte Roth & Zabel LLP
One Eagle Place
London, SW1Y 6AF
United Kingdom

Tel: +44 20 7081 8013
Email: martin.sharkey@srz.com
URL: www.srz.com

Schulte Roth & Zabel ("SRZ") is a market-leading law firm, serving the financial services industry from offices in New York, Washington, DC and London. SRZ's Finance & Derivatives Group structures and negotiates a variety of complex structured finance and securitization transactions. We assist clients with products involving the securitization of high-yield loans and bonds and corporate debt and handle private asset-backed securitizations, warehouse facilities and secured financings encompassing a wide range of assets. SRZ's asset-backed finance practice has a particular focus on the securitization and financing of "off-the-run" and esoteric assets, including many types of receivables: structured settlements; timeshare loans; royalties; insurance-linked securities; lottery receivables; equipment leases; life settlements; merchant cash advances; and litigation-related funding. SRZ serves as counsel to a wide range of market participants, including investment managers, issuers, purchasers and sellers of assets, underwriters, placement agents, borrowers and investors that are involved in sophisticated financing arrangements, including collateralized loan obligations ("CLOs") and asset-backed securitizations. In addition to structuring, drafting and negotiating, SRZ assists clients with regulatory filings and compliance issues. We also advise clients in complying with the risk retention regulations in the United States and the European Union, including assisting clients in the creation of risk retention vehicles.

www.srz.com

Schulte Roth&Zabel

ICLG.com

Current titles in the ICLG series

Alternative Investment Funds
Anti-Money Laundering
Aviation Finance & Leasing
Aviation Law
Business Crime
Cartels & Leniency
Class & Group Actions
Competition Litigation
Construction & Engineering Law
Consumer Protection
Copyright
Corporate Governance
Corporate Immigration
Corporate Investigations
Corporate Tax
Cybersecurity
Data Protection
Derivatives
Designs
Digital Business
Digital Health
Drug & Medical Device Litigation
Employment & Labour Law
Enforcement of Foreign Judgments
Environment & Climate Change Law
Environmental, Social & Governance Law
Family Law
Fintech
Foreign Direct Investment Regimes
Franchise
Gambling
Insurance & Reinsurance
International Arbitration
Investor-State Arbitration
Lending & Secured Finance
Litigation & Dispute Resolution
Merger Control
Mergers & Acquisitions
Mining Law
Oil & Gas Regulation
Patents
Pharmaceutical Advertising
Private Client
Private Equity
Product Liability
Project Finance
Public Investment Funds
Public Procurement
Real Estate
Renewable Energy
Restructuring & Insolvency
Sanctions
Securitisation
Shipping Law
Technology Sourcing
Telecoms, Media & Internet
Trade Marks
Vertical Agreements and Dominant Firms

The International Comparative Legal Guides are published by: glg global legal group