Collateralized Loan Obligations

What to expect when you are expecting your first CLO

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The market for collateralized loan obligations (CLOs) in the United States continued its remarkable resurgence in 2012. With $7 billion of new issuance in December alone, CLO issuance in 2012 reached $53 billion, the highest level of CLO activity since 2005. Estimates for new CLO issuance in 2013 range from $50 billion to $70 billion.

Surprisingly, not all CLOs launched in 2012 are managed by the large and established CLO managers that most investors flocked to in the post-crisis "flight to quality." According to Moody's, new managers accounted for more than 10% of CLOs rated by the agency in 2012. This is an astounding change from 2010 and 2011, when only two new manager CLOs were rated by Moody's in those two years. By showing solid performance even during the credit crisis, CLOs have not only become an asset class that is sought-after by investors but also an asset class that is sought-after by managers looking for stable and lucrative sources of management fees and incentive fees. It is likely that 2012 was not an aberration and new managers will continue to account for a significant portion of CLO issuance in the near future. So what should a potential new CLO manager expect when considering the launch of its first CLO?

No CLO for you! Unless you register...

With the repeal of the private adviser exemption by the Dodd-Frank Act, CLO managers must now be registered with the SEC as an adviser under the Investment Advisers Act of 1940 because none of the few remaining exemptions from registration under the Advisers Act are available to CLO managers. Although the registration process itself is not difficult, it consumes substantial effort and time of senior officers of the manager and it can take between 45 days or more. More importantly, as SEC-registered advisers, CLO managers must develop a compliance system that can meet the requirements of the Advisers Act. These include hiring of a chief compliance officer and preparation of written policies and procedures that are designed to avoid violations of the Advisers Act, including procedures relate to management of conflicts and valuation procedures.

Avoid drowning in a commodity pool

The Commodity Futures Trading Commission (CFTC) adopted rules under the Dodd-Frank Act repealing Regulation 4.13(a)(4) (which was used by many managers to avoid having to register as a commodity pool operator) and adding certain derivatives (such as interest rate swaps and certain credit default swaps) as commodity interests that are subject to the CFTC's supervision. These rules have forced many managers of hedge funds and private equity funds to register as commodity pool operators, forcing those managers to be exposed to a whole new set of regulations from the CFTC and the National Futures Association (the self-regulatory organization for the CFTC).

Fortunately for CLO managers, the CFTC also issued a no-action letter on 7 December 2012 (the "ABS No-Action Letter") that stated that "a traditional collateralized debt obligation (CDO) structure that owns only financial assets consisting of corporate loans, corporate bonds, or investment grade, fixed income mortgage-backed securities, asset-backed securities or CDO tranches issued by vehicles that are not commodity pools" would not be a commodity pool unless the CDO invested in "swaps which are used to create investment exposure". So a CLO manager could use in its CLOs swaps designed to hedge currency rate risks, interest rate risks related to fixed rate securities or basis risks but it should avoid using any credit default swaps, total return swaps or similar synthetic assets without first checking with its legal counsel regarding the effect of such derivatives on the ability of the CLO to rely on the ABS No-Action Letter.

Full cavity diligence

A new CLO manager should expect thorough diligence of the manager's investment personnel, investment management systems and back-office support capabilities from virtually every major party in its CLO, including the placement agent, rating agencies and investors. Even the CLO manager's own legal counsel will conduct diligence on the manager before issuing legal opinions in connection with the CLO transaction. One of the main diligence items will be the manager's key investment professionals. They must have substantial experience managing CLO portfolios and leveraged loans. Some investors may also require that at least two of such investment professionals be senior leveraged loan portfolio managers (typically with 10 or more years of experience). But competence in selecting loan assets is not enough. The documentation for a typical CLO is extensive, with the indenture alone often exceeding 250 pages. A manager's CLO execution team, compliance team and back-office infrastructure will therefore be thoroughly reviewed by interested parties to verify the manager's ability to comply with all of the obligations of the manager under the CLO documents.

Trade lightly

A new CLO manager may have substantial experience in investing in CLOs and leveraged loans for advisory clients, hedge funds or a proprietary trading platform. But the manager must understand that managing a CLO comes with a set of trading requirements that are much more restrictive than what it is used to as a manager of a credit hedge fund or an investor in CLOs or loans.

Monitoring the credit risk and performance metrics of a CLO portfolio is only a part of the manager's duties. A CLO manager must also monitor the compliance of each loan investment with the indenture asset eligibility criteria (including rating agency criteria and tax criteria) and the impact of each loan investment on portfolio concentration tests and other portfolio tests. A CLO manager is also subject to limitations on trading activities, even with respect to loans that may be credit risk or credit improved assets. This means that even if a CLO manager believes that it is in the best interest of the CLO to sell a loan and replace it with another loan, it may not be able to do so unless the CLO documents permit that trade.

Bigger is better... according to CLO CMAs

For better or for worse, relative to an investment advisory agreement for a managed account or an investment management agreement for a credit hedge fund or private equity fund, the collateral management agreement for a CLO is a much larger document with more detailed and burdensome provisions regarding the duties of the manager, the standard of care and liability of the manager, the removal of the manager (for cause or without cause) and disclosure regarding conflicts of interest. Many of these provisions are not only required by investors but also by rating agencies. For example, a rating agency will likely insist that the manager exercise a standard of care that is (i) no less than that which the manager itself exercises when managing comparable assets for itself, affiliates and third parties and (ii) no less than that which an institutional manager of international standing would exercise when managing comparable assets. It is unclear how a new CLO manager would know a standard of care applied by "an institutional manager of international standing when managing comparable assets" but having an investment officer that has worked for an institutional manager of international standing and knows about the standard of care used by such managers may be a good starting point. As another example, the provisions regarding removal of the manager for cause in a CLO collateral management agreement will likely include any willful violation of the collateral management agreement without cure periods or carve-outs for material effect. In addition, even though the CLO issuer is technically the client, a CLO manager can be removed for cause at the direction of the noteholders (often, a single class of noteholders).

BYOE – bring your own equity

The equity tranche in a new CLO is usually the hardest tranche to place and it is very difficult for a new manager to launch a CLO without bringing its own equity investors to the deal. Most new managers in 2012 were affiliates of large private equity firms or financial institutions that helped the managers to acquire 50% or more of the equity tranches of their CLOs or were independent managers with deep-pocketed sponsors. Some new CLO managers even have equity commitments on multiple deals, which will give added incentive to placement agents to work with those managers because of the potential for multi-deal engagements. In order to maintain a level

of confidentiality regarding the identity of the equity investors, some managers may wish to create private investment funds through which their equity investors will invest in their CLOs.

Similar to investors in seed deals in hedge fund and private equity fund industries, an equity investor in the first CLO of a manager may require an arrangement that will give the investor a share (which may range from 10% to 15%) of the management fees and incentive fees. Some equity investors may also require certain portfolio eligibility criteria, a "Key Person" provision, several consent rights and other provisions designed to protect and enhance the equity investor's interests in the CLO. Some investors may require that, if the manager resigns or is removed as the manager of the CLO, the successor CLO manager must agree to the same fee sharing arrangement. Of course, all material rights held by equity investors must be appropriately disclosed in the CLO's offering documents, with special care to disclose risks that such rights may pose to other investors in the CLO.

The ability of CLO managers to raise equity for their CLOs may take on an even greater importance once the US regulators finalize their final risk retention rules for securitization transactions. Under the proposed rules, a CLO manager is a sponsor of the CLO for purposes of the risk retention rules and one of the ways the manager can meet the risk retention requirement is by retaining the equity tranche that is equal to 5% of the par value of all of the CLO's notes. If the final risk retention rules are substantially similar to the proposed rules, only managers with the financial ability to comply with the rules will be permitted to issue CLOs. The impact of such rules cannot be overstated given the impact of the risk retention rules under Article 122a of the European Union Capital Requirements Directive on the European CLO market. That market (with only a handful of CLOs being launched or in the process of being launched) has not come close to starting its post-crisis revival due in no small part to the risk retention restrictions imposed by Article 122a requirements.

Controlling class wants control

Investing in new manager CLOs is attractive to investors for a number of reasons. According to a study by Moody's, the CLO portfolios of the same manager are likely to have similar obligor profiles with high correlation among them. New manager CLOs, therefore, give investors the opportunity to diversify their CLO holdings in a meaningful way. Another reason is that investors have a greater say regarding the terms of a new manager CLO than the terms of a CLO of an established manager. This is particularly true of an investor that will buy the majority of the most senior notes issued by the CLO. An investor that buys the majority of the most senior notes will generally be the "Controlling Class" under the CLO documents and will have numerous consent rights under the terms of the CLO documents, such as the right to terminate a manager for cause, the right to consent to amendments and other actions of the CLO and the manager. When a Controlling Class investor invests in a new manager CLO, it may require additional requirements including the following:

1. Shorter reinvestment periods (such as two to three years instead of four years) accompanied by other stricter reinvestment restrictions (such as severe restrictions or outright prohibition on purchases after the end of the reinvestment period unless the Controlling Class consents);
2. Key Person provisions permitting the Controlling Class to remove the manager if one or more Key Persons are no longer involved in managing the CLO or if the manager doesn't have a certain minimum number of investment management professionals managing the CLO;
3. Adding a pre-approved successor manager (usually an affiliate of the Controlling Class investor) that will step in as the successor manager if the manager is removed or resigns;
4. Narrowing the definitions of credit risk criteria and credit improved criteria;
5. Stricter investment guidelines, such as severe restriction or outright prohibition on non-US obligors, middle market loans and deferrable securities;
6. Compliance with weighted average life test in connection with amend-to-extend transactions; and
7. Controlling Class consent requirement even for amendments to deal documents that typically don't require noteholder consents.

A new CLO manager may not have sufficient bargaining power to fight off most of the changes requested by a Controlling Class investor in connection with the manager's first CLO. However, the manager must be cognisant that the Controlling Class investor may have an incentive to remove the manager and replace the manager with a firm that is affiliated with the Controlling Class or has agreed to manage CLOs for the Controlling Class at reduced fees, especially in deals where an affiliate of the Controlling Class investor has been appointed as a pre-approved successor manager. Taking into account such incentive, the manager must analyse each request from the Controlling Class investor that makes it harder for the manager to manage the CLO and determine (after discussions with the manager's legal counsel based on an honest assessment of the characteristics of the warehoused loan portfolio, the manager's investment strategy and the manager's investment and compliance infrastructure) if the request of the Controlling Class investor can be met or the request is an impossible demand that will likely doom the manager to a premature removal from the deal.

Investors who don't like free cash

Some CLOs have provisions that permit the issuer to issue additional equity securities or provisions that expressly permit existing equity investors or the manager to contribute additional cash or securities to the CLO (without compensation). These provisions allow a CLO to acquire more assets that would improve its ability to meet its obligations and they may seem like provisions that all investors in the CLO would love.

However, not all investors like such additional contributions of capital. Senior investors, for instance, may not be concerned about their ability to get repaid since they are at the top of the CLO's payment waterfall. But what they are concerned about is the effect of the additional assets on various collateral tests, such as coverage tests or event of default overcollateralization tests. The additional assets may allow the CLO to pass some or all of these tests, which in turn may have the effect of allowing the CLO to continue making interest payments to junior noteholders (which may not be possible if a coverage test is failing), allowing the manager to make reinvestments or avoiding a default caused by an overcollateralization test failure. In fact, some Controlling Class investors may impose strict requirements on such provisions, including the requirement that any such additional asset contribution be subject to their consent.

Of course, in a situation where the Controlling Class investor has a pre-approved affiliated manager that can replace the CLO manager, such investors may not have an incentive to consent to actions that would prevent failures of coverage tests and other collateral tests because such failures would make it more likely that the CLO manager will get replaced.

Conclusion

CLOs can be attractive investment vehicles for managers to manage. Unlike hedge funds, CLOs can deliver a stable stream of management fees over several years because they are not subject to investor redemptions. If a CLO portfolio performs as expected, the subordinated fees, the incentive fees and the manager's investment in the CLO's equity can all bring substantial revenues to the manager. However, managing a CLO is a resource-intensive business with many challenges for which the manager must prepare. **THFJ**

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