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From Collateral Damage to Cautious Optimism: The U.S. CLO Market Forges Ahead

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The author discusses 10 issues of concern to advisers as they work to structure new collateralized loan obligations in the face of evolving market and regulatory conditions.

The U.S. market for collateralized loan obligations ("CLOs") has suffered in recent years, the victim of guilt by association with its distant "acronymed" cousins—especially structured investment vehicle ("SIVs") and collateralized debt obligations ("CDOs") backed by other securities collateralized by subprime home mortgages and other poorly underwritten consumer debt. Recently, however, that perception has begun to reverse. Strong performance by CLOs first issued in the 2005-2007 era evidenced by equity returns in the 20 percent-plus range, tighter spreads on senior liabilities, primary loan issuances with wider spreads, and slowly emerging clarity on the regulatory front have contributed over the past two years to a slow but steady resurgence of CLO origination activity and continued interest in CLO manager acquisition opportunities. New issuance in 2011 surpassed

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

Here are 10 issues at the forefront of the minds of advisers as they work to structure new CLOs in the face of evolving market and regulatory conditions:

1. SECURITIES AND EXCHANGE COMMISSION ("SEC") REGISTERED ADVISER STATUS

Most CLO managers previously relied on the "private adviser exemption" from registration with the SEC as an adviser under the Investment Advisers Act of 1940 ("Advisers Act"). This exemption was repealed by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The narrow remaining exemptions from registration adopted in the SEC's final rules on the subject are not available to most CLO managers. As a result, existing CLO managers that were not registered were required to do so by March 30, 2012, and portfolio management groups considering managing CLOs in the future will need to register. Registration applications to the SEC, which require careful attention to prepare, are generally processed within 45 days of receipt.

2. EFFECTIVE COMPLIANCE POLICIES AND PROCEDURES

As SEC-registered advisers, CLO managers must adopt, implement, and review annually for adequacy and effectiveness written policies and procedures reasonably designed to prevent violations of the Advisers Act and administered by a chief compliance officer.[1] The SEC staff has expressed the view that "off the shelf" procedures not specifically tailored to an adviser's business or that fail to address risks presented by current market conditions or to take into account relevant contractual obligations are inadequate. Effective valuation procedures, for example, should at a minimum:

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

3. NEW WITHHOLDING TAX OBLIGATIONS

The recently enacted Foreign Account Tax Compliance Act ("FATCA") will impose a 30 percent withholding tax with respect to a CLO issuer's entire U.S. loan portfolio unless the CLO enters into an agreement with the Internal Revenue Service ("IRS") (a "FATCA Agreement") to

- obtain information from debt and equity holders necessary to determine if the holder constitutes a "U.S. account;"
- comply with verification and due diligence procedures required to identify U.S. accounts;
- report certain information with respect to U.S. accounts on an annual basis to the IRS and comply with requests by the IRS for additional information with respect to any U.S. account;
- attempt to obtain a waiver in any case where foreign law would prevent the reporting of information required with respect to any U.S. account, and "close" the account if the waiver cannot be obtained; and
- deduct and withhold 30 percent of any "passthru payment" made to a "recalcitrant holder" that does not provide the required information and certain other categories of investors.

Although the date on which withholding will begin has been extended to permit affected institutions to make appropriate changes to their systems and certain "grandfathering" rules apply, a collateral manager structuring any new CLO will need to revise its standard documentation, fairly extensively, to require investors to provide the necessary information, include appropriate remedies for non-compliance, revise disclosures and risk factors in offering materials appropriately to disclose the impact of the new regime, and develop a compliance plan with the indenture trustee to manage the information collection and information reporting to the IRS.

4. CONFLICTS REVIEW

An extended comment period has expired for rules proposed by the SEC that would implement Section 621 of Dodd-Frank. The proposed rules would prohibit collateral managers of CLOs, among others, from engaging in transactions that would involve or result in certain material conflicts of interest with a CLO's investors for a period extending from one year following the closing of the CLO. While the contours of the proposed rules remain subject to further definition, the proposals suggest that a transaction would involve or result in a "material conflict" for this purpose if either (i) the collateral manager would benefit directly or indirectly from the actual, anticipated, or potential (1) adverse performance of the asset pool supporting or referenced by the CLO, (2) loss of principal, monetary default or early amortization event on the CLO, or (3) decline in the market value of the relevant CLO (each, a "short transaction"); or (ii) the collateral manager would benefit directly or indirectly from fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration, as a result of allowing a third party, directly or indirectly, to structure the CLO or select assets underlying the CLO in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction as described above. The proposals suggest a deeper focus than ever for CLO sponsors and collateral managers on conflicts analysis and related disclosure, to ensure compliance with existing SEC regulations as well as the expected future rules. Such parties and their counsel also should consider the utility of conflicts management procedures, which may include important roles for advisory committees and independent directors.

5. RISK RETENTION — THE U.S. VIEW

The SEC and several other federal regulators have proposed rules[2] that would require the "sponsor" of covered securitization vehicles, including a CLO, to retain for the life of the CLO at least five percent of the credit risk of any asset that the sponsor transfers, sells, or conveys to a third party through the issuance of the CLO. Options for obtaining the requisite credit risk exposure, among others, include (i) retention of at least five percent of each issued class of CLO notes, (ii) retention of an amount of notes of the most subordinated tranche equal to five percent of the par value of all of the CLO's issued notes, and (iii) an L-shaped option combining (i) and (ii) in equal dollar amounts. The proposed rules explicitly state that CLO managers generally are "sponsors;"[3] however, that conclusion and the related contextual assumptions in the proposed rules have been challenged in comment letters. The extended comment period for these controversial proposals expired in August 2011, leaving the CLO industry in keen anticipation of further clarity on the scope and contours of the rules, and the viability of certain exemptions for CLOs proposed by leading industry groups and market participants. Unless an exemption is granted, the universe of U.S. CLO sponsors can be expected to be significantly reduced in number to those with the financial ability to retain the requisite credit risk in each new CLO. The risk retention requirement will become effective for CLOs two years after final rules are adopted.

5. RISK RETENTION — THE EU VIEW

Article 122a of the EU Capital Requirements Directive requires European credit institutions that invest in securitization vehicles, including U.S. CLOs, to adhere to new requirements in order to avoid very high capital charges. Similar legislation is being enacted in relation to European insurers[4] and fund managers.[5] Affected institutions must ensure that the original lender, originator, or sponsor of any CLO in which it proposes to invest will retain a material net economic interest of at least five percent in the securitized assets. The new legislation severely restricts the scope for European institutional investors to purchase CLO securities and, at a practical level, has meant the majority of transactions are either (a) not marketed in Europe, or

(b) constitute balance sheet CLOs in relation to which the originator retains the necessary five percent exposure. However, where economic fundamentals permit, there remain some alternative structuring options for new arbitrage issuance involving "originator SPVs" or an independent "equity retention holder." Collateral managers that have the capacity and willingness to deploy their own[6] balance sheet to meet the five percent retention requirement will also enjoy a competitive advantage. U.S. CLOs generally are not Article 122a compliant and include a risk factor to that effect. Moreover, Article 122a has posed a particular problem for European banks active in the U.S. CLO market, as their U.S. branches and subsidiaries often fall under its restrictions, which may prevent them from investing in CLO securities and providing other services (e.g., hedging) previously provided in connection with their arrangement of CLOs.

7. THE VOLCKER RULE

The proposed rules for implementing Section 619 of Dodd-Frank, popularly known as the "Volcker Rule," would prohibit insured depository institutions, bank holding companies, and their subsidiaries or affiliates from engaging in many proprietary trading activities and from investing in and sponsoring certain private funds and other investment vehicles. While certain technical details remain to be clarified, several features of the proposed rules suggest that the final rules will not impede the issuance of basic CLOs. Highly controversial, the proposed rules continue to be the subject of intense debate in Congress and in financial markets worldwide. Although regulators extended the rule comment period to February 13, 2012, the Volcker Rule becomes effective by statute on July 21, 2012. Notwithstanding the looming deadline, Federal Reserve Chairman Ben Bernanke has said the rule will not be enforced as of its effective date, relying on the two-year period under the Volcker Rule that runs from July 21 to bring banks' activities and investments into line with the rule. The Federal Reserve also has discretion to allow individual banks up to three one-year extensions of that period.

8. "AMEND-TO-EXTENDS"

As issuers of debt obligations included in CLO portfolios proceed to extend the maturity dates of such obligations through a variety of mechanisms and techniques, collateral managers are learning to live with increased pressure on weighted average life tests and to navigate complex indenture requirements to accommodate the extensions. Collateral managers are increasingly consulting their legal and tax advisors in the context of fact specific scenarios to ascertain their rights and obligations in the context of these transactions, including whether compliance with standard "purchase" requirements, such as meeting portfolio profile test requirements, is necessary, or not. These kinds of amendments may raise tax concerns if they are undertaken in a factual context that could be construed as, in substance, an origination of new loans.

9. "LOAN WORK-OUTS"

Restructuring the terms of a loan held in a CLO's portfolio can cause the CLO to acquire exchange assets that could cause the CLO to be engaging in a U.S. trade or business, which could have an adverse impact on the tax status of the CLO. Problematic assets include interests in a company that owns real property or interests in a limited liability company or other "pass through entity" that is a U.S. operating company. Careful analysis of existing transaction documentation and evolving rating agency guidance is required for the creation of "blocker" subsidiaries to address these problems.

10. NEW DISCLOSURE REQUIREMENTS

Rule 17g-5 under the Securities Exchange Act requires, among other things, that a credit rating agency registered with the SEC and being paid by a related CLO arranger to rate a CLO manage conflicts by maintaining a password-protected Web site for the CLO. The rating agency must provide free, unlimited access to the Web site to other registered rating agencies, identifying the information currently used to determine or monitor the credit ratings, to allow such other agencies to rate and monitor the CLO on an

unsolicited basis. In practice, a negotiation ensues among the issuer, the collateral manager, the placement agent, the trustee, and the accountants to allocate responsibility for posting information to the Web site, both pre-closing and post-closing, and to appropriately assign risk among such parties. CLO arrangers also should consider disclosure around unsolicited ratings.

NOTES

[1] Advisers Act Rule 206(4)-7.

[2] These rules implement Section 15G of the Securities Exchange Act of 1934, which was added by Dodd-Frank Section 941(b).

[3] *Id*., footnote 42.

[4] EU Directive 2009/138/EC (Solvency II), Article 135.

[5] EU Directive 2011/61/EU on Alternative Investment Fund Managers, Article 17.

[6] As distinct from the assets of their managed funds.