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CLO Group Client Alert:
Final Risk Retention Rules – Implications for U.S. & European Collateralized Loan Obligations

I. BACKGROUND

On October 21 and 22, 2014, the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Department of Housing and Urban Development, Federal Housing Finance Agency, Office of the Comptroller of the Currency, and Securities and Exchange Commission (collectively, the "**Agencies**") approved final rules (the "**Final Rules**") for implementing the requirements of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Final Rules take into consideration comments received on the rules proposed in August 2013 (the "**Modified Proposals**") and those originally proposed in April 2011. The Agencies adopted the Final Rules pertinent to collateralized loan obligations ("**CLOs**") with few changes from the Modified Proposals, except for, most importantly, the elimination of the proposed "cash trap" on distributions to the sponsor holding the eligible horizontal residual interest retention option and the elimination of a fair value measurement for retention that is held in the form of an eligible vertical interest. The Agencies rejected industry comments and proposals that would exempt certain types of CLOs or offer greater flexibility for the CLO industry (*e.g.*, a proposed reduced retention amount for "Qualified CLOs" or a third-party retention option).

II. WHAT IS THE REQUIRED RISK RETENTION?

The Final Rules require the "sponsor" of the CLO to retain, and to refrain from transferring, selling, conveying to a third party, or hedging, an economic interest in the credit risk of the securitized assets in an amount equal to at least five percent of the CLO securities issued in the transaction (the "**Required Retention Interest**").

III. HOW IS THE REQUIRED RETENTION INTEREST MEASURED?

The sponsor must determine its method of compliance as of the closing of the CLO, when it has the option of retaining an eligible vertical interest ("**EVI**"), an eligible horizontal residual interest ("**EHRI**"), or any combination of the two (an "**L-shaped interest**").[1] An

EVI for this purpose is five percent of the face value (*i.e.*, par value) of each class of CLO securities issued in the transaction, or a vertical security representing the cash flows paid on each such class. An EHRI is a first loss interest (*i.e.*, in the most subordinated class or classes of securities of the CLO) equal to no less than five percent of the fair value of all securities issued by the CLO, determined using a fair value methodology acceptable under GAAP.[2] In the case of an L-shaped interest, the percentage of the fair value of the EHRI and the percentage of the face value of the EVI (by class) must equal at least five percent.[3] Alternatively, the sponsor may establish and fund, in cash at closing, an "eligible horizontal cash reserve account" in an amount equal to the same dollar amount as would be required if the sponsor held an EHRI.[4]

IV. WHO MUST OR CAN RETAIN THE REQUIRED RETENTION INTEREST?

In defining the universe of potential retention providers, the Agencies focused on the party that actively makes decisions on asset selection and on loan underwriters. Their stated goals were to "help ensure the quality of the assets purchased by the CLOs, promote discipline in the underwriting standards for such loans, and reduce the risk that such loans pose to financial stability."[5] The options are as follows:

A. CLO MANAGER AS "SPONSOR"

The Final Rules generally provide that the CLO manager, as the "sponsor" of the CLO, or a majority-owned affiliate of the CLO manager, must retain the Required Retention Interest.[6] If there is more than one CLO manager in a transaction, each is required to ensure that at least one of them (or one of their majority-owned affiliates) retains the Required Retention Interest.[7]

B. "MAJORITY-OWNED AFFILIATE" OF A CLO MANAGER

A "majority-owned affiliate" of a CLO manager is "an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with," the CLO manager. Majority control means "ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined by GAAP."[8] The Agencies' explanation for permitting the majority-owned affiliate option is that it "ensures that any loss suffered by the holder of risk retention will be suffered by either the sponsor or an entity in which the sponsor has a substantial economic interest."[9]

Although the Agencies rejected an express "third party" class of potential retention providers, the option of a majority-owned affiliate of the CLO manager to hold the Required Retention Interest may provide meaningful flexibility for CLO managers that can source capital from other internal and external parties. For example, CLO managers with affiliates that have access to third-party, longer-term capital, whether through partnership arrangements, access to public or private equity or debt markets, by virtue of industry focus (*e.g.*, insurance), or otherwise will be in a better position to access the financial resources to source the risk retention capital required to stay in the market.

A key factor in determining compliance using a majority-owned affiliate may hinge on the meaning of "controlling financial interest", which must be determined in accordance with GAAP.[10] Accordingly, CLO managers will need to rely on the determinations of their independent public accountants in this analysis.

C. ORIGINATOR RETENTION

A CLO manager may offset part or all of its risk retention obligation by the portion of the Required Retention Interest assumed by one or more of the originators of the securitized assets so long as the originator originates at least 20 percent of the assets sold to the CLO issuer. An originator must acquire an amount of the Required Retention Interest commensurate with and not to exceed the percentage, by unpaid principal amount, of the securitized assets it originated. An originator is defined as a person that "(1) [t]hrough an extension of credit or otherwise, *creates* an asset that collateralizes an asset-backed security; and (2) [s]ells the asset directly or indirectly to a securitizer or issuing entity." As noted, this option is designed to work in tandem with the sponsor risk retention option (although, in the case of a transaction where a single originator provides 100 percent of the securitized assets, such originator could hold the entire Required Retention Interest).[11] The originator is required to retain its interest in the same manner and proportion (*i.e.*, EHRI, EVI or L-shaped interest) as the sponsor.

Given the fairly narrow definition of "originator" (at least as compared to the corollary definition in the EU risk retention rules, as described in X below), this option likely is not viable for most broadly syndicated CLOs (the lion's share of the CLO market), but may work for some balance sheet, middle market CLOs that are used by certain diversified asset managers as a means of financing new loan origination. A key component of this analysis will be how broadly the term "creates" in the definition of "originator" is interpreted (*i.e.*, whether it encompasses any initial lender under a loan facility or is limited to one of the arranging lenders under the loan facility).

D. LEAD ARRANGER AS RETENTION PROVIDER IN "OPEN MARKET CLOS"

Pursuant to this alternative to sponsor retention, the CLO manager must select only "CLO-eligible loan tranches" in which the lead arranger agrees to hold (and not hedge or sell) five percent of each such loan tranche until repayment, maturity, involuntary and unscheduled acceleration, payment default or bankruptcy default.[12] Among other requirements, the lead arranger of a CLO-eligible loan tranche must have taken the largest allocation, and an initial allocation of at least 20 percent, of the aggregate principal balance at origination.[13] Because the requirements for this option are discordant with current leveraged loan market practice, market participants do not anticipate it will be used anytime soon. Even if a dramatic decrease in CLO issuance were to trigger a change in current market practices of leveraged loan arrangers, it would presumably take several years for a sufficient amount of CLO-eligible loan tranches to be available to support robust trading by CLOs in such loans.

E. NO OTHER "THIRD PARTIES"

Although the Agencies rejected an express "third party" class of retention providers for CLOs, the majority-owned affiliate option may nonetheless provide meaningful flexibility for CLO managers to source debt and equity financing from others.

V. HOW LONG MUST THE REQUIRED RETENTION INTEREST BE HELD?

The Final Rules prohibit CLO sponsors from directly or indirectly hedging or otherwise transferring the Required Retention Interest until the *latest* of (1) the date the total unpaid principal balance of the securitized assets that collateralize the securitization is reduced to 33 percent of the original unpaid principal balance, (2) the date the total unpaid principal obligations under the CLO securities issued is reduced to 33 percent of the original unpaid principal obligations, and (3) two years after the closing date of the securitization transaction.[14] Therefore, assuming a typical reinvestment period of four years, the sunset date for the prohibition on transfer and hedging for CLOs is significantly longer than two years, and in no event shorter than the reinvestment period.

VI. CAN THE CLO MANAGER OR ITS MAJORITY-OWNED AFFILIATE OBTAIN DEBT FINANCING FOR ITS REQUIRED RETENTION INTEREST?

The Required Retention Interest can be financed and pledged as collateral so long as the financing is full recourse to the CLO manager or, if applicable, the retaining majority-owned affiliate. The Final Rules unfortunately do not address the effect of a foreclosure on such a pledge. Therefore, absent additional guidance in this area from the Agencies, uncertainty may temper the market's willingness to provide, and the CLO manager's desire to accept, such financing.

VII. WHEN DO THE FINAL RULES TAKE EFFECT?

The Final Rules will become effective for CLOs two years after the date of publication in the Federal Register, which is expected to happen by the end of this year. Although the Final Rules will not apply to CLOs that close before the effective date, they are already a force at work in the current market as investors begin to evaluate not only CLO managers' future prospects to satisfy the retention requirements once they become effective, but also the availability of future repricings, refinancings and other additional issuances of securities for CLOs being formed prior to the effective date.

VIII. DISCLOSURE REQUIREMENTS

The CLO manager must disclose key information about the methodologies and assumptions used to calculate the amount of its EHRI in accordance with fair value standards. Prior to closing, this means a range of fair values for the EHRI. A reasonable time after closing, it means the actual fair value measurement of the CLO securities and the EHRI that the sponsor is required to retain, expressed as a dollar amount and a percentage.

IX. CAN THE CLO MANAGER FALL OUT OF COMPLIANCE POST-CLOSING?

A classic violation of the retention requirement would be a prohibited transfer or hedging of the Required Retention Interest, or a majority-owned affiliate retention provider ceasing to satisfy the definition of majority-owned affiliate. There are other circumstances that arguably also could cause a CLO manager to violate its retention obligations. The Final Rules leave some important questions unanswered on this issue, including:

- If a CLO manager resigns, assigns its management rights and duties under the collateral management agreement, undergoes a change of control, or is removed for "cause", can or must the incoming CLO manager acquire the Required Retention Interest to maintain compliance with the Final Rules?

- If additional securities are issued by the CLO, whether in connection with a repricing, a refinancing or otherwise, must the CLO manager recalculate and potentially increase its Required Retention Interest based on the new aggregate principal amount of the CLO securities? Or, would the additional issuance not constitute a "securitization transaction" unless the CLO manager simultaneously causes the CLO to acquire additional assets?

- If the CLO manager (or its majority-owned affiliate) financed the Required Retention Interest and the lender(s) foreclosed on the pledged Required Retention Interest during the period in which the sponsor is required to retain such interest, would such foreclosure be deemed to result in a prohibited transfer by the CLO manager of its retention position?

X. U.S. VS. EU RISK RETENTION

CLO managers that seek to design (or redesign) their management platforms to appeal to the broadest possible base of investors will need to take into account the Final Rules as well as the European risk retention rules (the "**EU Rules**"). As the chart below illustrates, there are some points of intersection for market participants to explore. A CLO management platform that is not constructed to maximize efficiency in this regard could require retention by more than one CLO participant and in an aggregate of more than five percent of the value of the CLO securities in order to satisfy both regimes.

As discussed above, for U.S. CLO transactions, the retention requirement must be satisfied by the CLO manager (or a majority-owned affiliate), by lead arrangers through the lead arranger/CLO-eligible loan tranche option or by an originator. Under the European Union Capital Requirements Regulation (the "**CRR**"), only those entities that satisfy the strict technical definitions of "original lender", "originator" or "sponsor" will be eligible to act as retention holder in a securitization.[15]

Potential Retention Providers	Eligible in U.S.?	Eligible in Europe?
CLO manager as sponsor	Yes	Only some European Union-regulated CLO managers that satisfy the definition of "sponsor"
Affiliate of CLO manager	Only "majority-owned affiliates"	No, unless the definition of "originator" is also satisfied
original lender / originator	Yes, if under the lead arranger or originator options	Yes, if the definition of "original lender" or "originator" is satisfied

In order to comply with both regimes (assuming that the lead arranger and originator options under the Final Rules and the original lender option under the EU Rules are not viable for broadly syndicated CLOs), the retention provider could be (1) a sponsor under both the Final Rules and the EU Rules, (2) a majority-owned affiliate of the CLO manager under the Final Rules and a sponsor under the EU Rules, (3) a sponsor under the Final Rules and an originator under the EU Rules, or (4) a majority-owned affiliate of the CLO manager under the Final Rules and an originator under the EU Rules.

With respect to the first and second options above, to overcome the difficulty that the CRR requires a sponsor to be regulated under the EU Rules, a U.S. CLO manager/sponsor could have a majority-owned affiliate that is an EU-regulated co-manager and that could serve as retention provider under both the Final Rules and the EU Rules. The third and fourth options above may offer the route to dual compliance that is of most interest to U.S.-based CLO managers, as an "originator" under the EU Rules may include a secondary market purchaser/transferor of the securitized assets. We note that while the U.S. sponsor (or majority-owned affiliate) / EU originator model is workable within the current EU Rules, further guidance and/or a consultation from the European Banking Authority is expected by the end of this year and could alter market practice in this area.

In addition, differences in how the five percent retention interest is measured for EHRI compliance between the Final Rules and the EU Rules may complicate transactions seeking compliance with both regimes. Under the Final Rules, compliance is based on the fair value of the CLO securities issued in the case of EHRIs (compared to the nominal value of the securitized exposures under the EU Rules) and on the face value of the CLO securities issued in the case of EVIs (which is the same under the EU Rules). Furthermore, with respect to the EU Rules, the aggregate nominal value of the securitized exposures may increase over time where the CLO manager successfully builds par, which has resulted in retention providers either (1) holding more than the required five percent at closing in order to account for a potential future increase in the required retention amount, (2) introducing fail-safes to pay down investment gains or prevent reinvestment to avoid the nominal value of the securitized exposures increasing to a level that would cause a

retention deficiency, or (3) permitting the retention provider to purchase additional securities to cure a retention deficiency. It remains to be seen how the U.S. fair value measurements for EHRI will compare to the EU Rules on a dollar-for-dollar basis.

The Final Rules and the EU Rules also differ in that the burden of compliance is imposed on, for the Final Rules, a CLO manager as sponsor of the securitization, and for the EU Rules, the CLO's investors. (See XII below.)

XI. JURISDICTIONAL SCOPE

The Final Rules provide a safe harbor for certain foreign-related transactions, although the following conditions (particularly item (2) below) render it of limited utility given current practice in the European CLO market: (1) such transaction is not required to be and is not registered under the Securities Act of 1933, (2) no more than ten percent of the dollar value (or equivalent in the currency of the CLO securities) of all classes of CLO securities in the transaction are sold or transferred to U.S. persons or for the account or benefit of U.S. person, (3) neither the sponsor nor the issuing entity is organized or incorporated in the United States, and (4) no more than 25 percent of the CLO's portfolio is acquired by the sponsor or issuing entity, directly or indirectly, from a majority-owned affiliate of the sponsor or issuing entity located in the United States.[16] The safe harbor for foreign-related transactions includes a special anti-evasion provision which excludes transactions that are "part of a plan or scheme to evade the requirements of Section 15G and the Final Rules."[17]

XII. CONSEQUENCES OF NON-COMPLIANCE

Failure on the part of a CLO manager to comply with the Final Rules would constitute a violation of the Securities Exchange Act of 1934 and could give rise to civil enforcement actions, including monetary penalties, revocation of licenses and/or injunctive orders. In the case of egregious violations, the U.S. Department of Justice may bring criminal actions against a violating sponsor. Furthermore, isolating the sponsor within the CLO manager's corporate structure would not prevent potential enforcement against "control persons" who may face joint and several liability for sanctions and penalties.

[1] § _.4(a).
[2] § _.4(a)(2).
[3] § _.4(a)(3).
[4] § _.4(b).
[5] Final Rules at 231.
[6] The conclusion that the CLO manager is the appropriate party in a CLO to retain the risk is viewed by many as controversial, and was vigorously disputed by industry groups. A "sponsor" is defined as a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. § _.2. The Agencies reasoned that the CLO manager "indirectly transfers" assets to the CLO because the CLO manager selects the assets and directs the CLO issuer to buy them. Final Rules at 214. Moreover, the Agencies have explained that "an entity that serves only as a pass-through conduit for assets that are transferred into a securitization vehicle, or that only purchases assets at the direction of an independent asset or investment manager, only pre-approves the purchase of assets before selection, or only approves the purchase of assets after such purchase has been made would not qualify as a 'sponsor'." Final Rules at 33-34.
[7] § _.3(b).
[8] § _.2.
[9] Final Rules at 20.
[10] § _.2.
[11] Final Rules at 257.
[12] § _.9.
[13] § _.9(a) and (c).
[14] § _.12(a) and (f).
[15] Under the CRR, "originator" means "an entity which: (a) itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or (b) purchases a third party's exposures for its own account and then securitises them" (CRR, Article 4(1)(13)); and "sponsor" means "an institution other than an originator institution that establishes and manages ... [a] securitisation scheme that purchases exposures from third party entities" (CRR, Article 4(1)(14)). The definition of "original lender" appears to constitute a slightly narrowed sub-set of paragraph (a) of the "originator" definition set out in Article 4(1)(13) of the CRR. The EU Rules provide for a much broader "originator" definition than the Final Rules, encompassing not just entities that create the asset that is to be securitized, but also secondary market purchasers of an asset that is to be securitized.
[16] § _.20(b).
[17] § _.20(c).

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