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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

CLO Market Forges Path To Risk-Retention Compliance

By **Deborah Festa**

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"To improve is to change; to be perfect is to change often."

—Winston Churchill


Deborah Festa

Were this statement true of the market for collateralized loan obligation transactions (CLOs), the asset class would have achieved perfection long ago. Sponsors and structurers of CLOs have adapted continually to regulatory change over the past decade. The myriad changes have ranged from structuring CLOs to exclude bonds and other securities from their collateral pools to meet the requirements of the loan securitization exemption under the Volcker Rule to developing compliance strategies for the ever-evolving EU risk-retention rules. When the U.S. risk-retention rules became effective for CLOs last December, market participants began a new period of adjustment as they explored compliance strategies and debated related risk allocation issues. With the first few months of work behind us in this regard, approaches to compliance with the U.S. rules are beginning to become more standardized and best practices are beginning to emerge.

The Basics of the Rule

As the often exclusive "sponsor" of a CLO as that term is defined in the rules,[1] a CLO manager is required 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 5 percent of the CLO securities issued in the transaction. In practice, a CLO manager typically either opts to retain "vertically" by acquiring 5 percent of the face value (i.e., par value) of each class of notes issued by the CLO issuer or "horizontally" by acquiring an amount of the most subordinated notes issued by the CLO issuer having a fair value of not less than 5 percent of the fair value of all securities issued by the CLO, determined using a fair value methodology acceptable under generally accepted accounting principles.

The rules permit the "majority-owned affiliate" of a CLO manager to hold its retention position. To qualify, the affiliate must be "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."[2]

The retained amount must be held 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.

Disclosure Challenges and Evolving Solutions

The rules contain certain disclosure requirements, which are much more extensive where a CLO manager relies on the horizontal retention method of compliance as opposed to the vertical option. In general, the CLO manager must provide the disclosure to potential investors or cause it to be provided to them "a reasonable period of time prior to the sale"[3] of the CLO notes. Where a horizontal interest is retained, the disclosure must include a statement of the fair value of the retained interest, expressed both as a percentage of the fair value of all of the CLO notes issued in the securitization transaction and as a dollar amount. It is acceptable for the CLO manager to initially provide a range of fair values. The disclosure also must describe the valuation methodology used to calculate the fair values or range of fair values of all classes of CLO notes being issued, including the horizontal retention interest, along with a list of key inputs and assumptions used in measuring the fair values. A "reasonable time after the closing"[4] of the CLO, the CLO manager must provide to investors the final fair value of the horizontal interest that the CLO manager or its majority-owned affiliate retained as of closing, based on actual sale prices and finalized tranche sizes, and the fair value of the subordinated notes that the sponsor is required to retain under the rules. To the extent the valuation methodology or key inputs or assumptions used to calculate the original pre-pricing estimated values have changed in a material way, the post-closing disclosure must describe those differences.

In practice, many CLO managers to date have provided the initial fair values as a range of estimates approximately two business days prior to the pricing of the CLO notes. Delivering the disclosure in advance of the pricing date — which these days tends to occur about a month in advance of the closing date in a new issue transaction — ensures that investors have access to the disclosure before they commit on the pricing date to purchase notes on the closing date. In most transactions, this initial disclosure is included in the CLO issuer's final pre-pricing preliminary offering circular delivered to all potential investors. In many cases, the final post-closing disclosure is provided to investors via the trustee's website within a few weeks of closing.

Given the specific and elaborate disclosure requirements under the rules, many CLO managers relying on the horizontal retention method of compliance have found it useful to retain a third-party valuation agent to assist in calculating the initial fair-value ranges and the final fair values.

The Refinancing Context

There is no exemption available under the U.S. risk-retention rules for CLOs that closed prior to the date the rules became effective that are later refinanced. For example, if the holders of the requisite percentage (typically a majority) of subordinated notes issued by a CLO that closed in 2013 direct a redemption by refinancing today of all of the rated notes originally issued by the CLO, the retention requirement applies to the refinancing transaction.

One of many areas in which the rules are not directly explicit about how to comply involves the refinancing context, however. By way of illustration, the rules do not explicitly state how much of which specific classes need to be retained where fewer than all classes are refinanced. That said, the prevailing interpretation of the rules among market participants has been that the CLO manager or its majority-owned affiliate need only retain 5 percent of all classes of notes being reissued at the time of the refinancing. Therefore, in a case where only the notes rated AAA and AA are refinanced, unrefinanced notes ranking below those classes need not be retained to comply with the rules.

The question has also arisen whether any new notes need to be retained in the refinancing context where the CLO manager or its majority-owned affiliate holds an amount of subordinated notes acquired at the original closing of the CLO that has a fair value of at least 5 percent of the fair value of all of the CLO notes outstanding as of the date of the refinancing. The prevailing interpretation of the rules is that the CLO manager would not need to retain any of the newly refinanced notes in such a scenario, provided, however, that the pre-pricing and post-closing valuation and disclosure requirements mentioned above still apply.

Finally, certain legacy CLO refinancing transactions may also qualify for relief from compliance with the rules if their terms and disclosure are consistent with those described in a no-action letter issued by the staff of the Division of Corporation Finance of the U.S. Securities and Exchange Commission to Crescent Capital Group LP on July 17, 2015. In that letter, the SEC staff confirmed it would take no action against Crescent Capital, as the manager of a CLO that priced before the final risk-retention rules were published on Dec. 24, 2014, if it were to not comply with the risk-retention rules in the context of the refinancing of certain notes previously issued by the CLO.

The conditions upon which relief was granted are quite limiting, however. CLO managers intending to structure their refinancings in a manner consistent with Crescent must be aware that no changes other than those required to reduce the interest rate on the previously issued notes can be made, which, for example, precludes extension of the maturity date of the original notes, as has become popular in recent “reset” transactions.

The relief granted in Crescent was also predicated upon the condition that the supplemental indenture used for the refinancing would prohibit any refinanced classes from ever being the subject of a future refinancing. This requirement has caused some CLO managers significant consternation, as it could be interpreted to prevent even risk-retention-compliant future refinancings of the same notes. As a result of these restrictions and the inherent limitations of SEC staff no-action relief when compared to binding legal precedent or a statutory exemption, although we may in the future see additional CLO refinancings structured to meet the Crescent parameters, such transactions will not likely be the norm.

Deborah Festa is a partner in the Los Angeles and New York offices of Milbank Tweed Hadley & McCloy LLP.

[1] 17 CFR 246.2. See also 76 FR 24098 at footnote 42.

[2] 17 CFR 246.2.

[3] 17 CFR 246.4(c)(1)(i).

[4] 17 CFR 246.4(c)(1)(ii).