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Collateralized Loan Obligations

CLO 2.0: How Can Hedge Fund Managers Navigate the Practical and Legal Challenges of Establishing and Managing Collateralized Loan Obligations? (Part One of Two)

By Greg B. Cioffi, Jeff Berman and David Sagalyn, *Seward & Kissel LLP*

While its much-maligned counterparts, collateralized debt obligations (CDOs) and structured investment vehicles (SIVs), have languished, the cash-flow collateralized loan obligation (CLO) has emerged from the financial crisis relatively unscathed. The issuance of post-crisis CLO paper has experienced a sustained resurgence, surpassing $53 billion in 2012 and catapulting past $27 billion – encompassing 53 transactions managed by 48 separate collateral managers – in the first quarter of 2013 alone.

For many fund managers, managing a CLO may present a very attractive opportunity. Unlike the standard hedge fund platform, a CLO can generate lucrative and stable management fees with minimal redemption risk during the non-call period while remaining largely insulated from market value declines.

Although the characteristics of the post-crisis "CLO 2.0" hardly represent a sea-change from the pre-crisis version, there have been a number of important structural developments, including a movement toward higher levels of subordination, tighter collateral quality tests and shortened non-call and reinvestment periods. The CLO 2.0 era has also ushered in changes to the underlying transaction documentation aimed at addressing various lessons learned from the failings of CDOs and other structured products during the market meltdown. Despite the recent fanfare, there remain several practical and legal obstacles that a CLO manager can expect to encounter in the current market environment. This article is the first in a two-part series discussing the practical challenges of establishing a CLO in the current market environment, and how CLO managers can address the challenges.

Specifically, this article addresses a number of common documentation requests by anchor investors in the most senior and subordinated (or equity) classes of the CLO capital structure and explores certain inherent difficulties in obtaining warehouse financing in connection with the ramp up of the CLO portfolio prior to the initial issuance of CLO notes. The second installment in this series will present a brief overview of various legal developments that have or may alter the CLO management landscape, including (1) risk retention rules, the Volcker Rule and various Commodity Futures Trading Commission requirements under the Dodd-Frank Act, (2) enhanced registration requirements under the Investment Advisers Act of 1940, (3) the implementation of the Foreign Account Tax Compliance Act provisions of the Internal Revenue Code, and (4) Sections 409A and 457A of the Internal Revenue Code. See also "Key Legal and Business Considerations for Hedge Fund Managers When Purchasing Collateralized Loan Obligation Management Contracts," The Hedge Fund Law Report, Vol. 3, No. 13 (Apr. 2, 2010).

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Start from the Bottom – CLO Equity

The placement of the most subordinated class of CLO notes – commonly known as equity – is fundamental to getting a CLO 2.0 transaction off the ground. It has become commonplace for CLO placement agents to require the manager and its affiliates to commit to the purchase of anywhere between five percent and ten percent of the original issuance amount of equity prior to the formal transaction marketing phase. For a CLO with an aggregate note issuance amount of $500 million, this could entail a commitment to purchase approximately $5 million of equity. Moreover, a commitment from an anchor investor to purchase a substantial block of equity will sometimes come with significant strings attached, such as an agreement by the manager and its related entities to retain their equity holdings for a specified period of time.

Other notable anchor equity investor "asks" may include:

- a commitment by the manager to share a portion of its senior or subordinated management fees with such equity investor or waive such fees altogether;
- enhanced voting and consent rights;
- access to manager communications with non-equity investors;
- an agreement by the management team to make itself available for periodic equity investor meetings;
- stringent "key man" provisions;
- the right to direct redemptions by refinancing;
- limitations on manager expenses that may be borne by CLO cash flows;
- removal of, or consent rights with respect to, the interest diversion test, which affords the manager flexibility to redirect interest proceeds from the payment of equity to the purchase of additional collateral or the retirement of senior notes in order to increase the CLO's overcollateralization; and
- looser criteria for the removal of the manager for "cause."

The View from the Top – The Controlling Class

While the volume of asset managers, regional banks, insurance companies and other financial institutions vying for the purchase of controlling blocks of the AAA-rated notes representing the most senior tranche in the CLO capital structure – the CLO's "controlling class" – has steadily increased, controlling class investors continue to wield a considerable amount of negotiating power. And they are putting their leverage to work, requesting – and often receiving – rights and protections well beyond the customary controlling class privileges of older vintage CLOs, often to the detriment of the manager's trading flexibility.

It would appear that run-of-the-mill CLO consent rights, such as the right to terminate the manager for "cause" and to direct remedies, are no longer enough for controlling class investors. Armed with the lessons learned from the financial crisis, these investors have become increasingly focused on tightening the parameters governing the manager's day-to-day trading activity, particularly following the expiration of the CLO reinvestment period or the occurrence of a CLO event of default.

Transaction features that anchor controlling class investors may request include the following:

- a prohibition on the acquisition of assets maturing after the stated maturity of the CLO;
- strict constraints on a manager's ability to extend the portfolio's weighted average life, both in the context

of asset trading and the manager's ability to agree to amend-and-extend asset refinancings;

- restrictions on, or the strict prohibition of, the right of mezzanine and equity investors to voluntarily surrender their notes for cancellation prior to maturity;
- tighter restrictions on the types of principal proceeds that can be utilized for reinvestment following the reinvestment period;
- tighter reinvestment criteria following the reinvestment period;
- enhanced voting rights with respect to amendments to the underlying CLO documents;
- enhanced rights to direct portfolio liquidation following an event of default (and a reduction in the corresponding voting threshold);
- the right to approve sales of non-distressed assets following an event of default; and
- in the case of controlling class investors who also have a CLO management platform, a right to step in as manager following the occurrence of certain "cause" events.

Manager Negotiation Power

The growing laundry list of daunting investor demands, many of which would seem to limit a manager's ability to maximize returns, might leave a fund manager wondering: is CLO management worth it? For a number of managers, the answer would seem to be a resounding yes. It should come as no surprise that investor requests are heavily negotiated, with numerous possible permutations tailored to specific investor needs and the manager's asset management philosophy. A manager's leverage to resist these demands is often dictated by transaction timing: a period of comparatively lower investor demand means tighter deal terms. Another, less obvious, factor relates to the timeframe between the receipt of draft transaction documents by investors and transaction pricing. The earlier in the transaction marketing phase that investors receive documents, the more time a manager and its counsel have to evaluate and negotiate investor requests. Time crunches can often lead to a manager being force-fed onerous – and sometimes off-market – terms.

Transaction timing aside, the ability of a manager to reject or pare down investor "asks" most frequently turns on the manager's size, track record and CLO management reputation. Obviously, this puts both first-time managers and seasoned managers with no CLO 2.0 experience at a significant bargaining disadvantage. Nevertheless, managers often determine that the various constraints imposed by potential investors are a necessary cost of gaining a foothold in the CLO 2.0 management business.

Warehousing vs. Print and Sprint

Prior to the financial crisis, the assets that would ultimately comprise the initial CLO portfolio were generally purchased prior to transaction pricing through the utilization of a warehouse loan facility. In a pre-crisis environment where new issue loans were selling at par or near par, and then trading well above par in the secondary market, CLO warehousing was viewed by managers as a necessary evil. These warehouse facilities generally took the form of a loan or master participation agreement funded by the CLO arranger or one of its affiliates, with subordinated funding provided (and the corresponding first loss risk assumed) by the presumptive CLO manager or its funds under management – i.e., the "First Loss Provider."

Although these warehouse facilities enabled a manager to carefully ramp up a CLO portfolio over time, they also exposed the First Loss Provider to significant market value

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risk prior to transaction closing. The widespread breach of market value tests brought about by plummeting loan prices during the financial crisis resulted in the mass liquidation of CLO warehouse portfolios and substantial losses for First Loss Providers, and in some cases, senior lenders.

Still smarting from the memory of staggering warehouse losses, a number of CLO 2.0 managers have utilized a different sort of portfolio acquisition strategy: identifying loans in the days leading up to CLO pricing, entering into trade confirmations between pricing and closing, and then settling the trades with CLO issuance proceeds. However, diminished secondary market loan volume, the majority of loans trading on the secondary market at above par and increased borrower demand for lower interest rates have recently made this "print and sprint" approach significantly less appealing.

It would appear that CLO warehouse facilities are once again becoming the norm. While a number of arrangers have proved willing and able to provide at least partial warehouse financing, obtaining loan warehousing can present a significant obstacle for less established managers and those utilizing arrangers without the requisite balance sheet to support warehouse funding. Furthermore, even in situations where a warehouse facility is readily available, many CLO managers have experienced difficulty locating willing First Loss Providers. On the positive side, CLO issuance continues to be robust, indicating that a sufficiently motivated manager can still find a way to get a deal done.

Greg B. Cioffi is co-head of Seward & Kissel LLP's Structured Finance and Asset Securitization Group. Mr. Cioffi has extensive experience with a broad range of asset-backed, market value, cash flow and synthetic transactions. Mr. Cioffi's experience includes representing virtually all types of participants in CLO, CDO and SIV transactions, multi-seller commercial paper conduit transactions, secondary market and distressed debt trading and syndicated secured revolving credit and term loan facilities. Mr. Cioffi has a great deal of experience representing a full range of clients in international and domestic workouts and restructurings involving a broad array of asset-based financing transactions and secured and unsecured lending facilities and regularly advises clients on a wide variety of matters relating to CLOs, CDOs, TruPS and RMBS. Mr. Cioffi has been actively involved in the development of numerous innovative transactions, including the first leverage loan backed SIV, the first issuance of rated notes backed by mutual fund distribution fees, the securitization of motion picture and television broadcast rights and life insurance benefits, and the establishment of mortgage warehouse facilities and derivatives finance facilities.

Jeff Berman is a partner in Seward & Kissel's Structured Finance and Asset Securitization Group. Mr. Berman has extensive experience representing participants in multi-seller commercial paper conduit transactions, distressed debt transactions, CLO and CDO facilities and syndicated secured revolving credit and term loan facilities. He regularly represents funds and financial institutions in subscription loan facilities secured by the unfunded capital commitments of the fund's investors. Mr. Berman also advises clients in workouts and restructurings in asset-based financing transactions and secured lending facilities and advises clients relating to TruPS CDO disputes and RMBS put-backs. Mr. Berman regularly represents dealers, placement agents, underwriters and issuers in a variety of asset-backed, market value and synthetic securitization programs. Mr. Berman also frequently advises investment funds and managers in connection with transactions, financings and general corporate matters.

David Sagalyn is a senior associate in Seward & Kissel LLP's Structured Finance and Asset Securitization Group. Mr. Sagalyn represents a wide array of market participants in the issuance, workout and restructuring of CLO, CDO and other asset-backed transactions. Mr. Sagalyn also frequently advises investment funds and managers in connection with general corporate matters.

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CLO 2.0: How Can Hedge Fund Managers Navigate the Practical and Legal Challenges of Establishing and Managing Collateralized Loan Obligations? (Part Two of Two)

By Greg B. Cioffi, Jeff Berman and David Sagalyn, *Seward & Kissel LLP*

CLO deal volumes in 2012 and the first quarter of 2013 clearly indicate that investor appetite for CLO investments has returned. At the same time, establishing and managing CLOs can present attractive revenue-generating opportunities for fund managers. Nonetheless, these opportunities are accompanied by new challenges for managers, which are outlined in this two-part series of articles.

This second article in the series presents a brief overview of various legal developments that have altered or may alter the CLO management landscape, including (1) risk retention rules, the Volcker Rule and various Commodity Futures Trading Commission (CFTC) requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), (2) enhanced registration requirements under the Investment Advisers Act of 1940 (Advisers Act), (3) the implementation of the Foreign Account Tax Compliance Act (FATCA) provisions of the Internal Revenue Code (Code), and (4) Sections 409A and 457A of the Code. The first installment of the series touched upon several of the practical challenges CLO managers can expect to encounter in establishing a CLO in the current market environment. Specifically, the first article addressed a number of common documentation requests by anchor investors in the most senior and subordinated (or equity) classes of the CLO capital structure and explored certain inherent difficulties in obtaining warehouse financing in connection with the ramp up of the CLO portfolio prior to the initial issuance of CLO notes. See "CLO 2.0: How Can Hedge Fund Managers Navigate the Practical and Legal Challenges of Establishing and Managing Collateralized Loan Obligations (Part One of Two)," The Hedge Fund Law Report, Vol. 6, No. 25 (Jun. 20, 2013).

Regulatory Developments

Changes in the post-crisis legal environment have altered the landscape for a number of CLO managers. A few critical CLO legal developments are described in more detail below.

Risk Retention under the Dodd-Frank Act

The proposed risk retention (or "skin in the game") requirements for asset-backed securities under the Dodd-Frank Act would mandate that CLO managers retain at least five percent of the credit risk of any CLO asset pool. Whether this retained interest will be required to be allocated equally across the capital structure, applied solely to the equity tranche or allocated on some other basis has not yet been determined. Clearly, obligating the manager to retain a five percent vertical slice of the entire CLO capital stack would be a barrier to entry to all but a few CLO managers.

There are signs, however, that the impending rules will not signal a death knell for CLOs. Over the past several months, market participants and organizations such as the Loan Syndications and Trading Association (LSTA) have been advocating against the applicability of the risk retention rules to CLOs and have argued that even if such rules are determined to apply, the five percent skin in the game requirement is both illogical and unduly punitive in the CLO context. In an effort to educate regulators as to the perils of the application of the risk retention rules to CLOs, the LSTA has recently spearheaded a data gathering initiative among CLO managers with the goal of quantifying the rules' potential negative impact on the CLO marketplace. Although there is no guaranty that this initiative will be successful, there is hope among CLO market participants that the final rules will take into account the substantial stake that managers already have in the vehicles' performance by virtue of the priority of payment of their senior, subordinated and incentive management fees in the CLO waterfall.

The Volcker Rule

Section 619 of the Dodd-Frank Act – commonly referred to as the "Volcker Rule" – would prohibit certain banking entities (including insured depository institutions, bank holding companies and their respective affiliates and subsidiaries) from engaging in proprietary trading or acquiring or retaining ownership interests in, sponsoring or having certain relationships with a hedge fund, private equity fund and other investment vehicles. See "Proposed Volcker Rule and the Effect on Private Fund Sponsors and Investors," The Hedge Fund Law Report, Vol. 4, No. 38 (Oct. 27, 2011). While the Volcker Rule and the implementing rules contain an exemption applicable to the securitization of loans, there is a concern that the rule as currently drafted might nevertheless prevent certain CLOs from performing various essential obligations, including holding cash, short-term liquidity instruments and other debt or equity securities. In addition, traditional CLO warehousing arrangements may not be permissible under the Volcker Rule. In response to these ambiguities, the LSTA has submitted a comment letter urging that, among other things, the rule be clarified to reflect what would seem to be a clear legislative intent to exempt CLOs entirely.

A recent regulatory release indicated that the compliance date for the Volcker Rule will be July 21, 2014. However, the Federal Reserve has the ability to extend the compliance period. While there is no assurance that clarifications will ultimately be made to the final Volcker Rule, market participants remain hopeful that the CLO market will not be adversely impacted.

CFTC Regulation

Other recent regulatory developments may increase the cost of CLO managers entering into hedge agreements on behalf of the CLO, and may in some circumstances prevent the practice entirely. The CFTC has promulgated various requirements under the Dodd-Frank Act that may affect the terms, pricing and compliance costs associated with hedge agreements. Among other things, these recently-adopted rules include "swaps" along with "commodities" as contracts which, if traded by an entity, may cause that entity to be a "commodity pool" under the Commodity Exchange Act. Generally, any person that, on behalf of such entity, engages in or facilitates such trading activity is deemed a "commodity pool operator" (CPO) and a "commodity trading adviser" (CTA). See "Do You Need to Be a Registered Commodity Pool Operator Now and What Does It Mean If You Do? (Part Two of Two)," The Hedge Fund Law Report, Vol. 5, No. 19 (May 10, 2012). Regulation of a CLO as a commodity pool and/or a manager (or another transaction party) as a CPO and CTA could subject the CLO to burdensome, and possibly very costly, registration and reporting requirements. See "CPO Compliance Series: Registration Obligations of Principals

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and Associated Persons (Part Three of Three)," The Hedge Fund Law Report, Vol. 6, No. 6 (Feb. 7, 2013). While it was once commonplace for underlying CLO documents to permit managers to enter into hedge agreements in order to, among other things, hedge against interest rate risk, these recent regulatory developments have led many newly-issued CLOs to prohibit hedge agreements, or to only permit such agreements if certain conditions precedent are satisfied, such as the receipt of investor consent and the availability of (and successful application of the CLO manager or other relevant transaction party for) an exemption from registration as a CPO and CTA. Consequently, there may be circumstances where a CLO manager may be prohibited from entering into a hedge agreement on behalf of a CLO even though it may be prudent to do so.

Registration under the Advisers Act

In the past, many CLO managers could avoid registration as an investment adviser by relying upon the now-repealed "private adviser exemption" found in Section 203(b)(3) of the Advisers Act, which exempted an investment adviser from SEC registration if it had fewer than 15 clients during the preceding 12 months and did not hold itself out as an investment adviser to the public. However, the Dodd-Frank Act repealed this exemption, and the remaining exemptions from registration found in the Advisers Act are narrow and generally not available to CLO managers.

The SEC required existing CLO managers not eligible for an exemption to register as investment advisers with the SEC by March 30, 2012. See "SEC Delays Registration Deadline for Hedge Fund Advisers, and Clarifies the Scope and Limits of Registration Exemptions for Private Fund Advisers, Foreign Private Advisers and Family Offices," The Hedge Fund Law Report, Vol. 4. No. 21 (Jun. 23, 2011). Unregistered asset managers who are considering a CLO platform should take into account the additional disclosure and compliance burdens imposed by SEC registration, including the adoption, implementation and annual review of written policies and procedures to be administered by a chief compliance officer and the filing of Form PF, which requires detailed reporting with respect to assets under management.

FATCA

FATCA may subject CLOs to a 30 percent U.S. withholding tax on income received from certain CLO assets beginning January 1, 2014 and on the proceeds from the sale, maturity or other disposition of certain CLO assets beginning January 1, 2017, unless the CLO timely enters into an agreement with the Internal Revenue Service (IRS) to report certain information with respect to CLO investors or complies with the terms of an Intergovernmental Agreement (IGA) between the United States and the CLO's country of organization. See "What Impact Will FATCA Have on Offshore Hedge Funds and How Should Such Funds Prepare for FATCA Compliance?," The Hedge Fund Law Report, Vol. 6, No. 5 (Feb. 1, 2013). It has therefore become standard for CLO 2.0 documents to require investors to provide the CLO issuer or its agents with any information that may be required in order to prevent the imposition of U.S. withholding tax under FATCA. See "Rothstein Kass Provides Roadmap for FATCA Compliance by Hedge Fund Managers," The Hedge Fund Law Report, Vol. 6, No. 24 (Jun. 13, 2013). In response to FATCA, the government of the Cayman Islands, the jurisdiction of choice for CLO organization, has announced its commitment to enter into a "Model 1" IGA with the United States in order to implement FATCA. The IGA is anticipated to require CLO issuers to comply

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with Cayman Islands legislation giving effect to such IGA in lieu of entering into an agreement with the IRS under FATCA. While the terms of the legislation are uncertain, it is expected that CLO issuers will be required to report investor information to the Cayman Islands Tax Information Authority, which will in turn provide such information to the IRS. Until this process reaches its conclusion, however, uncertainty as to the impact of FATCA on the CLO marketplace will remain. As such, it is important for both new and seasoned CLO managers to stay up to date on the latest FATCA developments.

Code Sections 409A and 457A

In drafting CLO collateral management agreements, managers and their counsel must be aware of the requirements of Section 409A of the Code, enacted in 2004, which may necessitate specific timing as to when managers can electively defer their senior and/or subordinated management fees and when such deferred fees are permitted to be paid. See "How Can Hedge Fund Managers Minimize Tax on Deferred Compensation from Offshore Hedge Funds?," The Hedge Fund Law Report, Vol. 2, No. 40 (Oct. 7, 2009). Failure to abide by the provisions of Section 409A would result in the imposition of a 20 percent penalty tax on any such deferred compensation.

Section 457A of the Code, enacted in 2008, imposes a 20 percent penalty tax on any deferred compensation paid to a U.S. taxpayer by a person who is not subject to U.S. federal income tax. See "The End of Deferral As We Know It: The New Rules Prohibiting the Deferral of Compensation Paid to U.S. Managers By Off-Shore Hedge Funds," The Hedge Fund Law Report, Vol. 1, No. 23 (Oct. 28, 2008).

For purposes of Section 457A, deferred compensation is any compensation for services which is paid more than 12 months after the close of the taxable year in which the services were performed, unless such compensation is subject to a "substantial risk of forfeiture," meaning that such compensation will be forfeited if the service provider is not performing services on the scheduled payment date. In the CLO context, deferred payment of management fees to a U.S. manager could trigger Section 457A because a CLO is not subject to U.S. federal income tax. There are several alternatives which have been adopted by the industry to avoid the application of Section 457A, including:

- electing to treat the CLO as a partnership for U.S. federal income tax purposes (thereby causing the management fees to be treated as allocations of partnership income and therefore not subject to Section 457A);
- permitting the deferral of management fees only if such fees are subject to a "substantial risk of forfeiture"; or
- eliminating the management fee deferral mechanism entirely.

Conclusion

No longer suffering from guilt by association with collateralized debt obligations and structured investment vehicles, CLOs are on the rise, with estimates for 2013 ranging from $50 billion to $70 billion in original issuance. While CLO management poses a host of unique challenges, the reward of a viable CLO 2.0 platform is well worth the undertaking for fund managers willing to navigate the myriad practical and legal issues.

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